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Limitations of the Present Balance-sheet *

By Charles B. Couchman

Producers of any marketable product and creators of any worthy service must constantly compare their output with the improvements that are being made in thought and in invention. Accountants are not exceptions to this rule. It is quite essential that we should pause from time to time and study our output to see whether or not we are taking advantage of the best developments in the analysis and interpretation of economic facts. In making this study we suffer from no dearth of willing and eager advisors. Suggestions for proposed improvements in our financial statements pour in upon us from a multitude of sources—clients, professors, bankers, bookkeepers, students, stock-market touts, economists, would-be economists and members of our own profession. These suggestors manifest varying degrees of enthusiasm and of temper and their suggestions range in tenor from the results of calm and thoughtful consideration upon the one hand to lurid attempts at biting sarcasm on the other. Regardless of the manner of presentation, the profession of accountancy would be foolish to disregard all these no doubt well meant and perhaps well founded suggestions. It would be much more foolish, however, if it adopted them without careful study as to the outcome of such adoption.

One of the most important statements produced by the public accountant is the statement showing the financial condition of a person or of an organization at a given date, whether such statement be called balance-sheet, a statement of assets and liabilities, a statement of resources and obligations or by any other name of similar import. Aside from exceptional cases, these statements are presumed to display financial condition on the basis of a going concern. Any exceptions to this usually bear specific notation showing the purpose for which they are prepared and the basis of valuation. In this paper I propose to discuss only the statements prepared on the basis of a going concern and for convenience shall refer to them as balance-sheets, discarding for the moment any technical differentiation of terminology so far as the title of the statements is concerned.

Much criticism of balance-sheets as now generally prepared by public accountants has been voiced, and apparently such

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criticisms are becoming more numerous. These arise chiefly from a desire to have the balance-sheet express something which it now omits or to express differently some element which it does display. Some clients consider that their business is worth more than the amount shown in the balance-sheet and that the assets as displayed therein should be stated at a higher figure. A few, ultra-conservative in character, offer a criticism of an opposite kind. As an illustration, one client voiced his sentiment in this remark, "Are you certifying that I could get this much for my business if I offered it for sale today?" Some feel that the fixed assets should be valued on a sound reproductive basis rather than at depreciated cost; others that the valuation should be based on the efficiency of the plant as a whole; still others that the valuation in the balance-sheet should bear a direct relation to the earnings; and yet another group is demanding that the price offered for the capital stock on the stock market should be the determining factor of the worth of the business and should be reflected in the financial statements. How delightful it would be if we as accountants could satisfy them all! After all, accountants are accommodating rogues and would be happy if they could satisfy all these varying demands. Such desire, however, becomes further complicated by a group which says that fluctuating values of the dollar should be recognized and that values in the balance-sheet should be measured in terms of unit purchasing power. The problem becomes more difficult.

I am not ready to propose to the Institute that we should accept all these friendly suggestions and immediately proceed to apply them to the balance-sheet that we put forth in the future. I fear we should encounter some difficulties in making one poor sheet of paper tell so many varying stories. However, I think it is well for us to look at these different demands and see to what extent the statements we put forth may be modified because of them.

PRESENT BASIS

In the preparation of financial statements the public accountant is guided to some extent by the purpose for which such statements are required. If an organization is facing insolvency and a statement is demanded that will display as far as possible the probable result of forced realization of the assets, the accountant is willing to prepare what is known as a statement of affairs. This differs materially from the recognized balance-sheet and usually bears little resemblance to a statement prepared on the going-concern basis. Liabilities are classified according to their priority of claim, such priority being fixed either by statutory regulation or by character of contract. The assets are valued according to their expected realization.

Again, if a statement is desired to serve as a basis for sale, it may include certain special features which are made a part of the terms of the sales contract. If a balance-sheet is prepared for the purpose of rate determination under the rulings of the interstate commerce commission or of some other public-service commission, special consideration must be given to the various factors which properly enter into such calculation and again the resultant statement may differ in some respects from the ordinary balance-sheet into which such special considerations do not enter.

There are numerous other cases in which a special purpose justifies specific treatment on the part of the public accountant. These, however, are exceptional cases and the profession has displayed as much flexibility in its treatment of these cases as is consistent with the fundamental principles which must govern its work.

