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# Current Assets and Liabilities*

By Anson Herrick

The question of the accuracy of much of the present practice relating to the classification of current assets and liabilities has long interested me and it is my purpose in this paper to advocate certain principles which it is believed should affect the question. It is hoped that these principles will be found sufficiently sound to be the bases for more satisfactory definitions of the terms "current assets" and "current liabilities" or else that their presentation will promote thoughtful discussion leading to ultimate solution of the controversial questions which may be developed. If this paper does no more than demonstrate that present practice contains inconsistencies and justifies study and improvement its preparation will have been justified.

This discussion of the subject will avoid matters of valuation and will be directed only to the question of what should be included within or excluded from the current section of the balance-sheet. I believe this question to be of considerable importance because of existing variations of opinion and lack of uniformity of practice resulting from the absence of well founded or generally accepted rules. Such rules as there are have been developed from arbitrary standards generally determined by bank credit officers, whose view naturally is restricted to matters primarily involved with the determination of credit risk. If the only purpose of a balance-sheet were the development of credit-risk data, it would be appropriate to look only to the rules adopted by the banks if such rules, in codified or universally accepted form, could be found. However, balance-sheets usually are not restricted in purpose, and universally accepted bank rules do not exist. On the contrary, there seems to be considerable divergence of opinion among banks as to what does or does not constitute a current asset or a current liability. Accordingly, if well founded rules are desirable, it seems appropriate for the accounting profession to undertake their formulation.

While it does not follow that we necessarily should conform to rules or principles advocated by banks, it is true that the credit

* An address delivered at the annual meeting of the American Institute of Accountants at New Orleans, Oct. 18, 1933.

element in relation to balance-sheet preparation is an important factor and such settled views as bankers may have developed call for great consideration. To determine if sufficient uniformity of view existed among the banking fraternity to indicate accepted principles or settled practices, I prepared a series of questions which I addressed to the credit officers of a number of the larger banks, selecting, where I had the information, those officers who were active in the work of the Robert Morris Associates. I have been gratified both at the uniformly indicated desire to coöperate and at the evident recognition of the importance of the subject. I addressed sixteen questionnaires and received thirteen replies of which one discussed the subject generally so that I only can tabulate the responses with respect to twelve. The locations of the twelve banks from the senior credit officers of which responses were received are as follows:

| | | | | | |
|---|---|---|---|---|---|
| California...... | 2 | Missouri....... | 1 | Oklahoma........ | 1 |
| Washington.... | 2 | Virginia........ | 1 | Massachusetts.... | 1 |
| New York...... | 2 | Minnesota...... | 1 | Illinois........... | 1 |

The following tabulation states briefly the questions propounded and indicates the substance of the replies received:

| Questions | Responses: Yes | No | Notes |
|---|---|---|---|
| 1. Should current assets include: | | | |
| (a) Collectible trade notes and accounts due beyond 12 months | 4 | 8 | 2 affirmative answers include reservations. |
| (b) Collectible non-trade notes and accounts.................. | 5 | 7 | 1 affirmative and 3 negative answers include reservations. |
| (c) All merchandise, work in process and raw materials even if the conversion period is more than 12 months................ | 10 | 1 | 1 failed to answer. 3 answers include reservations. |
| (d) Life insurance cash-surrender value..................... | 3 | 8 | 1 failed to answer. 1 negative answer includes qualification. |
| (e) Prepaid expenses (exclusive of deferred charges)........... | 1 | 11 | 4 negative answers include qualification. |
| (f) Marketable securities purchased for long-term investment.... | 3 | 5 | 4 failed to answer. |
| 2. Is marketability the sole test of current classification of securities... | 7 | 4 | 1 answer states government bonds only security entitled to current classification. |

| Questions | Responses: Yes | No | Notes |
|---|---|---|---|
| 3. Should current liabilities include: | | | |
| (a) All term debt instalments due within 12 months.......... | 12 | | |
| (b) Trade notes payable due beyond 12 months................ | 1 | 11 | |
| (c) Provision for accrued portion of prospective regular dividends not yet declared........... | 3 | 8 | 1 answer not clear |
| (d) Provision for contractual obligations for capital expenditures..................... | 5 | 6 | 1 answer not clear |
| 4. What importance has the current ratio as a credit determining factor | | | 7 state, merely one of several. 4 state, important or most important. 1 states, small importance. |

(The questions recited above are abbreviations of the full questions and connected explanations actually sent out. In nearly all cases, as was to be expected, the answers were not categorical and in some instances it was necessary to deduce, for purposes of the tabulation, what the direct answers would have been. Accordingly, there may be instances in which the deductions are not accurately reflective of the views intended to be indicated.)

