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## What Is the Matter with Accounting? \*

BY HENRY RAND HATFIELD

Some there are who have made bold to exalt accounting because of its antiquity and to draw invidious comparisons with the natural sciences. These boast that the essentials of accounting had already been developed at a time when medicine, and biology, and chemistry were still a mass of fantastic superstitions.

Writers who dwell on the long existence of correct accounting methods are prone to exalt the science as representing the old nobility among a horde of upstarts, and to assume that its age is a testimonial of its dignity and worth. But may not these very facts bear a different interpretation? Accounting was well established while other sciences were undeveloped. Is that to say that in four hundred years the natural sciences have made tremendous advances, that alchemy has changed into chemistry, astrology into astronomy, and the medicine man has become a bacteriologist, but that accounting alone boasts of its past, and with more than British conservatism refuses to budge? Antiquity in this case may mean petrification; early maturity may mean senile decrepitude; the symbol of the accountant may perhaps be an Egyptian mummy, which was the same four thousand years ago as it is today.

The introduction of bookkeeping was not an isolated phenomenon, but part of a general awakening, when men's minds, after centuries of stagnation and slumber, in a measure broke from the traditions of the past and began to think along new lines. But in other sciences this awakening, or this renaissance, was only a beginning. Is it conceivable that accounting alone came forth in a nearly finished form that needed no improvement?

But perhaps accounting has in reality progressed despite the assertions of its protagonists. It was indeed claimed, more than two hundred years ago, that accounting had reached a state of perfection, and that "without a fault nothing can be rescinded from or added to it." Yet, strangely enough, almost every subsequent textbook has claimed to be a new or improved system and that what went before was practically worthless.

\*Address delivered at the annual meeting of the American Institute of Accountants, Del Monte, California, September 21, 1927.

Let us turn from such vague claims of advance and ask for details and specifications. Have substantial discoveries been made in the science of accounting as in other fields of human knowledge?

Yes, says Holland, speaking for the seventeenth century, for my great scholar Stevin, who advanced mathematics through his invention of the decimal system, did also introduce—the compound journal entry.

Yes, says England, for I place beside the name of James Watt, who in the next century invented the steam engine, that of Edward Thomas Jones, whose work was protected by patent and lauded by the governor of the Bank of England as an entirely new system of accounting.

Yes, says Italy, for the nineteenth century saw not merely the dazzling discoveries of Marconi, but the introduction by Cerboni of a really new system superior to double entry and adopted by the Italian government.

Yes, says America, in this latest era, I place on the scroll of fame, alongside the achievement of aviation, the introduction of—loose-leaf ledgers.

A rather sorry list of achievements. Compound entries are but poor rivals to so momentous an invention as the decimal system. Jones' heralded invention is one which those of you who know of it at all remember only as a curiosity. Logismography, despite certain merits, has in fifty years declined rather than expanded. And the loose-leaf system, while a more generally accepted improvement, is, forsooth, at best but a somewhat petty technical device which in no way affects the general principles of accounting.

It would, however, be unfair not to recognize evidences of progress. Three of these are prominent. The unprecedented outflow of serious scientific literature is a hopeful sign. This is so recent that some of you remember its beginning. In England one may take Dicksee and Pixley as the pioneers in this field, and these are both still active accountants; in this country the beginnings were with Sprague, whom many of you knew, and Cole, whom all delight to honor. It were invidious to mention other names. Most of you see a prominent author of accounting literature every time you look in your mirror.

Another bit of evidence exists in the fact that again, after some centuries of neglect, practically all universities in America, and

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some abroad, are giving serious attention to instruction in accounting. I should hesitate, being an academically inclined person, to mention this before a group of professional accountants. The man who does often contemns him who teaches. But I am emboldened by the fact that my fellow speaker, the sometime president of this organization, is at the same time one of those academic guys, and that many others of your members are in the same boat.

A third evidence of progress is the undeniable improvement in the standing and dignity of the profession which you so honorably represent. Your opinion is sought not only in the ordinary course of business but by the government when it frames new laws, when it needs to wage a war, when it has the vastly more difficult task of arranging for the payment for a war already lost and won. You would not now be represented in the councils of the nation and of the world, if the science had not materially progressed.

It may even be possible to list some specific points in which present-day accounting excels that of former times. The most striking, though to me by no means the most interesting, has been the general improvement in technique, to which America has contributed so much. The problem of modern accounting is to deal with the myriad transactions of big business. Volta's first generation of an electric current was, indeed, the really significant step in advance in the study of electricity; but today the problem is not how to make a laboratory spark, but how to conduct, and control, and utilize, the power of a million horses over a tenuous copper wire. So with bookkeeping, the handling of transactions in enormous numbers is a real problem, not faced in past centuries, but wonderfully achieved today.