The question we are facing today is not concerned with these types of statements. Instead, our problem is with the ordinary, every-day, garden variety of balance-sheets, wherein none of these special considerations enters; in other words, the balance-sheets prepared for the organization which is not facing the problem of forced sale nor of rate-making nor of merger or sale contract, but rather the problem of continuing to operate in the periods subsequent to the date of the balance-sheet in the same general way in which it has been operating in the past.

With regard to this type of balance-sheet, we are called upon to consider whether or not it is now prepared in a way that best serves the interests of all parties concerned. This kind of balance-sheet has been the subject of much criticism, just or unjust. Accountants state that the basis of value measurement in this balance-sheet is that of a going concern, and people ask what is meant by that term. It is doubtful if the reply can be expressed briefly. In the first place, accountants believe that their primary function lies in the verification, the analysis, the recording and the accumulation and display of the results of financial transactions and obligations. This opinion is generally accepted throughout the commercial and legal world. In applying these principles accountants have attempted as far as possible to apportion the effects of transactions to their proper periods of time. As a result, a balance-sheet prepared for a given date attempts to display on the one hand all values resulting from past transactions, the use or benefits of which apply to periods subsequent to that date, and on the other hand to display all obligations resulting from such transactions which must be met subsequent to that date. This apportionment between periods is in many cases the result of exact verification, as in the case of cash and various other current assets, or the result of arithmetical calculations, as in the case of prepaid items which by contract cover definite periods of time. Other allocations are the result of estimates only, as no enforceable contract governs the allocation. Under this heading come the estimated loss on receivables, depreciation or obsolescence of fixed assets and the apportionment of certain types of deferred charges. Such allocations of value to the future because of past expenditures, whether they are the result of exact calculation or of estimate, are based on the assumption that the organization will continue to operate in such a way as to utilize these values.

By this method the income statement displays all elements of past transactions not carried forward on the balance-sheet. In other words, all effects of transactions from the origin of an organization to a given date are reflected in the income statements during the period and the balance-sheet at the final date. The advantages of such a system are self-evident and facilitate many of the accountant's functions. The fundamentals of this procedure are sound, but the proper allocation of values to a balance-sheet of a given date constitutes one of the accountant's chief difficulties.

Accountancy, if it fulfils any function worthy of the place it now occupies in the business world, must base its records and its financial statements upon something that is definite or as nearly definite as may be. Financial transactions, either in the form of accomplished acts or of contracts of a legally binding nature, supply a basis of definiteness and of a fair degree of accuracy upon which the accountant may rear his structure of statements and reports. Some modifications of this basis have been accepted and now enter to some extent into the majority of financial statements. With regard to the accomplished transactions and the legal contracts, the person or organization whose financial statement we prepare must be or have been a party to them. Using fixed assets as an illustration, if the organization audited has expended a certain sum of money for these assets, that expenditure represents a transaction made by the organization and supplies a definite amount known as "cost," which may be used as the basis of value for certain assets on the balance-sheet; or if only a portion of the purchase price has been paid and a binding purchase contract has been entered into and title legally transferred to the organization, the accountant has a definite basis for the value which he may use in the balance-sheet.

Of the modifications above referred to which are accepted in general accounting practice, two illustrations may be given with regard to fixed assets. The first relates to depreciation or decrease in value of the assets since the date of acquisition. Here there is no financial transaction nor legal contract to serve as a basis. The figures that the accountant uses must be estimates and these estimates must be based upon the best available data. Even so, experience constantly shows that the estimates are incorrect and from time to time, as assets are replaced or are disposed of, adjustments must be made to correct the errors. No one realizes the inaccuracies resulting from depreciation estimates better than does the practising accountant. Nevertheless he knows that depreciation does take place and he uses or should use the best information he can obtain in setting up his estimate of the decrease in value that has taken place up to the date of his report.

Another modification which is not based upon completed transactions nor upon binding contracts is concerned with the element of appreciation of fixed assets. When an organization has its assets appraised by competent disinterested third parties, the public accountant, if he has confidence in the integrity and ability of such third parties, may bring into his balance-sheet values for fixed assets as shown by the appraisal, making proper adjustments of the reserve for depreciation. Any excess net worth resulting from appreciation he displays by a classification that will distinguish it from surplus from earnings or from other sources.

