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## Correspondence: A Layman Looks at the Balance-Sheet, Accounting Principles and Local Statutes

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## Correspondence

### A LAYMAN LOOKS AT THE BALANCE-SHEET

*Editor, THE JOURNAL OF ACCOUNTANCY:*

SIR: I sometimes wonder if it would not be a good plan for accountants to take a sabbatical year, as they say in the colleges, and during that time refrain absolutely from any technical consideration of accounts, accounting or accountancy. If in such sabbatical year they would engage in some totally different vocation and look objectively only upon financial statements and their preparation, it seems to me it would be helpful to all concerned. Every man whose calling occupies his entire time becomes inevitably somewhat dogmatic. He grows so familiar with the working tools, as they might be called, that he is unable to think without them, and he fails to remember that other people engaged in other vocations really have no knowledge of the highly distinctive nature of his occupation. Everyone knows of physicians who talk a language which the ordinary patient does not understand at all. Sometimes, of course, this is done for the sake of creating an impression of learning, but generally the fault is due to a lack of comprehension of the patient's medical ignorance. Everyone knows of lawyers who love to talk profoundly of rules of evidence and of jurisprudence in a way that is quite unintelligible to the laity. And, alas, most of us know of wearers of the cloth who couch their spiritual instruction in a vocabulary known only to the inner circle. It is not surprising, therefore, that accountants should have fallen into the same error; but some of them have gone even further than their brethren of the other professions. They impress us mightily, but they tell us comparatively little. We hear of earned surplus and reserves for depreciation and of depletion and obsolescence and income accounts and profit-and-loss accounts and heaven only knows how many more things which are merely words to us.

I have been much concerned in attempts to understand the reports of some of the companies which have helped me to lose my patrimony during the present lustrum. Up to the middle of 1929, I was perfectly content to have my profit-making companies pay me the dividends which I thought were richly deserved, and I was not much worried about figures which were put forth now and then in an attempt to tell me as much as the companies thought was good for my soul. It was the custom of most of us who flourished in those palmy days to glance occasionally at the balance-sheet—whatever that may mean—and to see that it bore the signature of an accounting firm. Sometimes the firm's name was well known to me because I played golf with one of the partners. At other times the names had an unfamiliar ring. It made no difference, however. Somebody apparently had made an investigation and was prepared to tell me and all the rest of the stock-holders that he thought all was well. Perhaps he did not even say so much as that. He may have said merely that he had audited the accounts and, subject to more qualifications than I had the patience to analyze, he appended his certificate. That also made no difference. The great point was that dividends were payable and were paid when they were due.

Now, however, we are learning by experience the importance of facts. Fancies in the past played their part and kept us in luxury, but they have gone and the places where they were known no more. Today I want to know if there is any value at all in the stock of the companies whose engraved certificates lie fallow in my safe-deposit box. With an optimism wholly unreasonable, some of us still cling to a hope that in some day near or far we shall be able to sell those certificates for coin of the realm. And some outrageously confident persons even expect that the regime of the dividend will return. And so we are interested in knowing or in trying to know what is the actual condition of the companies, what they are doing, what they may do and where we stand as the owners. Therefore, we begin to turn to the accounts and to the accountants to find out.

The first thing that is presented to us is a balance-sheet. Now I have no genuine knowledge about the question of a balance-sheet. Presumably it is a statement of financial affairs in which the assets and liabilities at a certain date are set forth, and I know that if I compare the balance-sheet of 1933 with that of 1932 I should be able to discover whether the company has advanced or gone backward. Apparently, if one may believe in terminology, a balance-sheet is a sheet which balances. We all know that no company, save in some improbable incident of fate, can effect a true balance between assets and liabilities without a certain amount of manipulation, which may be called net income or surplus or deficit; but we don't believe that balance is essential to happiness. However, we are inclined to permit the perpetuation of the word balance-sheet, and we recognize it as a holy instrument of the accounting priesthood. Its consecration is almost a sacrament. Consequently we are concerned to ascertain what the balance-sheet is trying to tell us and to find out also what it is trying not to tell us, which is perhaps much more important.