In addition I would mention three achievements, one of practical, one of pedagogical, one of theoretical interest. The first is the development of cost accounting (due to engineers rather than to professional accountants, but still an achievement in the science). This I consider the typical contribution of the present generation.

The second is the substitution, for the idea that bookkeeping is in essence a mere matching of debits and credits, of the view that its significant aspect is its striving to present the equation:  $\text{assets} = \text{liabilities} + \text{proprietorship}$ . The name of the honored and lamented Sprague stands prominent in this movement. But

it was formulated long before his day, and can be traced back to German, American and English writers—for more than a hundred years. But the general adoption of the so-called balance-sheet approach in place of the purely journal method is a recent matter. Paciolo and his immediate successors give no hint of it.

The third point is the effort to introduce some unity into accounting theory instead of regarding its phenomena as diverse. For long it was generally considered that the investment of capital was in marked opposition to the payment of an expense. This view was crystallized in the phrase “capital expenditure or charge against revenue.” It assumed that these two were radically different in nature, and one must never be confounded with the other. Today one sees a continuous gradation, land, building, machinery, raw material, expense of labor—each one of a series, each differing only as to length of the service which it renders, each paid for with the view of getting all possible use out of it in the productive process. The development of this point of view is, I believe, a real achievement in accounting theory—one not dreamt of in earlier centuries.

I find real cause for congratulation (I can not say pride, for, alas, I am not one of you) in these indisputable evidences of life, vigor and hence of progress in the profession. It may be ungracious, but perhaps for your souls' good, if my congratulations are tempered by raising the question as to what the science, or profession, lacks. In what is it weak? Where has it failed?

To do this, it is first necessary to ask what is, in fine, the purpose or nature of accounting. It is one of the technical languages wherein the facts of business are expressed. In this it is a twin sister to statistics, which expresses a different set of business facts through a different medium. It is, as it were, the distinction between the French of diplomacy and law Latin, languages at one time indispensable to government functions, each used in a restricted field, each with a separate vocabulary. Accounting is something other than a set of clever devices for beating the income tax with the least damage to one's conscience, something more than a specious way of window-dressing whereby the best possible appearance is given to a somewhat undesirable stock of goods. It is a universal language of business.

The prime requisite of a language is that it be understandable. There is a suspicion abroad that accounting as it exists today is not impeccable in this respect. Hartley Withers has said that

“to most of the shareholders, [the balance-sheet] is about as comprehensible as a passage from Browning, translated into an unknown language” and speaks of it as an “impossible cryptogram with an esoteric meaning that is only revealed to an initiated caste, after much fasting and mortification.”

Perhaps this criticism is somewhat unfair. The fluent lucidity of Xenophon, of Cicero and of Goldsmith is wasted on one who does not know the languages in which these wrote. Mr. Withers' inability to grasp all the beauties of the annual report of the Steel Corporation may possibly betray his own illiteracy rather than any lack of lucidity on the part of the Steel Corporation or the distinguished accountants who act as its auditors.

In order to be understandable a language must possess a clearly defined terminology, and the lack of this is the chief defect of accounting. As in economics, no new vocabulary has been adopted (I trust I do no injustice to my colleagues who have adopted “equities” in place of “proprietorship and liabilities” or have devised the really picturesque term, “where-got-gone statement”), but the ordinary language of the market place has been used in senses the market place knew not of, and in senses varying with different accountants.

Accounting is almost the only science (with the exception of economics, if that be a science) which is deficient in this respect. Physics may not know the ultimate nature of electricity, but progress has been made in describing its manifestations. When one speaks quantitatively of its various aspects there is no lack of definiteness, and ohms, volts and amperes are standard around the world. The nature of matter may be unknown to the chemist, but the formulas  $H_2O$  and  $C_2H_6O$  can never be confused, even though, before Volstead, the substances may have been mixed. But it is different with accounting terms, even with those of greatest significance.

This is manifest in respect of the more interesting and important of the two phases of accounting—that relating to the increase of wealth taking place during a fiscal period. Income subject to the federal income tax is indeed a fairly definite term, although, in many cases, a more appropriate rubric would be “the amount which we expect to get away with at the revenue office.” But other aspects of the increment during the year are more significant than the amount taxable. Business is not run for the purpose of paying taxes, but for the purpose of making profits (call this

by some other term if you wish), and there should be no uncertainty in defining the term, no unavoidable vagueness in expressing the best possible guess at the amount.