There are other modifications in the basis of valuation which the accountant recognizes, such as the measure of doubtful accounts receivable; but the accountant is deeply concerned with limiting the number of such modifications in his balance-sheet and as a rule they are of a character showing decrease in net worth rather than increase; in other words, showing allocation of expense to past periods, rather than anticipation of possible future transactions. In the main, the value of assets displayed by the accountant in the balance-sheet as it is prepared today may be substantiated by transactions of a completed nature or by contracts legally or morally binding. When consideration is given to the responsibility resting upon the public accountant, his hesitancy in departing from such a firm foundation can readily be understood and should be respected. I think I am justified in insisting that the chief functions of the accountant must relate to past transactions or current binding contracts and that other factors which he accepts must be kept at the minimum.

It appears that most critics who see a possibility of change are too ready to think they have hit upon something new and to burst into tirades against the accountant who has failed to incorporate their ideas in his reports and to hurl at him such adjectives as "blind," "hide-bound" and "narrow-minded." They overlook the possibility that the accountant may have thought of the same idea that has so suddenly struck them and may have conscientiously weighed its possible effects and discarded it.

To summarize briefly, the theory underlying the balance-sheet of a going concern is that every classification displayed therein shall have resulted from accomplished financial transactions and/or unfulfilled obligations to which the organization is a party, modified by the attempt to allocate to proper fiscal periods all earnings and all expenses. Aside from this element of allocation, all classifications may be substantiated by provable facts. Because of the nature of the accountant's work and his responsibilities this is a desirable foundation on which to stand. We have been asked to step from it or at least to shift one foot to another support. Before we acquiesce we desire some proof of the trustworthiness of the new footing and some assurance that the shift will be justified.

Some of the suggestions seriously made to us imply that, instead of basing the balance-sheet upon the transactions of the organization concerned, we should substitute transactions of outside parties; that instead of basing values on past transactions we should base some of them upon future transactions which may or may not occur; that instead of using as a unit of measure the legally established monetary unit of the land, we should use an economic unit as yet unfixed and unapproved by any properly constituted authority. Our hesitancy about hastily accepting these proposals seems to me to be well justified. However, if the quality of our service to the business world is to be improved by such steps, we should investigate.

IMPERFECTIONS

I have no desire to suggest that the balance-sheet as put forth today is a perfect document, or that our methods of measurement of balance-sheet elements has reached the ideal of accuracy. On the other hand it is doubtful if any one realizes the shortcomings better than does the public accountant himself. We are eager to improve our handiwork, but our responsibilities are not to ourselves alone but to third parties, and we must therefore advance with due and reasonable caution. Even so, I believe we are progressing as rapidly as are other professions, for they too must advance with care.

We admit with due humility and without hesitancy that our balance-sheets are not perfect. There are imperfections of which we are well aware and, no doubt, imperfections which we do not realize. We should be glad to find some safe and sane method of eliminating these.

We have already adopted on occasion some modification of the established theory of the basis for balance-sheet measurement. As an illustration, we have incorporated appraisal values in our balance-sheets, but we have carefully set up in the surplus group an account to measure any appreciation of depreciated cost and have so adjusted this account that the difference between it and the adjusted asset value at a given time shows the amount of cost remaining after deducting the depreciation which has been carried to the income accounts. Other modifications of the basic theory have been made from time to time but it has seemed wise to keep these modifications to the minimum.

One of the greatest faults in our balance-sheets lies in the incorrect allocations of cost to past periods when there are neither completed transactions nor binding contracts upon which exact measurement may be determined. A paper read before the American Institute of Accountants last year commented upon the fact that certain assets, particularly those of the fixed-asset group, were frequently much overstated. This result is evidently due to allocating to past periods too small amounts, as depreciation or as obsolescence.