The above tabulation presents a variation of views that indicates absence of generally accepted rules or principles. In the case of only four of the twelve questions is there uniformity or approximate uniformity of opinion, and in three of these cases I believe the answers clearly are unsupportable upon logical grounds and in any event, in instances, are inconsistent with other views expressed. Eight replies held that there was no requirement for recognizing as a current liability the accrued portion of prospective regular dividends not yet declared, but every reply held that current liabilities should include all term debt instalments due within twelve months, regardless of circumstances. Theoretically, the requirement of cash withdrawal for prospective preferred or other regular dividends is a contingency until the dividend has been actually declared but, except in these days of depression, the requirement of such withdrawals, for preferred dividends at least, is sufficiently definite to call for recognition. In the case of term debt instalments the uniformity of view that they must be included probably arises from the fact that they are existing liabilities, and any inconsistency with the contrary view that dividends do not require recognition may be denied upon that ground or upon the ground that in the case of dividends the wherewithal to make the payment will arise through future earnings. But that may be true only in part and the same claim usually can be made in the case of term debt instalments. In that case not only the profits but realization through depreciation or depletion may be relied upon as a source of payment. Here is a clear case of inconsistency. To follow the bank rule indicated by the above tabulation, a preferred dividend payable on January 31st for the preceding six months period is not required to be shown as a current liability, if not declared prior to December 31st, even though 5–6ths of its amount is supposed to have been earned and constitutes in effect a lien on the existing current assets. On the other hand, the bank rule requires that a term debt instalment due twelve months after the balance-sheet date must be included as a current liability even though its payment will be provided from funds to be accumulated by the operations of the intervening period. Justifiable reasons for the variation of view do not appear. There is no more reason for including in current liabilities all term debt instalments due within twelve months than there is in requiring that all bond interest payable within a similar period must be shown as a liability in advance of its accrual.

Inconsistency is again exhibited in the answers to questions 1c, 1a and 3b. In the first, it is the practically unanimous view that all merchandise, work in process and raw materials should be included within current assets even though it is clear that realization will not be effected within twelve months. But when the merchandise has been changed into accounts receivable it then is the majority opinion that realization within a year is essential to current classification. In the case of question 3b it was the nearly uniform opinion that liabilities arising out of trading transactions should not be included within current liabilities where circumstances had led to a deferring of the due dates beyond the magic twelve-month period. This view appears to ignore the fact that in instances it might result in including merchandise as a current asset while excluding its cost from current liabilities.

I have not circularized accountants as I did bankers but my frequent discussion with them has evidenced variations of opinion quite comparable to variations between bank credit officers. Certainly there is no uniformity of opinion.

Joining the views revealed by various discussions with bankers and accountants upon this subject with the specific answers in response to my queries and the general views expressed, it seems fair to say that the present conception of current assets and liabilities may be stated as follows:

> Current assets include those which normally will be converted into cash within twelve months or may be quickly converted, and current liabilities include all determined liabilities as at the date of the statement which will require payment within a twelve-month period.

It seems to be the desire of the banks, and I have heard it so stated, that there be shown, on the one hand, all existing liabilities which the enterprise may be called upon to pay within the ensuing year and, on the other, the assets available for such requirement. On the one hand they view the statement from the standpoint of liquidation while on the other they recognize the fact of continuing operation in permitting the use of going concern values. It is not unnatural that the attempt to satisfy these conflicting requirements has resulted in an uncertain and variable practice.