But one finds a state of actual confusion in this fundamental matter. Net earnings, net income, gross profits, profits, net profits? I have tried for years to find the proper term to be used and the exact connotation of each of the terms just quoted. I have appealed to academic writers, both economists and accountants, and I find only confusion. I have turned to the courts, and found in their decisions a confusion overwhelmingly ludicrous. If one sees the word "profits" in a textbook he has no idea of its content until he carefully studies the context. Even then he may still be left in doubt. It is as if one picked up a book and read a single word spelled "d-a-m-i-t." Until he learned whether the book were German or English he could neither pronounce the word, nor know whether it was an in-offensive conjunction or a mildly profane expletive.

So I turn to you, the recognized organization of the ablest group of professional accountants in the world. I turn to you who use the terms every day of your lives. I turn to you, as I would turn to the chemists for the meaning of ethyl alcohol, or as I would turn to engineers to learn what is the meaning of horse-power. I look through formal published statements, and I find that what one of you calls "net income" another calls "profits." I find that by some "income" is a comprehensive term including profits and also other items; by others "profits" is the more inclusive term, from which, certain deductions having been made, "income" remains. I find that a perfectly respectable, nay, an outstanding, accountant approves of a statement in which "net income" represents a remainder after subtracting interest on bonds, while another outstanding, nay, even perfectly respectable, accountant sanctions the use of the same term where interest is not deducted. Does one chemist describe water as a combination of one atom of oxygen with two of hydrogen, while another thinks it legitimate to use the same term for a combination from which one of the atoms of hydrogen is omitted? Does one engineer use a formula in which  $\pi$  is multiplied by the square of  $R$ , while another using the same formula omits the exponent of  $R$ ?

Accounting, however, needs something more than a definite nomenclature. It needs above all else the formulation of sound theories, which can be crystallized into clear terminology.

Progress in the other sciences has for its milestones a series of formulated theories, comprehensive and significant. Astronomy was not content with calling the stars by name, but has developed a law of gravity which, starting with a falling apple, gives a rule applicable to suns and spheres remote beyond human comprehension, and which made it possible to posit a still invisible planet. Chemistry has developed theories which, permeating all matter, solve the mysteries of the infinitesimal. Like astronomy, it too was able to predict the existence of missing elements, as yet undiscovered in the laboratory. Biology found the theory of evolution, which embraces the immeasurable expanses of time and makes a continuum of all life in all ages.

But accounting is a laggard. Its great problems (I refer to matters even more significant than that bone of contention, whether in certain places the ink used should be black or red) are not only unsettled but their surface has scarcely been scratched. Some of these may be mentioned in sequence.

Accounting primarily deals with imputed values and records the changes therein. Can progress be made without formulating some theory as to what value is proper for accounting purposes?

There is, indeed, rather general agreement that in the first instance a newly acquired asset is valued at cost. But as to any theory, underlying and supporting this rule, there is general silence. A statement found in a thesis which your own association has crowned with your noblest laurels asserts, "We deny that a given object can have a value to its owner in excess of cost." I am in doubt as to just what the author meant, but surely you and the author alike must agree that what he says evidently is not true.

There are undoubtedly some practical advantages in preferring costs to guesses, but I have still to find any adequate theory or scientific hypothesis which supports the opinion just quoted. Accountants in this respect rely on reiteration in lieu of argument.

In the more difficult problem as to the basis for revaluing assets at the close of a fiscal period, the lack of sound theory is as great, the divergence in practice appalling. On this matter accountants (and for purposes of criticism only, I make bold to include myself among accountants), on this matter we accountants have been—or, more correctly, are—illogical, inconsistent and vacillating. We have arbitrarily laid down different



rules for different classes of assets; we have promulgated the phrase "cost or market, whichever is lower", supporting it by a ludicrously inappropriate argument; we have for years strenuously advocated a given rule, only to make a complete *volte face*, when the effects of the great war made a continuance of such a policy unpleasing to one's clients.

The arguments adduced in favor of valuing at cost or market, whichever is lower, are so brilliant an instance of flabby thinking as to deserve some further attention. The stock argument is that such a procedure is justified on the ground that it is conservative. But if conservative treatment is desirable, if, as Neymarck says, accounting is good to the extent that values are underestimated, the rule of cost or market, whichever is lower, is illogical and unsatisfactory. It permits a commodity, which was purchased at the top of the market for \$2.00, to be valued at the full present market quotation, say \$1.95, but forbids that an article purchased for \$1.00 and now risen to \$2.00 be valued at even \$1.20, although that is 40 per cent. below the actual market. Surely, if conservatism is the goal, it would be more effectively secured by saying that merchandise should always be valued at market less a margin for safety, even though in some cases that represented a marking-up. It is this sort of slipshod theoretical discussion of accounting problems which does little justice to the intelligence of the profession and raises doubts as to the distance which it has traveled since its mediæval beginnings.