What may be considered as another modification arises in the case of a corporation where assets are acquired for capital stock and the valuation at which such assets are recorded is determined by a board of directors and is neither true cost, in the sense of purchase price resulting from negotiations made at "arms length," nor a value determined by scientific appraisal. The only justification which the accountant has for displaying in his balance-sheet a value for such assets is the action of the board of directors. There is reasonable doubt whether or not an accountant would have any right to challenge the value so fixed. In the case of corporate reorganization wherein a new corporation with the same stockholders acquires the assets of the old on the basis of an enlarged stock issue, the assets so acquired are set up at a stipulated value as though that were the cost to the new corporation. From the viewpoint of a new legal entity, it is probable that the term "cost" is rightfully so applied but in a broad, economic sense the organization is no more than a continuation of the old, whereas the amount shown on the books of the new corporation for fixed assets may be greatly in excess of the cost to the old organization. Yet in such a case the accountant does not display any account which measures the appreciation of book value over cost. Ultimately this amount becomes a charge to operations during the years of use so that whatever error there may be in the original valuation decreases year by year.

We frequently find that our balance-sheets carry investments in the securities of other corporations at the original cost price without regard to the change in value which may have taken place in such securities. This is particularly true of unlisted stock. In this account there is no depreciation to reduce any error of overvaluation.

The problem of deferred charges is not always solved to the satisfaction of the accountant. Cost may be the base, but a problem arises as to elements which justifiably may be included in the classification.

We are frequently criticized also, and perhaps justly, because our balance-sheets claim to be on the basis of going-concern value but without sufficient indication of *where* the organization is going. Perhaps this criticism would be met, at least partly, if all balance-sheets were accompanied by earnings statements showing the results of operations over a period of several years.

Indeed there are few classifications in a balance-sheet to which some adverse criticism might not be directed if one were sufficiently captious. I have described merely a few of the imperfections which, we admit, apply to present-day balance-sheets. Accountants have given much thought to them, in the hope of finding a method of eliminating them without producing still more unsatisfactory results.

I am sure that we as a profession will be thankful for any aid in standardizing our procedure and in eliminating or reducing faults. The existence of faults, however, does not weaken the basic theory on which our statements are built. Many of the faults arise from modifications of this basic theory which we have accepted. Others can, no doubt, be corrected to some extent, and we are willing and eager for any method which will aid in this correction. None of the suggestions for basic changes in balance-sheet presentation so far as I am aware will aid materially in the elimination of all these imperfections.

LIQUIDATION BASIS

Let us first give consideration to the suggestion that balance-sheets should contain values on the basis of liquidation. With the exception of very few organizations, such, for instance, as stock-exchange houses the greater part of whose assets are of a readily marketable character, forced liquidation results in a price determined almost wholly by the exigencies of the financial condition of the seller. The amount can not be foreseen or estimated with any degree of accuracy. It would be suicidal for most organizations to present a balance-sheet on such a basis.

In the greater number of organizations a forced sale of the business would result in marked loss in nearly all the assets save cash. Receivables can seldom be sold for any amount approaching book value. Prepaid expenses may prove to have little recoverable value. Deferred charges may have no value at all. Fixed assets, particularly such as specialized machinery, may bring no more than junk prices. On the other hand, if an organization is not facing forced sale but is to continue its operations, it manifestly would be unfair to display valuations on the forced-sale basis or to omit items such as prepaid expenses and deferred charges. One purpose of accountancy is to allocate income to the periods in which it is earned and, conversely, to allocate costs to the periods in which the services are received. To do otherwise would result in the loss of all the benefits that have been obtained from this development of accountancy. It would bring us back to the cash-receipt-and-disbursement basis with all its attendant injustices and inaccuracies.

Another element that seems to have been overlooked by the advocates of liquidation values is the purpose of the organization whose balance-sheet is being prepared. Is it the purpose of all organizations to continue in business or to sell? Of course, if all for whom financial statements are prepared are on the auction block, having no function so important as to find a buyer, then let us hasten to revise our conception of the purpose of the balance-sheet. It can no longer be an expression of the going value of a concern if the concerns are all ceasing to go. If all individuals and organizations expect to sell, who will purchase? Is it believed that all organizations and individuals having balance-sheets propose to sell their present assets only to repurchase others, so that we may have a veritable merry-go-round of title changing? If so, this business world would face immediate collapse, and manufacture, commerce and industry would perish over night. Of course no such cataclysmic intent governs the purpose of the commercial organizations for which we prepare balance-sheets. Therefore, why should we infer any such purpose or adopt any such basis for the statements which we prepare? The balance-sheet is not a price ticket.