The practice which has developed in these circumstances, frequently but not always, is neither consistent, logical nor fair, often exhibiting an incorrectly favorable current ratio or incorrectly impairing the ratio. It is a practice which may result in incorrect variations between the current ratio and the amount of net current assets at different dates thus indicating an improving or a retrograde situation not in accord with the facts. It excludes liabilities which, in effect, are liens upon existing current assets, such as the accrued portion of prospective preferred or other regular dividends and, occasionally, accrued interest or similar charges. On the other hand, it includes as current liabilities items which will not be paid from existing current assets and constitute no lien against them, such as term debt instalments due to be paid, at least in part, out of the realization upon capital assets through depreciation or depletion during an ensuing period. It includes as current assets marketable securities, on the ground that they are realizable, regardless of whether they may be held as long-term investments for income or as protections against uninsured losses or whether their availability of use for current liability liquidation would exist only in case of emergency not requiring consideration in reference to the ordinary balance-sheet. Prepaid expenses (not deferred charges) are excluded from current assets, notwithstanding that their conversion into cash may be more certain and rapid than will be true of much of the merchandise.

Many may claim that the foregoing is hypocritical and unduly technical. To the extent that this may be true it is justified by the necessity of demonstrating that such rules as may be said to exist are arbitrary, in some instances inconsistent, and in others not productive of logical results. It should not be inferred that the present practices are considered wholly erroneous, for such is not the case. But, inconsistency and opportunity for important variations of opinions and practices do exist. It should be conceded that their elimination is desirable and that an attempt toward that end is justified and important.

In any serious consideration of the question of what should be embraced by the current section of the balance-sheet, it is desirable to consider the subject in its theoretical aspect. If it can be determined from a purely theoretical standpoint what should or should not be embraced, then a sound basis will have been established and the group limits thus determined may be increased or decreased to suit desirable practice or the requirements of particular purposes.

All of the capital invested in any enterprise is divisible into two and often three parts. The first is that capital which is invested in working assets; the second that which is employed in fixed properties, tangible or intangible; and the third, that capital which sometimes is invested for income or other purpose in property not essential to the continuance of the business operations. Working capital represents that portion of the total capital which is invested, or is available for investment, in those assets which comprise a necessary part of the trading or operating cycle of an enterprise, those assets in which an enterprise operates as opposed to those with which it operates. Part of the total capital required for the operations is obtained by the use of credit, either of necessity or as a convenience, and the liabilities so incurred constitute, in effect, a lien against the working assets, and the working capital, as the term is here used, represents only the excess of the total of working assets over the connected or working liabilities.

The usual conception of current assets and current liabilities squares in general with working assets and working liabilities and net current assets are generally considered as the measure of the working capital. However, exceptions sometimes result in important variation between net current assets as determined in practice and true net working capital, and the variation usually is sufficient to impair the significance of the so-called current ratio. Working capital has a definite meaning and a significant relationship to total capital. Its determination, either in theory or practice, leaves small room for variations of opinion. Net current assets as now generally developed sometimes coincide with working capital. The question naturally arises as to whether the inconsistencies and uncertainties of present practice would not be eliminated by the adoption of a rule that current assets and liabilities should be the same as working assets and liabilities and that net current assets should always reflect the amount of working capital. I shall take as a premise that such should be the case and shall discuss the ends to which it will lead, as well as the element of practicability, as it concerns general in addition to bank credit data requirements. (It is observed that the term working assets here is given a broader meaning than is warranted by the common definition.)

Proceeding from the foregoing premise, current assets should be those which are necessary or incidental to the operating cycle of an enterprise—exclusive of any part of properties subject to depreciation or depletion—together with those assets which are available for such use; while current liabilities should be those which are a natural consequence or incident of the trading cycle or otherwise constitute, in effect, liens upon existing current assets in that their liquidation will be provided by their natural conversion.

With this broad definition in mind, current assets and liabilities will be found to embrace the following elements:

| Current Assets | Current Liabilities |
|---|---|
| (1) Cash, other than balances obligated or earmarked for purposes other than operations. | (1) Cash borrowed for operating purposes. |
| (2) Trade notes and accounts receivable. | (2) Notes and accounts payable for materials, merchandise, services and expenses and interest accrued thereon. |
| (3) Inventories, and advances for the purchase of stock in trade, raw materials, manufacturing supplies and products in process of production. | (3) Interest and redemption or sinking-fund payments upon funded debt to the extent that such have accrued. |

Current Assets

(4) Materials on hand and services purchased but not yet received, comprising elements of operating cost, such as operating and repair materials and prepaid expenses currently realizable in the natural course of operations.