It seems to me that it ought to be possible for a man of average intelligence to write a simple, straightforward statement to the effect that a company has operated, let us say, seventy-five per cent of the working hours of a year. During that time it has manufactured at a cost of \$1,000,000 goods which it subsequently sold for \$2,000,000 and that out of the difference, which I believe would be called gross profit, it has expended \$100,000 for expenses not directly concerned with manufacturing, such as salaries of officers, light, heat, power, taxes, etc., and has written off, as the saying goes, \$200,000 for physical deterioration of its plant and has set aside in real cash \$100,000 to provide for emergencies (I am not speaking now of the reserves which often are no reserves at all but merely a matter of bookkeeping. Nothing is truly set aside in most cases. I can not believe that a reserve which is not represented by cash or its liquid equivalent is a reserve at all) and has expended for the promotion of sales \$200,000 and has paid interest on its bonds amounting to \$100,000 and has declared dividends on its preferred stock amounting to \$200,000 and has added to its working capital \$100,000 and has declared a dividend on the common stock of \$100,000. Any of us could understand that. It ought to be quite within the bounds of possibility for a statement to be prepared, which might be called a balance-sheet, if it were necessary to follow that archaic tradition, which would reveal in plain, simple language the current value (and by that I mean the price at which an article could be sold in the ordinary, existing course of events) and the debts which would have to be paid, whether to note-holders

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or trade creditors, and the amount of honest surplus available for dividends if it were determined to wind up the company, and the amount owed to the company by people who could be safely relied upon to meet their obligations, and the amount of capital stock in the hands of share-holders, and the amount of bonded indebtedness and its interest which would have to be paid, and the result of operations for the past year and any other items indicative of fact. It should, I say, be possible to have such statements as these; and many of us trust that in the reorganization of all business relationships we shall have precisely what I have suggested.

But the accountant finds a difficulty in presenting to us a statement of accounts which is so plain that even the most uninformed among us can grasp its full significance. To begin with, there is the question of double-entry, and that itself is rather mystifying. Undoubtedly no one has discovered any other form of adequate presentation of accounts, but the trouble is that we who are outside the fane do not understand. I am not a bookkeeper and I am not an accountant and therefore, I fail to grasp what is perfectly clear to any one who knows the theory behind double-entry. It is not feasible for me to go back to school and to study bookkeeping, and my fellows in business and in the professions, except accountancy, are in the same position.

There was a time when the accountant seemed to think it necessary to be obscure, very much as lawyers and physicians did. Of late, of course, there has been an improvement and by the application of a good deal of thought it is possible to understand most of the elements in the financial accounts of a company. But we should like to have even more plainness. We are simple folk who yearn for full comprehension.

Not long ago a great accountant for whom I have profound personal regard informed me that if a man could not understand a balance-sheet it was such a man's own fault. He should educate himself to know all the significance of every item in every balance-sheet. With all due deference to my friend, I wish to say now, as I said to him, that no profession could adopt such an attitude as that and perform its full share of the world's work. We do not expect the physician to credit us with a knowledge of therapeutics. If we understood the healing art, we should not have to go to the physician. If we knew all about law we should not have to consult a lawyer. If we knew all about accounting we should not have to consult an accountant. So I maintain that, if the accountant is to continue in the practice of his profession, he must make that profession more and more intelligible by explaining the truth. I venture to say that if it were the practice of accountants never to issue a statement which a man of ordinary lay intelligence could not fully understand, the growth and prestige of accountancy would advance with a rapidity hitherto unknown. We need the accountant with the clear mind, the honest independence and, above all, with the God-given ability to present the facts so that the uninitiate can understand.

All this plea has been uttered many times and some accountants have joined in signing the petition for exposition, but we do not make the progress which we desire. The clouds of tradition still darken the day.

This letter is not written in any spirit of captious criticism. I know that there must be a technique of every profession and that the terminology of the technique must be more or less peculiar to its own profession. But I do hon-

estly believe, and many accountants concur in this, that a great deal could be done in addition to what is being done to simplify and render commonly intelligible the statements which are prepared by accounting departments of companies and audited by professional accountants.

Yours truly,

INVESTOR

[We publish this letter because it reflects a somewhat general feeling among investors who are not acquainted with the technical aspects of accounts. Many of the criticisms which the letter contains are probably unjustified, but that fact does not make the letter less interesting. Furthermore, there are many accountants of high standing who have been arguing for years in favor of greater clarity and a departure from what our correspondent calls the dogmatic.—*Editor.*]

### ACCOUNTING PRINCIPLES AND LOCAL STATUTES

*Editor*, THE JOURNAL OF ACCOUNTANCY:

SIR: We are again admonished, this time by Mr. George S. Hills, because of our practice of making up accounts with an eye single to fair and clear presentation of financial condition, not attempting to make of them, primarily, exhibits to a legal argument that state statutes have been observed.

