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Students' Department

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Students' Department

EDITED BY H. A. FINNEY

THE STATEMENT OF APPLICATION OF FUNDS

A REPLY TO MR. ESQUERRÉ

There appeared in the correspondence department of THE JOURNAL OF ACCOUNTANCY for May, 1925, a communication from Mr. Paul-Joseph Esquerré in which he expresses disapproval of the form of the statement of application of funds used in a solution which was published in the *Students' Department* for July, 1921. While Mr. Esquerré's letter is, specifically, a criticism of a particular solution, it is, in its broader implications, an expression of disapproval of the general form of the statement of application of funds which is in more or less general use, and of which the solution in question was merely an illustration.

I am in agreement with Mr. Esquerré that the statement of application of funds has not yet been perfected. No doubt certain elements of the statement as usually prepared are difficult for the layman to comprehend, particularly the theory underlying the adding back of depreciation to the profits to determine the total funds provided by the profits. This procedure and the theory on which it is based should not be especially difficult for the trained accountant to comprehend, but if the statement were perfected so that the layman would understand it as readily as he understands the profit-and-loss statement and the balance-sheet its usefulness would be greatly enhanced.

The statement of application of funds has considerable value. Undoubtedly its potential value is greater than its present realized value for the very reason that it does tax the understanding of some laymen and even some accountants. It is therefore to be hoped that Mr. Esquerré's letter will "stir the interest of accountants in general, and bring about a salutary discussion of the points at issue." The columns of the *Students' Department* are open for, and the editor will welcome, solutions of the problem in question which readers may care to submit as contributions to the discussion. If, out of such contributions, a form should be found which would be a real improvement of the old form, Mr. Esquerré's letter would prove to have been a service to the profession.

It is, of course, a matter of personal concern to the editor of this department that Mr. Esquerré saw fit to make use of such expressions as "forcing the funds" and "forced figure." The first reading of the letter left the editor with the impression that he had been accused of a mathematical forcing of a balance, and it is not unlikely that many readers obtained the same impression. Such an accusation would of course have been unwarranted and untrue, as can be determined by an inspection of the problem and the solution, which are reprinted hereinafter for purposes presently to be mentioned.

Upon second reading, it appeared more likely that Mr. Esquerré meant to convey the thought that figures were grouped in a manner which was not in accordance with his interpretation of the requirements of accounting principles. If this is the correct interpretation of his remarks, it is to be regretted that, in stating what merely amounts to a difference of opinion as to correct principle and procedure, use was made of words charged with so aspersive a connotation.

If, as it is hoped, this discussion is to result in constructive suggestions for the improvement of the form of the statement of application of funds, it is perhaps desirable to reprint, so that they will appear in one issue, the problem, the solution as it originally appeared in the *Students' Department*, and Mr. Esquerré's suggested statement. It may also be helpful to explain how the original statement was prepared, to comment to some extent on Mr. Esquerré's criticisms, and to analyze his statement in order to determine whether it is an improvement or not. There follows, then, the problem:

Problem

Prepare a statement of resources and their application for the 12 months ended December 31, 1920, using the following data:

THE HALL MANUFACTURING COMPANY—BALANCE-SHEET

Assets	Dec. 31, 1919	Dec. 31, 1920
Cash	$5,000	$1,800
Accounts receivable	30,000	32,000
Raw material	12,000	14,500
Goods in process	16,000	17,500
Finished goods	21,000	19,000
Land	70,000	100,000
Buildings	115,000	170,000
Machinery	90,000	100,000
Tools	26,000	23,000
Patents	30,000	28,000
Discount on bonds		2,000
Investment in stocks	25,000	
Advances to salesmen	500	1,000
Unexpired insurance	300	250
	$440,800	$509,050
Liabilities		
Accounts payable	$35,000	$10,000
Notes payable	25,000	5,000
Bank loans	20,000	
Bonds payable	200,000	300,000
Reserve for depreciation, buildings and machinery	20,000	29,000
Reserve for bad debts	1,200	1,500
Reserve for construction	16,000	20,000
Capital stock	100,000	100,000
Surplus	23,600	43,550
	$440,800	$509,050

Following is an abstract of the surplus account:

Balance January 1, 1920		$23,600
Add net profit for 1920		8,950
Add appraisal increase in land		30,000
Total		62,550
Deduct credit to reserve for construction	$4,000	
Deduct dividend paid December 31, 1920	15,000	19,000
Balance, December 31, 1920		$43,550

Depreciation was provided during the year as follows:

Credited to reserve for depreciation, buildings and machinery	$10,000
Written off from tools	5,000
Written off from patents	2,000

During the year machinery which cost $7,000 was sold for $6,000. The loss was absorbed in the reserve for depreciation.