(5) Other assets available of use for normal operating purposes such as—

(a) Notes and accounts receivable, other than those resulting from operations, which automatically will, or promptly can, be converted into cash free for operating use.

(b) Securities or other property which represent investments of free cash and are convertible quickly into cash, exclusive of securities held for purpose of control, business advantage, income production or investment of surplus reserves.

Current Liabilities

(4) Other notes and accounts payable due at such a date as to require payment out of existing current assets or the proceeds thereof.

The following discussion of these elements, developed by the theoretical approach, will embrace such points of conflict as there may be with present practices.

While all cash is generally assumed, without question, to be a current asset, this is not always true. An evident exception would be an instance of funds obtained from the sale of securities or from long-term borrowings for use only in the acquirement of fixed assets. A less evident exception would be a case in which a part in fact is earmarked for investment in an insurance reserve fund. The determining factor should be whether any part of the total cash was not normally usable for operating or working capital purposes. The absence of legal bar to its employment for the liquidation of any debt should not determine the point, though the existence of such a bar, as might be the case in the first illustration, would definitely preclude a current classification.

While situations are infrequent in which some part of the cash is not a current asset, they do occur. While not now imminent, the time again will come in which stocks and bonds will be sold to produce funds for capital expenditures and rules should be adopted to militate against the misleading practice, so frequent in the past, of bolstering up the current assets and current ratio with cash balances more correctly belonging in the capital section.

The question sometimes arises as to whether dividends, bond interest or other special payments due for payment upon the day following the balance-sheet date should be treated as a deduction from the cash balance. Assuming full disclosure, such a procedure is believed to be supportable because, owing to the nature of such liabilities, an equal part of the cash correctly represents an accumulation for the particular purpose. The question, however, does not affect the showing of net current assets—working capital—and circumstances should determine the preferable procedure in each case. But the propriety of deducting such liabilities from cash balances must not be construed as justifying a similar procedure in the case of general notes or accounts payable, even though similarly due on the day following the balance-sheet date. The character of such liabilities is distinct from dividends and bond interest. In the former the funds necessary to make the payment may be replaced normally by incurring similar debts, while in the latter case the funds required may be replaced only by future operations or by the incurring of a liability of a different character.

Accounts or notes arising from the sale of merchandise or service are a necessary element of the operating cycle. Their current-asset position is not open to question, it being understood of course that they should be stated at their fair realizable value by the elimination of uncollectible accounts and the provision of collection loss reserves. The date of prospective collection might be argued to be not material on the ground that an account or note, assured of ultimate collectibility, continues to remain a part of the working capital until collected. But such a view is not correct. Strictly speaking, accounts and notes not assured of collection within the normal period established by the terms of sale become lost to working capital regardless of prospective ultimate collectibility. But so to provide would produce practical difficulties not justified by practical advantages and it becomes necessary, or at least desirable, to recognize that a large part of trade accounts will not be paid in accord with the customary terms of sale and that the period of the operating cycle is longer than theoretically should be the case. Consequently, it becomes necessary to adopt some arbitrary period beyond the normal collection date during which trade accounts and notes will retain their position as a part of working capital. Practice has indicated the usual desirability of a twelve-months period and this, possible exceptions being recognized, will serve as well as any other.

It is not believed, however, that those trade notes and accounts receivable, such as instalment accounts, which by their original terms are due at dates more than a year beyond the statement date, should be denied current classification because of that fact. Where a long-term collection period is normal, it merely means that the duration of the business cycle is longer than normal, consequently requiring a greater amount of working capital or net current assets in proportion to total current assets.

With the foregoing as a basis, it is believed that the rule should be that current assets should include all notes and accounts receivable, resulting from operations, which will be collected within a year following the statement date, together with such as, in accord with the terms of sale, will be collected beyond that date. Notes and accounts due to be collected currently but prospectively collectible only at dates beyond such twelve months period should be considered as lost to working capital and should be excluded from current assets, on the ground that, because of necessity or sometimes of willing special arrangements for a deferring of collection, a part of the capital devoted to working or current assets has been diverted to an investment. It is believed that such a rule is sound in all respects.