REPRODUCTION BASIS

The suggestion that all assets of a fixed or permanent nature should be valued on the reproduction basis, rather than at cost, has more to recommend it to the serious consideration of accountants. In cases where clients desire the reproduction basis and have had values duly determined by reputable appraisal companies, public accountants are willing to incorporate these values in their balance-sheets. However, as a rule, this revaluation is not made frequently in the case of any one organization. Apparently few desire to incur the expense of having such reappraisals made annually, but where it is done the accountants may and do incorporate the revaluations in their annual balance-sheets. In doing this, however, care must be taken that the earning results are not distorted or unduly influenced because of revaluation. This requires the setting up of special accounts very carefully designated and adjusted properly from year to year. An excellent brochure has been prepared by leading authorities on appraisals showing how such accounts may be set up and properly adjusted. With this procedure the public accountant has no quarrel although it appears to him as having slight value. During periods of considerable fluctuation in the reproduction cost of assets it causes marked fluctuations in the balance-sheets of organizations which indulge in this pastime. These fluctuations are not caused by anything within the organization nor are they concerned with its operations. They are wholly of an academic nature, based upon probable cost to dismantle and reproduce the present plant, when perhaps there is no intention to do any such thing.

After all, how is the financial condition of an organization vitally affected by the fact that it would cost more or less to reproduce its plant than it would have cost in some preceding year, if it does not intend such replacement? If it does intend to replace its assets, should not the value of such assets on the balance-sheet be reduced to the amount of their junk or turn-in value?

I think it is reasonable to assume that at a given date an organization is intending to replace its fixed assets or it is not. If it is not, why should the replacement value be displayed in the balance-sheet? On the other hand, if it is intending to replace such assets, is it not desirable to set up from surplus a reserve for the cost about to be incurred, rather than to use a replacement value for assets which are to be discarded? I do not feel that as yet the advocates of continuous-replacement value as the basis for fixed-asset valuation on the balance-sheet have proved their case sufficiently to justify accountants in demanding that basis for their reports. It might be delightful from the viewpoint of appraisal companies but that is scarcely a valid reason why public accountants should insist upon it as the basis for their balance-sheets. One argument in favor of the proposed procedure might be advanced in case of organizations which are carrying their assets at amounts in excess of the amounts that would be shown by appraisal, but I fear that this type of organization would be slow to accept any such requirement. If the value of fixed assets were accurately determined on the basis of their efficiency to serve the needs of the organization a much more desirable and logical result would be obtained and if this were brought into general practice I believe that it would greatly improve the value of balance-sheets for certain purposes.

THE FLUCTUATING DOLLAR

One of the groups which advocate drastic changes in the methods of presenting accounting reports insists that reports should recognize and give expression to the variance in the purchasing power of the dollar. Some members of this group have become quite vociferous in their denunciations of accountants for failing to interpret their financial reports in terms of purchase-units rather than merely in terms of dollars, and they have indicated a belief in the abysmal ignorance of accountants with regard to the fluctuation of the dollar and the laws of economics.

I think they are mistaken. The shrinking qualities of the dollar which have been raised to the dignity of star parts in the drama of economics by certain loud speakers are not wholly unfamiliar to accountants. The dictionaries give two definitions of the word "shrinking" and the accountant has experienced them both. One defines it as "withdrawing, recoiling, drawing back as with timidity" and the accountant has frequently discovered this quality of the dollar in his attempt to obtain it. The other definition is "becoming less, growing smaller" and we have found this quality to be true after we have obtained the dollar. Therefore we have no doubt as to the dollar's fluctuations.

So far as I am aware, proponents of fluctuating values have not presented any definite methods whereby accountants may make the desired application of their suggestions. All of us recognize the fact that the dollar has fluctuated greatly since 1913 but no measure of such fluctuation has yet been devised, even by the ablest economists, which fully meets the requirements of a unit for the general valuation of balance-sheet items. At the present time, we are limited in the main to "dollars" as the unit of our measurement. This unit at least has the advantage of having been approved by national law. It is quite essential that accounting reports, if they fulfil the function demanded of them, be expressed in terms which are as definite as possible. The dollar may fluctuate in its value, but at least it is a definite thing, known to those who must interpret financial reports.