The statement of application of funds is based on the increases and decreases of assets and liabilities shown by a comparative balance-sheet; but it is impossible to use these items of increase and decrease in the statement of application of funds without first giving serious consideration to the question whether any funds (or if the word "resources" is preferred, the reader is privileged to substitute that word wherever the editor uses the word "funds," it being the thought that each of these words conveys a broader meaning than mere cash) have been provided or any funds applied in ways which are significant but which are not brought to light by the comparative balance-sheet.

For instance, the increase in the surplus during the year is clearly not the amount which the profits have contributed in the way of funds during the year—if for no other reason, because dividends have been paid. Such payments constitute an application of funds which should be shown on the statement, and the charge of the dividends to the surplus has had the effect of reducing the increase in surplus for the year to an amount less than the profits. Hence, after determining the increase or decrease in each item which appears in the balance-sheets, it is necessary to give consideration to any adjustments which must be made in order to obtain more correct figures to include in the statement of application of funds.

The accompanying working papers show the increases and decreases in the various balance-sheet items, and the adjustments:

The first column of the working papers contains the balance-sheet as of December 31, 1919; the second column that of December 31, 1920. The third and fourth columns show the net debits in excess of the net credits, or vice versa, in each account during the year and the amounts of such net debits or net credits. The changes during the year are classified as debits and credits rather than increases and decreases in order that the items in the adjustment columns (5) and (6) may be uniformly applied to them as debits and credits.

Since it is known that the increase in surplus does not represent the amount of funds provided by profits, this increase, $19,950, is transferred by adjustment (A) to a lower space, where room will be available for the application of all necessary adjustments.

If the fact of the appraisal had not been stated, the increase of $30,000 in the land account would appear to have resulted from the application of funds of an equivalent amount in the purchase of land. But the problem states that the land was merely written up by a credit to surplus. The increase in the land account can not properly be shown as resulting from an application of funds, because the increase resulted from a mere book entry which did not require funds. This item must therefore be eliminated, and the elimination is accomplished by the credit adjustment entry (B) on the land line. But, on the other hand, the increase of $19,950 in surplus has been partly caused by this book

WORKING PAPERS

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Balance-sheets		*Net change*		*Adjustments*		*Working capital and deferred charges*		*Funds*	
	Dec. 31, 1919	Dec. 31, 1920	Debit	Credit	Debit	Credit	Increase	Decrease	Applied	Provided
ASSETS										
Cash	$5,000	$1,800		$3,200				$3,200		
Accounts receivable	30,000	32,000	$2,000				$2,000			
Raw material	12,000	14,500	2,500				2,500			
Goods in process	16,000	17,500	1,500				1,500			
Finished goods	21,000	19,000		2,000				2,000		
Land	70,000	100,000	30,000			$30,000 B				
Buildings	115,000	170,000	55,000						$55,000	
Machinery	90,000	100,000	10,000		{ $1,000 H 6,000 I }				17,000	
Tools	26,000	23,000		3,000	5,000 F				2,000	
Patents	30,000	28,000		2,000	2,000 G					
Discount on bonds		2,000	2,000			2,000 K				
Investment in stocks	25,000			25,000						$25,000
Advances to salesmen	500	1,000	500				500			
Unexpired insurance	300	250		50				50		
	$440,800	$509,050								
LIABILITIES										
Accounts payable	$35,000	$10,000	$25,000				$25,000			
Notes payable	25,000	5,000	20,000				20,000			
Bank loans	20,000		20,000				20,000			
Bonds payable	200,000	300,000		$100,000	$2,000 K					$98,000
Reserve for depreciation	20,000	29,000		9,000	10,000 E	$1,000 H				
Reserve for bad debts	1,200	1,500		300	300 J					
Reserve for construction	16,000	20,000		4,000	4,000 C					
Capital stock	100,000	100,000								
Surplus	23,600	43,550		19,950	19,950 A					
	$440,800	$509,050	$168,500	$168,500						