Somewhat similar is the problem of the balance-sheet. Accountants agree with Sprague's felicitous statement that the balance-sheet is the starting point and the goal of all accounting procedure. If the balance-sheet is so important, should there be any uncertainty as to its nature and purpose? I speak not now of divergencies of opinion and practice as to insignificant matters of technique, such as the sequence and subdivisions of assets, or whether an item should appear as an addition or as a subtraction from the *contra* side. There should be agreement as to its essential character. But some hold that a balance-sheet is an exhibit of conditions at a given moment—when the clock strikes twelve at the end of a fiscal year. Others assert that the balance-sheet is a history of past events, showing what has been contributed to the concern and how the funds so received have been employed. In one conception, capital funds unwisely invested, "sunk and gone" to use a famous phrase, are no longer

existent and hence have no place in a "cross section" of the concern of today. From the other viewpoint, the investment in an unproductive plant is a historical fact, and adequately explains the use made of contributed capital. Do you all know which view is correct? Do any of you consistently adhere to it? Will some one of you explain the proper view to the rest of us?

Depreciation is another matter on which your science has been laggard, although by no means absolutely paralyzed. Substantial progress has been made, but there are still those who speak of depreciation in unscientific terms. Not infrequently statements are prepared in which a given sum is stated as "amount available for depreciation and dividends." Such a confusion of unlike things should not be tolerated by a profession of the standing of yours. It is as though wages and overhead were subtracted from sales and the remainder labeled "amount available for replacement of raw materials and dividends."

Again, there are still those who, both in their practice and in their writings, not infrequently speak of depreciation as a reserve, something held back, or as a deduction from profits. But depreciation is something gone, not something kept; it is, as Cole so cleverly said, a "hole in the assets," and a hole is a difficult thing to hold in any position. Ever to speak of depreciation as a deduction from profits is a glaring error. It is not merely the survival of a form of expression, as when even an astronomer speaks of the sun rising, for even if you accountants know better, the average business man still thinks of depreciation as something other than it is. Or, at least, he did until the internal-revenue bureau allowed a deduction for depreciation. It is of only indirect credit to the profession that it could not put over the right view on a scientific matter until it became financially expedient so to do. If the average business man has wrong conceptions of accounting principles, the profession can not be considered efficient. Even the medical profession did not rest easy until it convinced mankind that the proper treatment of epilepsy was not by means designed to exorcise a devil, and that a horse chestnut in the pocket is unreliable as a prophylactic against rheumatism.

Accountants do indeed agree that if a machine wears out in ten years its cost must somehow be distributed as a charge during those years. But there is no agreement whatever as to the proportion of the amount to be allotted to each particular year. I

need not recall the interminable debate over the relative merits of straight-line and curved-line depreciation. Accountants, with rare impartiality, apply one system to one class of assets, another to other classes. It is somewhat as if one applied the Ptolemaic system to the motion of Mars, but regarded Jupiter as operating according to the Copernican system.

More distressful and more pertinent to the present discussion is the nature of the arguments adduced in support of one or the other basis. These are often barren of any vestige of accounting theory. It may be said that the charge should be relatively low in the early years, not because depreciation is less, but because it "is inconvenient to burden the early years" with a heavy charge, or because such a charge would show an initial deficit. Is accounting a device to secure what is convenient, or to show what is real? Should accounting be twisted so as to conceal an initial deficit if one really exists, or should it show the facts? Even the physician does not always alter his diagnosis because it would be inconvenient for the patient just then to have an attack of smallpox. His duty as a scientist is to determine whether that disease is present. The accountant, if a scientist, should be concerned solely in what charges may properly be assigned to the current year as the effect of depreciation.

Sometimes a specious theoretical basis is indeed brought forth, namely, that the straight-line method is preferable to a curved-line method, because the former alone charges the actual cost. Here I argue neither for nor against a particular procedure, but merely assert that accounting in this case shows a crudely unscientific attitude. Whether a straight-line method is preferable or not is subject to discussion. But whatever merits it may have—and these may consist in the virtues of simplicity, ease of application, and understandability—the one thing that is certain and should be unquestioned is that the straight-line method does not charge off each year the amount actually paid for that year's service rendered.