It is true that various indexes of dollar value are used today in statistical reports. Each is measured upon the ratio of the purchasing power of the dollar for the period indicated as compared with its purchasing power in some preceding year, such as the year 1913. But these indexes vary. Some are based upon a comparison of the purchase price of various items entering into the cost of living, particularly foods. Others are based upon the relative purchase price of metal and metal products; others upon the purchase price of building materials; still others upon a composite basis involving several or all of these factors.

It has not yet appeared that any of them would fully meet the needs of the public accountant if he attempted to express his financial statements in such terms, instead of, or in addition to, the dollar values. The balance-sheet of a piano-manufacturing corporation calibrated in terms of relative cost of food products would scarcely satisfy the thoughtful accountant unless for some strange reason the piano company were considering a conversion of its assets into bacon, turnips and potatoes. Or again, why should the balance-sheet of any corporation be written in terms of a building-material index, if the organization does not intend such a use of its assets? Even the composite index would scarcely give results that would be valuable in determining the financial condition or the financial progress of an organization which was contemplating a continuance of its present operations and the payment of normal dividends.

Perhaps there would be merit in the reduction of our financial figures to some unit other than the dollar, but such a unit must be carefully worked out to serve the purpose effectively, and it must be standardized to such an extent that those who interpret the balance-sheet may understand the meaning of the expressed results. More than that, the accountant would probably feel that to shift from a dollar valuation to any other unit would not be sound policy until it had been definitely established by governmental authority. Under the present method the accountant may at times have to estimate the number of units in a particular financial element, but at least the unit itself is not misinterpreted. If some other unit of an unstable nature were used there would be uncertainty both as to the number of units measuring the item and as to the worth of the unit itself. It is highly desirable that uncertainties in the accountant's reports be avoided.

Accountants do not underestimate the value of comparative reports reduced to a purchase-unit basis, if such a unit can be definitely and authoritatively established. Reports may show that an organization, year after year, made a profit expressed in dollars and had a constantly increasing surplus, whereas it may be true that expressed in purchase units this organization may have been making losses year by year instead of profits, and its accumulated surplus today may have less purchasing power than did its surplus of a number of years before. If this theory be properly applied it may be found that many corporations which face the possibility of an application of section 104 of the present income-tax law will have no surplus to which this section can apply.

From the viewpoint of economics there is no denying the significance of the fluctuating power of the monetary unit. It is not a theory merely but a serious reality. While this is a recognized truth, there has not been devised a method which has established itself as justifying the public accountant in adopting it as the measure in his reports.

RELATION OF BALANCE-SHEET VALUE TO MARKET PRICE OF STOCK

Several recent magazine articles have bewailed the fact that the balance-sheet of a corporation does not seem to bear any direct relation to the value of the stock of that corporation, as indicated by the stock-exchange quotations, and have commented upon the low mentality of accountants for allowing such a discrepancy. Some writers have advocated that the capital stock as shown on the balance-sheet should be expressed in terms of the market value of the stock and the goodwill of the corporation should be set forth or adjusted accordingly.

I doubt if the accountancy profession will accept this recommendation. Some of us feel that the prices bid for stock on the market have very little relation to true values of the stock or to the balance-sheet of the corporation it represents. I can conceive of few greater accounting absurdities than to attempt to use the market value of stock as a basis for the adjustment of values in the balance-sheet of a corporation. Such a procedure would, among other things, be a reversal of the order of cause and effect, and one can readily imagine the anomalies that might result from attempting such a procedure.

Under the present conditions governing bids and offers of stock on the market, a limited group might raise or lower the price of stock of a particular corporation to almost any degree desired, regardless of the fact that the actual values in the corporation remained constant during the period. If this procedure were followed by accountants, stock manipulators could dictate the financial statements of listed companies regardless of earnings or other facts.

The market quotations from day to day usually apply to comparatively few shares of the stocks quoted. There is no proof that this price would remain constant for the entire issue if that issue were offered. There is, therefore, no justification for applying to the entire stock issue as displayed on the balance-sheet a price per share which has been offered or accepted for comparatively few shares.

It is probable that the incongruity between balance-sheet values and stock-market quotations will continue and he who expects to find harmony between these two almost unrelated items will continue to be disappointed. Forecasting is dangerous, yet I venture to predict that the market value of a stock will not be accepted by accountants of standing as a proper basis for balance-sheet-value adjustment so long as present conditions which govern stock-market fluctuations continue.