Funds provided by profits:						
Increase in surplus................		19,950 A				
Appraisal increase in value of land...	30,000 B					
Credit to reserve for construction....		4,000 C				
Dividends paid..................		15,000 D				
Provisions for depreciation:						26,250
Buildings and machinery.......		10,000 E				
Tools.......................		5,000 F				
Patents.....................		2,000 G				
Increase in reserve for bad debts.....		300 J				
Funds applied to payment of dividends...	15,000 D				$15,000	
Funds provided by sale of machinery.....		6,000 I				6,000
	$95,250	$95,250				
Increase in working capital and deferred charges............................				66,250	66,250	
			$71,500	$71,500	$155,250	$155,250

entry; certainly this credit to surplus did not provide funds, and if we are to adjust our surplus account increase figure to the true amount of the funds provided by profits the $30,000 must be adjusted out of the surplus. This is accomplished by the debit adjustment entry (B).

There has been transferred out of surplus during the year an item of $4,000 which was credited to a reserve for construction. This reserve is merely an appropriated surplus account, and the $4,000 transferred out of surplus during the year must be returned to it in our working papers in order to adjust the surplus increase for the year to the true amount of funds provided by profits. This transfer is accomplished by adjustment entry (C).

During the year dividends were paid in the amount of $15,000. This payment constituted an application of funds; moreover, it reduced the balance of the surplus account and consequently caused the increase in the surplus to be less than the funds provided by the profits. Adjustment is therefore made by entry (D) to add this item back to the surplus increase, to determine the funds provided by the profits and to set up on a separate line the amount of funds applied in the payment of dividends.

Entry (E) transfers out of the reserve for depreciation and into "funds provided by profits" the amount of depreciation provided for buildings and machinery. The theory underlying this adjustment and the addition of depreciation provisions to the net profits in the statement of application of funds itself is one of the most difficult things to understand in connection with the preparation of this statement. In order not to break the continuity of the present explanation, we shall defer for a short period the explanation of this treatment of depreciation and merely call attention to the fact that entry (E) has the effect of taking out of the reserve for depreciation and adding back to the surplus the depreciation of buildings and machinery credited to the reserve during the year; entries (F) and (G) have the effect of adding back to the assets and to surplus the amounts of depreciation of tools and patents which were credited to asset accounts during the year. (Mr. Esquerré criticizes the editor for using the word "depreciation" in connection with patents; his attention is directed to the problem.)

During the year machinery which cost $7,000 was sold for $6,000. If this transaction had been the only one recorded in the machinery account during the year, that account would have shown a decrease of $7,000, but that would not have been the amount of funds provided by the sale of the machinery. (To make this point clear it is only necessary to suppose that machinery costing $7,000 had been written off during the year against the reserve; in that case no funds whatever would have been provided.) An adjustment entry (H) is therefore made, debiting the machinery account and crediting the reserve. Adjustment (I) is then made transferring out of the machinery account and to a separate line at the bottom of the statement the item of $6,000, which represents the true amount of funds provided by the sale of the machinery. Returning to the machinery line, it will be found that the original net debit increase of $10,000 has been increased by two debit adjustments totaling $7,000, and the aggregate of these items, or $17,000, is the amount of funds applied to the purchase of machinery. This item of $17,000 is therefore carried out to the "funds applied" column, which, like the net change debit column and the adjustment debit column, is also a debit column.

Adjustment (J) adds back to surplus by transfer from the reserve for bad debts the amount of the increase in the reserve during the year. The reason for this adjustment is similar to that which justifies the treatment of depreciation. (An alternative, and perhaps preferable, method would be to deduct the reserve balances at the two dates from the accounts receivable balances, and deal with only the net balances as the real values of the receivables at the two dates.)

During the year bonds of a par value of $100,000 appear to have been sold at a discount of $2,000, thus producing funds of a net amount of $98,000. The discount item of $2,000 is therefore offset, by entry (K), against the increase in bonds payable, to determine the net amount of funds provided by the additional issue.

Now that all adjustments have been made the adjustment columns are footed to see that a balance has thus far been maintained. The items in columns (3) and (4) plus or minus the adjusting items in columns (5) and (6) are then carried to their appropriate columns—(7), (8), (9) and (10). It will be noted that the item of $26,250, appearing in the "funds provided" column, represents the net amount of all surplus and surplus adjustment items.

After distributing the figures as indicated, columns (7) and (8) are brought to a balance by inserting the "increase in working capital and deferred charges" item of $66,250, and as this increase in working capital and deferred charges represents an application of funds, the amount is also entered in the "funds applied" column.