Mr. Hills considers that the failure of accountants to make accounts to agree with his idea of implications of local statutes is "appalling," and he mentions the federal reserve *Bulletin*, federal income-tax form and form in the regulations under the securities act as bad examples. The federal securities act has for one of its principal objects the fair presentation of accounts; pursuing that object it has adopted the form which accountants approve but which appalls Mr. Hills. The federal forms are devised to exhibit the financial position of corporations so that it will be understood; even on the theories of Mr. Hills (with which I differ) as to implications of state laws, they are in harmony with the statutes of a majority of the states.

Mr. Hills holds that there is necessarily placed a legal interpretation on accountants' statements. Our statements are intended to be financial, not legal, documents, designed to convey information to laymen. Accounts can not be generally understood unless prepared on a consistent basis; yet we are told that accounts should be made variously as state statutes vary. "Practices adopted by one corporation are of little or no value as precedents to another."

Accounts prepared as we are told to prepare them would be unintelligible to all who were not informed as to the state of incorporation, the laws of that state at the date of incorporation and at the date of any transactions in capital stock, the steps taken or to be taken to free frozen surplus, and the conditions in which capital stock had been acquired; for all, or nearly all, states allow stock to be received in payment of debt not otherwise collectible and, in some other circumstances, irrespective of surplus.

Illinois and Pennsylvania have just changed their laws—are changes retroactive? What is the legal status of a corporation of Illinois that had acquired some of its stock in 1933, some earlier, some in settlement of debt, some from dissenting stockholders, and that has subsidiaries incorporated in other states

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at various dates and under various statutes? Is that matter for an accountant to decide?

As to the temporary freezing of surplus in some states when capital stock is acquired, I believe it is quite sufficient if the accountant make up the balance-sheet in the accepted manner adding to the surplus a note somewhat as follows:

"Of this surplus, \$ . . . . . is invested in capital stock of the company and should not be distributed without legal advice until either the capital has been reduced formally or the stock again sold."

Having thus reported on the financial position the duty of the accountant is done. Such surplus is invested, not extinguished. Earned surplus can not be created by mere filing of a certificate, yet upon formal reduction of capital the surplus becomes unfrozen as it was before the purchase of capital stock. The procedure for formal reduction of capital is little more than a perfunctory filing of a certificate even in the states that require any action at all. We are told that surplus is reduced when shares are acquired. There is no authority nor any reason for such a statement. It is purely assertion without authority.

Surplus, as understood by accountants, by the federal government, and by business men is the excess of assets over all liabilities, including capital stock in the hands of others—after deducting treasury stock. The state of Massachusetts also takes this view, as demonstrated by the form of balance-sheet prescribed for reporting corporations. Taxes on surplus have been proposed and some have been enacted; I can not think that surplus manipulated as Mr. Hills would have it would be accepted as the basis of a tax. If it were, corporations could eliminate surplus at their discretion by issuing and repurchasing stock.

The financial position of a company that has repurchased some of its own stock is the same as it would have been if the stock had never been issued. The purchased stock is removed from actual liabilities. Legal fiction may say that for the purpose of some legal concept the liability remains, but we should not deal with such fictions beyond putting clients on notice to obtain legal advice on legal matters.

So far as I can find there is no state or federal law that purports to say how the financial position of a corporation shall be displayed on the balance-sheet, and wherever regulations do so they prescribe the form that Mr. Hills dislikes.

The less we attempt to embody legal fictions in our accounts the more useful they will be. We meet few more exasperating obstacles to clear accounts than the citation by clients of legal opinions that something not so frank satisfies legal requirements. Besides all that, it would be impertinent for us to trespass upon the territory of the lawyer. In effect we are asked to do this.

I have before me a special report of Prentice Hall, Inc., dealing with accounting provisions under some 1,000 codes; the report says that almost every code contains specific methods of accounting and that our work as accountants "will be governed in future by these codes." One feels like saying "Oh, yeah?"

We are asked to conform to (1) sound accounting, (2) accounting according to alleged requirements of 50 changeable local statutes, (3) accounting under the federal securities act provisions, (4) accounting governed by 1,000 codes, which are in process of revision and, (5) accounting as required by income-tax laws.

When we certify accounts we say that "in our opinion" they set forth fairly, etc. Our opinion is not changeable at the dictation of others. Shall we say that in our opinion accounts set forth fairly, etc., except as they are distorted to

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conform to what are alleged to be requirements of local statutes and 1,000 codes? Or shall we say that in our Illinois opinion they set forth fairly, etc., but in our Washington opinion they misrepresent?

Let us not be stampeded. The public looks to professional accountants for sanity unaffected by fantastic ideas of those without much accounting experience or knowledge.

Yours truly,

F. W. THORNTON

Denville, New Jersey, March 6, 1934