While matters of balance-sheet arrangement are not intended to be embraced by this discussion, it incidentally may be pointed out that where the extent of notes and accounts receivable which are not due to be collected during the ensuing year are of any importance in relation to the total, their amount should be separately shown. Also, there is no justification for the practice, which sometimes is employed, of showing the provision for collection losses as a reserve account outside of the current section. To do so is to overvalue the current assets and working capital, even though the surplus be stated correctly.

Inventories of stock in trade, of raw materials, manufacturing supplies and products in process of manufacture permit of no question of the propriety of their inclusion as current assets. They clearly represent property in the process of conversion in the course of the operating cycle regardless of its length. A question may be raised with respect to manufacturing supplies, on the theory that they are not realizable, or at best only in part, except through the continuance of operation. Aside from the fact that the normal balance-sheet assumes a going-concern condition, such an objection would be inconsistent with the accepted practice in the case of other items, as the same objection might be raised with equal force against raw materials and products in process, for without continuance of operations a realization of their normal value would be the exception. The term manufacturing supplies as it is used here is meant to embrace those materials or supplies which enter into the manufacture of an article or its container and, in effect, differ from a raw material only because of less importance. Salt in the case of butter or fish, labels in the case of canned goods are illustrations.

Operating supplies as the term is used here embrace those materials and supplies which are incidental to the operation of a plant or the rendering of a service, such as fuel, equipment repair parts or shipping or delivery supplies. By prepaid expenses is meant payments made for services to be received currently such as insurance, rent, taxes and the like. The term does not include deferred charges, such as advertising, which represent payments made for services received but prospectively may have a future benefit. Operating supplies and prepaid expenses are of exactly the same character and they both may be characterized correctly as prepayments of operating costs. Their cost or value definitely represents capital invested in the operating cycle; they are a part of working capital and the propriety of their inclusion as current assets on such grounds should be clear. There is no determining difference between prepayments of expenses and operating supplies on the one hand and manufacturing supplies on the other. The fact that the latter becomes a physical part of the product whereas the former becomes a part of the cost of fabricating the product is merely a technical difference without substance. An objection based upon absence of realization in the event of a cessation of operations is as fallacious as in the case of manufacturing supplies. By continuance of operations, operating supplies and prepaid expenses become converted and realized frequently with a greater rapidity than merchandise and with equal assurance of a realization of full value. The statement that a prepaid expense represents no value is without basis. The right to use a facility during a future period, as in the case of rent, is a matter of tangible value. It could not be claimed that a rental payment due on

January 1st covering the ensuing month should reduce working capital by its inclusion as a current liability on December 31st, and it would be equally illogical to maintain that such reduction should be made because the payment happened to have been made on December 31st instead of January 1st; but that is the effect of denying current asset classification.

In practice it is unusual to find prepaid expenses included within current assets, and operating supplies also are frequently excluded. One of the twelve banks questioned considered the item properly included and several appeared incredulous that the question should even be considered. And yet the item of operating supplies, of the same character and usually of greater importance, frequently is embraced by the innocuous caption of "inventories" and reaches a current position without comment. The erroneous view respecting expense prepayments seems to have originated in the frequent and illogical confusion of prepayments and deferred charges, a confusion probably arising from the fact that the former item frequently is unimportant in amount and has seemed conveniently grouped with the latter under a miscellaneous caption. The error of such procedure should be clear. Correctly, prepayments and operating supplies should be grouped as an item of current assets. This segregation should be adopted as occasion may require to avoid misinterpretation. Such a procedure will be based upon correct theory, will coincide with the facts and should be acceptable in practice.