It is thought that the foregoing explanations will clarify the theory underlying the treatment of items other than depreciation, and it will be noted that the various items can be traced from the working papers to the following statements. (Reference to Mr. Esquerré's adaptation of the schedule of working capital and deferred charges will show that he included, and in a somewhat changed form, only the working capital items, omitting the deferred charge items, and thus making it appear that the total of the supporting schedule did not tie up with the main statement.)

Solution

THE HALL MANUFACTURING COMPANY

Statement of application of funds—year ended Dec. 31, 1920

Funds provided:			
By net profits before providing for depreciation and bad debts:			
Net profit carried to surplus		$8,950	
Add depreciation:			
Buildings and machinery	$10,000		
Tools	5,000		
Patents	2,000	17,000	
Add provision for bad debts		300	$26,250
By issue of bonds:			
Par		100,000	
Less discount		2,000	98,000
By sale of investment in stocks			25,000
By sale of machinery:			
Cost		7,000	
Less loss charged to reserve		1,000	6,000
Total funds provided			$155,250

Which were applied as follows:		
To purchases of fixed assets:		
Buildings	$55,000	
Machinery	17,000	
Tools	2,000	$74,000
To payment of dividends		15,000
To increase in working capital and deferred charges		66,250
Total funds applied		$155,250

THE HALL MANUFACTURING COMPANY

Schedule of working capital and deferred charges
December 31, 1919, and December 31, 1920

	Dec. 31, 1919	Dec. 31, 1920	*Working capital* Decrease	Increase
Current assets:				
Cash	$5,000	$1,800	$3,200	
Accounts receivable	30,000	32,000		$2,000
Raw material	12,000	14,500		2,500
Goods in process	16,000	17,500		1,500
Finished goods	21,000	19,000	2,000	
Total current assets	84,000	84,800		
Current liabilities:				
Accounts payable	35,000	10,000		25,000
Notes payable	25,000	5,000		20,000
Bank loans	20,000			20,000
Total current liabilities	80,000	15,000		
Working capital	4,000	69,800		
Increase in working capital			65,800	
			$71,000	$71,000

Deferred charges

	Dec. 31, 1919	Dec. 31, 1920	Decrease	Increase
Advances to salesmen	$500	$1,000		$500
Unexpired insurance	300	250	$50	
	800	1,250		
Net increase in deferred charges			450	
			500	500

Summary

Increase in working capital	$65,800
Increase in deferred charges	450
Total	$66,250

Let us now return to the question of the treatment of depreciation. To make the matter as simple as possible let us assume that a man invested $800 in

business as a peddler. With $700 he purchased an automobile truck, and with the remaining $100 he purchased fruit and vegetables. He did a strictly cash business and sold his goods for exactly twice what he paid for them. At the end of the year he prepared a statement as follows:

Sales	$10,000
Less cost of sales	5,000
Gross profit	5,000
Less expenses	1,000
Net profit	$4,000

The net profit shown by the statement is represented by $4,000 of cash deposited in bank, and he decides to buy a building with it. It is perfectly apparent that his profits have provided funds of $4,000 and that these funds have been applied to the purchase of a building. The time arrives for preparing his tax return and he calls on an accountant to help him prepare it. The accountant looks at the foregoing profit-and-loss statement and amends it as follows:

Net profit (as above)	$4,000
Less depreciation of delivery truck	200
True net profit	$3,800

Now, if we were to prepare a statement of application of funds for the peddler, it would appear as follows:

Funds provided:	
By profits:	
Net profit	$3,800
Add back depreciation of delivery truck	200
Total	$4,000
Funds applied:	
To purchase of building	$4,000

The profits *must* have provided funds of $4,000 because a $4,000 building was purchased, and it is quite apparent that they did furnish funds of $4,000 because the depreciation charge, while reducing the profits, did not reduce the funds provided by the profits.

Mr. Esquerré appears to agree in general with this theory because, in his suggested statement, he adds back to the profits the amounts added during the year to the reserve for depreciation of buildings and machinery and to the reserve for accounts receivable. But, both in his comments and in his suggested statement, he indicates that a different treatment should be followed in regard to tools and patents. He states:

"Passing now to the source of the very funds which were applied, I find that 'tools' which must have been consumed by, and charged to, operations, since the decrease suffered by the asset has not been set aside out of profits, have produced $5,000 of cash or asset funds; that the amortization of patent value (which the editor refers to as 'depreciation') has been written off the asset, charged to operations as a profit-and-loss charge, but, nevertheless, has pro-

duced $2,000 of cash or asset funds. Whether it is cash or asset funds which the editor has in mind makes no difference whatever; in either case, he advances the theory that one of the means of providing funds is to consume assets or to write off intangibles."