EARNING-POWER BASIS

The present opinion of the investment world seems to be that the earning power of an organization is the primary measure of its worth. If earning power could be applied as the basis for asset valuation, financial statements might be more in keeping with the desires of the financial world. Such application, however, presents numerous problems the solution of which has not yet been made clear.

To attempt to adjust fixed-asset valuation according to earning power would result in many absurdities. Therefore if it is made a basis for balance-sheet values the adjustment would have to be in some intangible item, such as goodwill, formulæ, trade marks, or some classification of similar import. This adjustment would have to be reflected either in the capital stock or in some surplus classification. Earned surplus already would have been increased by past earnings. Further to increase surplus because of the capitalization of such earnings would be in a sense a duplication. All accountants are familiar with numerous illustrations where past earnings for several years prove to be no true indication of future earnings. In such a case a balance-sheet prepared upon the basis of capitalized earnings would grossly misstate the real worth of the organization. Also, we in the United States have not attained any uniformity in the measure of goodwill. Several elements must enter into such measurement:

1. The number of years of earnings to be considered.
2. Adjustment of earnings because of non-recurring charges, scientific depreciation, proper capitalization of asset improvements and numerous other elements.
3. The amount of return upon investment to be allowed before capitalization.
4. The rate of capitalization.

Until there is a generally accepted standard for each of these elements, it would be hazardous for the profession to adopt this method as the basis for all balance-sheets. However, this basis probably has more to recommend it for our serious consideration than has any of the other bases which I have discussed.

CONCLUSION

I have no authority to speak for anyone but myself, but I do not believe the time is yet at hand when the essential bases of balance-sheet valuations as now used and accepted in the accounting and business worlds can be radically changed. I believe that we shall continue for some time to prepare our balance-sheets on the basis of going concerns and that the values displayed therein will be those resulting from financial transactions and from legally binding contracts to which the organization is a party. I do not believe that we may justly be considered smug or hidebound or slaves to precedent, merely because we have failed and continue to fail to accept suggestions which have not been found wise or those which careful study shows to be absurd in principle or a violation of sound economics and of business judgment.

It must be remembered that the principles which now govern the preparation of financial reports are not the result of the edicts of any accounting Mussolini or any ill-advised statute or any compulsory basis whatsoever, but rather are merely the consolidated results of accumulated business experience, seasoned with common sense and a careful study of cause and effect.

It is not my intention summarily to dismiss suggestions as being unworthy of our consideration but rather to indicate my own opinion as to why the accounting profession has not seen fit to adopt some of them. I have said before that our present basis for balance-sheet values is determined by completed financial transactions wherein legal right to property or to services has passed either to or from the organization concerned, plus consideration of legally binding contracts yet to be consummated. To this we have gradually added certain adjustments. These adjustments we have endeavored to keep to a minimum, for it is from them that most of our difficulties arise. Before we add further adjustments, it is only right that careful consideration be given as to whether or not the benefits will outweigh the defects.

I, therefore, respectfully offer the suggestion that the American Institute of Accountants should consider the advisability of appointing a committee for the purpose of studying all the suggestions which may aid us in producing balance-sheets which will be more useful to those whom we serve.

It should be the purpose of this committee first to outline specific methods of determining the amounts that may be properly carried in the balance-sheet in cases where the allocation to expense accounts is not the result of definite calculation; second, to give consideration to the various suggestions regarding fundamental changes in the method of balance-sheet valuation and to offer recommendations regarding any such changes which it may approve; third, to offer any other recommendations which it considers will improve the usefulness of balance-sheets to all parties concerned.

If the report of this committee recommends any marked changes in the character or content of balance-sheets and if the report is approved by the Institute, individual accountants would have justification for incorporating in their balance-sheets methods thus sanctioned by the profession.

It has not seemed pertinent in this paper to discuss the excellent service rendered by the public accountant nor the worth of his services in the business and legal fields. The good work that he does in the way of advice and recommendations, in systemization, in simplifying procedures, in building up controls over activities, in the detection of losses and irregularities and in the various other phases of his activities is entirely apart from the points that it has been my purpose to present.