This may be established by assuming that A rents property for two years at an annual rental of \$104.76 to be paid in advance on January first each year. The contract is made in December, 1927, but the lease does not begin until January 1, 1928. Just before that date the owner suggests to the prospective tenant that he pay rental for both years on January 1, 1928, instead of paying it in two equal annual instalments. The tenant is perfectly

willing to do so, provided proper adjustment can be made. Obviously, unless interest for him is at the rate of 0 per cent., he will not pay \$209.52. Assuming a rate of 10 per cent., he would be justified in paying just \$200. This is made up of the \$104.76 in any case due and payable January 1, 1928, and \$95.24, the value as of that date of \$104.76 payable a year later. If then he pays \$200 for two years' rental, the actual amount paid for the first year is not, as is assumed in the argument under criticism, one-half of the amount paid for two years, but a larger sum. When the interest rate is unknown, the only statement that can be made with confidence is that the amount actually paid for the first year is not the total price divided by the number of years of service.

Even in its progress, accounting has been hampered by careless reasoning. Two instances are in point. The first relates to municipal accounts. The increasing use of a municipal balance-sheet, due to the campaign inaugurated some twenty years ago, has everywhere been hailed as a real improvement. But, unfortunately, it was apparently assumed that the customary form of double-entry balance-sheet, invaluable to a corporation, should be used by a municipality. A spur being a good thing for quickening the speed of a horse, therefore let us use spurs to accelerate our automobiles, forgetful that a pneumatic tire is a quite different thing from a horse's flanks. Only after some years was it recognized that the characteristic of a corporation balance-sheet—the easy comparison of liabilities with the assets protecting them—does not at all apply to a municipality. With little exaggeration it may be said that municipal debt is, in reality, secured by the value of all the assets within the city walls save those which belong to the city and are listed in the municipal balance-sheet.

While modifications of the balance-sheet are now made, municipal accountants generally continue to employ the forms of double-entry bookkeeping. Is it an impossible hope that there is among you some genius who will invent a new form of accounting, particularly suited to governmental accounts? One can not foretell its nature, any more that those whose plodding backs built the pyramids could foretell the exact nature of Watt's invention which was to lift man's burdens, nor than the runner from Marathon, who exhausted himself in hastening the news to Athens, could tell how in future ages news would be brought

without runner, without even a road, through the pathless ether. Cerboni attempted a new system, in logismography, but without notable success. But I long for the appearance of the genius who shall transcend tradition and devise a system of municipal accounting as superior, for that purpose, to double entry, as the latter excels the accounting procedure of Menher and Gramma-teus. Will not the candidate for this honor kindly raise his hand?

The second instance of imperfect progress is found in the consolidated balance-sheet. This anomalous document is a balance-sheet of a non-existent entity; it combines the debts of one corporation with the assets of another legally distinct corporation; it lists indiscriminately assets which belong to a given corporation with those which do not. It is something new, distinctly American in origin. But the consolidated balance-sheet serves a purpose. The task before you accountants is to agree on the rules for playing this new game. If in this country we play American football instead of Rugby we at least agree on the rules for Americans to follow. But eminent accountants still disagree on such significant matters as the treatment in the consolidated balance-sheet of a pre-existing surplus of a subsidiary company and the value to be attached to the shares of non-consenting stockholders. It is not strange, therefore, that in England there has been much recent discussion as to the legitimacy of this American device. One would similarly question football if umpires were uncertain whether the game consisted in forcing the ball over the opponents' goal or in seeing how long the fullback could maintain his balance while sitting on the ball. You have devised a new and valuable form. It is your task to perfect it.

My argument has been that notwithstanding the excessive claims of its admirers, accounting really is not a mummy, but is alive and growing. Progress it has indeed made, but nevertheless deficiencies appear, several of which have been mentioned. If I am to sum these matters up, it would be by saying that in the busy strife of professional life, in the problem of how to meet the task of serving the innumerable clients flocking to your office and each demanding immediate attention, you have somewhat neglected the higher task of developing a sound set of accounting theories. With the necessary attention to the anise and cummin you have, perforce, neglected the weightier matters of the law. After all, advancement in any service comes most often from the

consideration of abstract problems. Pupin made long-distance telephony possible because of research which he carried on in regard to the amplification of waves before there ever was a telephone; the greatest improvements in medicine were brought about by studies of test tubes rather than by diagnosing individuals; the great dye industries are the outgrowth of experiments in chemical laboratories rather than in factories.

American accountants lead the world in technique. They probably also lead the world in the formulation of accounting doctrine. But the present need of the profession is a further development of sound theory rather than improved practice.