Notes and accounts receivable other than those which result from direct trading transactions fall, generally, into one of two groups—first, notes and accounts created by transactions which are incidental to the operation of the business and, second, those which represent loans or advances. The former, current collectibility being presumed, should be accorded the same treatment as notes and accounts which arise out of direct trading transactions, as they are a necessary incident of the operations and correctly represent capital invested in operating assets. A case in which the account or note had arisen from the sale of a capital asset under conditions requiring the proceeds to be applied to a particular liability not falling within the current category would be the rare exception. Loans or advances, other than those unimportant and temporary advances reasonably construed as incidents of operation, may find a place in current assets only upon the theory that they constitute temporary investments of surplus cash. But such inclusion can be justified only by the condition that they be realizable currently or, in other words, that they be collectible upon demand or within a short period. Where these conditions are not met fully the amounts involved must be considered as having been withdrawn from working capital and should not be classed as current assets. Advances or loans falling within this group sometimes represent a lending of the credit of the enterprise as an accommodation to the borrower. In such cases there will be no surplus cash to justify the theory that the loans constitute temporary investments and the funds lent will be found to have come directly or indirectly out of bank loans or other current liabilities. Loans of this character have no place in the operating cycle and, theoretically, they do not justify current classification. However, in fact, such loans may be considered as offsetting an equal amount of liabilities. The situation frequently is similar to one in which a contingent liability has been incurred through endorsement or other guaranty. When such conditions are met reasonably, such loans and advances, current collectibility being always assumed, do not represent a reduction of the working capital and should be included within current assets. Otherwise the amount of net current assets or working capital, and the ration of current assets to liabilities, would be incorrectly impaired.

Generally speaking, and still from a theoretical viewpoint, notes and accounts which are not a result of trading, or are not attributable directly to incidental operating transactions, constitute investments or accommodations and should be included within current assets only when current collectibility is so assured that the amounts are in fact available for working-capital purposes. Accordingly, the rule should be that notes and accounts receivable, other than those arising from trading or incidental operations, are current assets only when they automatically will or can be collected on demand or within a current period. I believe that such a rule coincides closely with general practice.

Marketable or currently realizable securities are current assets when they represent a temporary investment of surplus cash. However, they are not necessarily current assets merely because quickly realizable. A marketable security acquired with the intention of long-term investment for income or one which represents the investment of depletion or insurance reserves is not a current asset because it represents capital not used in the operating cycle and normally not available for such use. The fact that marketable securities may be available legally and may be converted quickly for the purpose of liquidating a current debt is beside the point. Current assets should not embrace assets which are not used in operation merely because quickly realizable in emergencies, any more than they should exclude raw materials or prepaid expenses merely because they are without a quickly realizable value in the absence of continued operations. The situation should be clear, particularly in those cases where the securities represent investments of surplus reserves or otherwise constitute a protection against uninsured or uninsurable losses. In such cases they in fact are available for instantaneous use in the liquidation of debt but such use impairs the safety of future operations. Real estate comprising a part of the plant frequently will have some value which may be realizable quickly, but that fact would never justify the inclusion of such value as a current asset. In some cases securities which are marketable or are subject to reasonably quick conversion may be held for purposes of control or for reasons of business advantage. Such factors confirm their investment, as opposed to a current, character.

Having in mind that current assets should include only those which are a part of working capital, the rule should be that securities should be classed as current only when they are marketable or otherwise quickly realizable and represent investments of surplus working capital. Such a definition is in some conflict with present practice which appears usually to call for current classification of all marketable securities which legally are available for meeting the current liabilities should such use be required. But it should be obvious that the present practice is justifiable only upon the theory that a balance-sheet is presumed to exhibit the liquidating situation. As this is not the case, there is no justification for the inclusion of securities as current assets, regardless of how marketable, when they are held for purposes other than temporary investment of surplus working capital. This view appears to be supported by five out of eight banks that responded to the question.

The cash-surrender value of life insurance represents amounts withdrawn from working capital and invested in the acquirement of an asset which may be relied upon to compensate for loss of earnings which might follow the death of important officers. In no sense does it represent a part of working capital and there is no theory to justify its inclusion in current assets. This view conflicts with what was general practice but now seems to be changing because of a growing recognition that the practice has been in error. The practice of current classification has arisen from the single fact that surrender value is quickly realizable, although the recent financial situation has demonstrated that this can not always be assumed. But it is obvious that realization must be accompanied either by a cancellation of the policy, which destroys the protection of future operations, or by its use as collateral. The procedure and effect is the same as in the case of a fixed asset. While the theoretical view differs from general present practice, the error in the practice should be obvious and, in fact, is beginning to be recognized as is shown by the replies received from banks.

So much for the asset side. Except in the case of the treatment of prepayments and of securities and insurance-surrender values, it will be found that there is little of the classification which is reached by the theoretical approach which should not be acceptable for credit or other practical purposes. In the case of current liabilities, however, greater conflict will be found, but it is a conflict which may be resolved without difficulty. In theory, liabilities which require classification as current embrace only those which have created current assets or those which for other reason will be liquidated in the ordinary progress of the operating cycle from funds produced by the natural conversion of existing current assets. Practice embraces all liabilities payable within a year regardless of circumstances.

Cash borrowed for operating purposes and notes and accounts payable for operating requirements represent liabilities which, coincident with their creation, have produced equal amounts of current assets out of which they will be liquidated upon their conversion in the ordinary progress of operations. Such liabilities, regardless of when payable, constitute a lien against the related assets, a lien which continues until the assets are converted into cash and the liabilities are extinguished.

Inconsistency has arisen in the practice of stating accrued expenses and term-debt redemption instalments for statement purposes. Accrued interest, accrued rent or other accruing liability for an operating purpose must be stated as a liability only in the proportion of the future payment which has ratably accrued. On the other hand, it is the practice to require the total of all redemption instalments due within a year to be treated as current. Redemption instalments accrue and should be provided for by the operations in the same way as interest. The inclusion of the total instalments is just as erroneous as would be the failure to include as current such part as had accrued. A bond redemption instalment due at the end of a year frequently represents the amount to be realized during the year through depreciation or depletion. Such is usually the case in realty bonds. Timber bonds, the redemption payments of which are intended to be provided by the stumpage cut, constitute a particularly clear case. In these and similar instances the inclusion in current liabilities of all bond redemption instalments due within a year is unwarranted by any theory. It is the equivalent of including as a current liability the indebtedness for merchandise while excluding the merchandise itself as a current asset. The fact that the instalment represents an existing liability which must be liquidated within a twelve months is beside the point. Accrued interest and accrued parts of debt instalments represent liabilities payable out of profit and other operating realization. Operating profit and depreciation and depletion realization will have increased current assets and so much of such assets as equal the accrued interest and redemption instalments may be considered as earmarked against these requirements. Accrued interest and accrued debt redemption instalments should be treated in the same way. The proportion which has ratably accrued to the statement date should be included as a current liability—to include more is clearly incorrect.

Notes and accounts payable which do not result from operations, such as liabilities created by expenditures for additions to plant or equipment, as a rule also constitute current liabilities. This is true in theory because the acquisition of plant, in the absence of available capital funds, can be provided only out of working capital and a liability of this character represents the working capital so withdrawn. But where such liabilities are payable in the future the situation in theory sometimes becomes similar to the case of a term-debt redemption. This similarity is clearly evident in cases in which the liability is progressively payable and has resulted from a purchase of equipment, the use of which, prospectively, will produce the funds required to meet the debt instalments as they become due. In such cases the working capital is not reduced at the time of the incurring of the debt but only as the payments become due and only that part of an instalment which has accrued to the statement date may be properly classified as current. It is only such amount that constitutes a theoretical lien upon current assets.

Debts which are due for payment beyond a year or those which are secured by real property liens are not necessarily to be excluded from current liabilities because of such facts alone. A debt which was current when incurred does not lose its current character merely because its normal due date has been deferred or because a property lien has been executed to afford the creditor an added security, unless the circumstances are so changed that the debt is fairly to be construed as borrowed capital. On the other hand, a debt for money borrowed upon the security of real property usually represents borrowed capital and is not a current liability at the time incurred.

Preferred stock dividends, particularly the cumulative variety, are not essentially different from bond interest, and the proportion which has accrued to a statement date fairly should be considered a current liability. The same is true of common stock regular dividends in those cases, somewhat rare today, in which no question exists of declaration and payment. While it is true that a dividend is not legally a liability until declared, it is not a sound procedure to ignore the reasonable certainty of declaration. The fact should be recognized that the proportion which has accrued to a statement date represents a theoretical lien upon the current assets created by the profit out of which the dividend will be declared. It is this theory of accruing lien upon the current assets that justifies the current-liability classification of what is, from one aspect, a reserve and in any event is not an existing legal liability. While the accrued part of prospective dividends should be considered as current, I do not believe that dividends which have been declared in advance with respect to a period after the statement date should be similarly treated. Such dividends do require to be recognized, but their status is similar to term-debt redemption instalments and the current liability should be restricted to that part which has accrued.

The question of liabilities concerned with contracts for the acquisition of capital assets contains some difficulty. A liability which reduces working capital is clearly involved. On the other hand the actual withdrawal is only prospective and before such withdrawal is necessary its amount may have been produced by profits or depreciation realization. Consequently, exceptions being possible, it would seem to be a reasonable rule that there is no requirement for a provision as a current item of a liability involved with contractual obligations for the acquirement of capital assets. Balance-sheet footnotes, however, would be in order.

It is to be observed that in this discussion the test of current classification of liabilities has been the question whether the assets out of which liquidation is to be naturally expected are embraced by existing current assets. The test has not been whether payment was required within a prescribed time. Liabilities determined to be current by this test will include all operating and similar liabilities such as are usually currently payable and, further, in instances will include amounts not due for payment within the ensuing year. On the other hand, it will exclude items which under present practice would be classed as current upon the ground that their due dates fall within a year. But in every case the amounts due within a year which would be excluded will be found to be amounts due to be liquidated, not out of existing current assets, but out of proceeds of operations after the statement date.

Objections which may be raised on the ground of an insufficient showing of existing liabilities which must be liquidated within the ensuing year may be eliminated in practice by providing for special indication of those items of funded debt which currently will become due or by providing a separate caption to accumulate all items which do not fall within the category of current liabilities in accord with the proposed rules but nevertheless require payment within a year.

The foregoing discussion has taken as a premise the belief that current assets and current liabilities should determine the amount of working capital and, principally, has considered only the theoretical elements. I believe that the conclusions reached as to what should be included within or excluded from the current section of the balance-sheet are logical and consistent and produce a balance-sheet without element of misstatement and containing nothing which should impair its use by banks for credit purposes. On the other hand the procedure will show clearly the amount of working capital and will permit the computation of a current ratio which will state accurately the relationship between operating assets and liabilities and will be a more trustworthy basis for determining the relative adequacy of working capital than the ratio as it is now developed. An adoption of the proposed procedure will eliminate much of the arbitrary character and inconsistency of existing rules. I believe that it will tend to create a consistent practice firmly founded on sound theory and consequently not liable to important variations incidental to different interpretations.

Proposed definitions of the terms "current assets" and "current liabilities" are presented as an appendix to this discussion.

## APPENDIX

### Proposed Definitions of "Current Assets" and "Current Liabilities"

*Assets—Current:*

Those assets which are necessary or incidental to or result from the operating cycle of an enterprise—exclusive of any part of properties subject to depreciation or depletion—together with those assets which, regardless of operations, will be converted automatically into free cash within an ensuing period of usually not more than a year and those which can be so converted without impairing the continuity and safety of operations.

They usually embrace—

(a) Cash, other than balances earmarked for permanent investment purposes or for liquidation of funded debt;

(b) Notes and accounts receivable which have resulted from operations;

(c) Inventories of stock in trade, including raw materials, manufacturing supplies and products in process of manufacture or production;

(d) Prepaid expenses—but not deferred charges—including operating and repair materials, currently realizable in the natural course of operations within an ensuing period of usually not more than a year;

(e) Notes and accounts receivable, other than those resulting from operations, which automatically will be or can be converted into cash within an ensuing period of usually not more than a year;

(f) Marketable securities which represent investments of free cash, exclusive of such as are held for purposes of control, operating advantage, income production or investment of insurance or other surplus reserves.

The term is usually applicable only in cases of production, trading and service enterprises and is related to current liabilities (q.v.). The excess of current assets over current liabilities determines the amount of working capital of an enterprise.

*Liabilities—Current:*

Those liabilities which are a natural consequence or incident of business operations and in effect are liens upon current assets in that the funds for their liquidation are on hand or will be obtained by realization of existing current assets. They include payments required to be made for the liquidation of term debt or for interest thereon only to the extent that such have accrued. They usually embrace—

(a) Cash borrowed for operating purposes or for the acquirement of current assets, including interest accrued thereon;

(b) Notes and accounts payable for materials, merchandise, services and expenses, including interest accrued thereon;

(c) Accrued interest and other charges and the accrued portion of fixed redemption or sinking-fund instalment upon funded or other long-term debt;

(d) Other notes and accounts payable which are due for payment within an ensuing period of usually not more than a year, including dividends declared with respect to a period which has expired.

The term is usually applicable only in cases of production, trading and service enterprises and is related to current assets (q.v.).