The editor does not advance any such theory. The adding back of the depreciation is not based on "the theory that one of the means of providing funds is to consume assets or write off intangibles." The peddler's depreciation was not added back to the net profits because the accountant's provision of depreciation resulted in the provision of funds; it was added back because the provision of depreciation reduced the net profits below the amount of funds provided by the profits. That is to say, the funds were provided by the profits, not by the depreciation; the effect of the depreciation provision was to make the net profits somewhat smaller than the funds provided by the profits.

To this, Mr. Esquerré may be assumed to reply that his remarks did not apply to depreciation provided by setting up a reserve, but to the reduction in value of tools, which was recorded by writing down the asset instead of setting up a reserve, "because the writing off of the asset 'tools' in the amount of $5,000 is not 'depreciation' and, therefore, has not been set aside out of profits. The writing-off of tools is the result of an inventory which, when opposed to the prior inventory and to subsequent purchases, shows that the operations have actually consumed a value of $5,000 which must be considered as cost of goods manufactured, or, at any rate, as a profit-and-loss charge operating against inaccurate operating profits. The same thing is true of patents: in this case, as well as in the case of tools, a reserve was not created; the patents lost a value proportionate to the amortization of their active life, and, therefore, the loss was charged to operating profits which were too high."

The editor fails to follow Mr. Esquerré in this distinction. He can not agree that "the writing-off of the asset 'tools' in the amount of $5,000 is not 'depreciation'." If it is not depreciation, what shall we call it? Is it material as to whether the loss from wear and tear of a fixed asset due to its use in operations is computed by applying an estimated rate rather than by determining the depreciated value by means of an appraisal? Shall we say that the loss in the value of a fixed asset due to its use in operations is depreciation if it is computed by multiplying by a rate per cent, but that it is not depreciation if it is computed by appraising the property at its depreciated value? And is it material whether the charge for depreciation is offset by a credit to a reserve or by a credit to an asset account? Shall we say that the loss in the value of a fixed asset due to its use in operations is depreciation if it is recorded by a credit to a reserve, but that such a loss is not depreciation if it is recorded by a credit to the fixed asset account?

Mr. Walton, in writing of depreciation and tools, says that depreciation may be recorded "by a charge to revenue and a credit to the asset accounts themselves. This is called writing down the assets. . . . Since the tool acts directly on the material, it wears out much faster than a machine, and since the uses to which tools are put vary very greatly, it is impossible to fix any rate of depreciation that will be even approximately correct. . . . The only proper way to value them, when closing the books, is to take an inventory of them, as they stand at the time."

As to patents, let us assume that our peddler had invented a horn which was as effective in obtaining a following as that of the Pied Piper. And let us

assume that the accountant had charged off $50 as amortization of the value of the patent. That would reduce the net profit to $3,750. It would appear to be necessary to add back the amortization of the patent as well as the depreciation of the truck in order to arrive at the $4,000 of funds provided by the profits.

Mr. Esquerré objects to the use of the word "funds." "The editor of the *Students' Department* uses the term 'funds' but does not say whether these funds are cash or asset funds. His terminology indicates that cash is at issue, since he says that the funds provided were applied to purchase assets and pay dividends; but it also indicates that assets are at issue, since he says that funds were applied to 'increase in working capital.' I assume, of course, that the editor did not mean to say that cash had been applied to reduce the asset cash, and above all to reduce the asset finished goods."

The criticism of the word "funds" is perhaps the most significant of Mr. Esquerré's criticisms. The term "funds" is likely to be misconstrued as meaning cash, and yet if cash were meant the statement would have been called a statement of receipts and disbursements. While the term "funds" suggests something more than cash it is not unlikely that the term "resources" is preferable.

As to the remarks about applying cash to reduce cash and finished goods, Mr. Esquerré is correct in his assumption that the editor did not intend his statements to be so construed, and it is difficult to see how any such construction could be made. The statement seems to say clearly that the new funds or resources which came into the business during the year were applied to certain purposes, such as purchases of fixed assets and payments of dividends, and have also resulted in an increase in the working capital. But since the working capital is the excess of the current assets over the current liabilities, the net increase is accounted for in detail by showing in the supporting schedule the increases and decreases in various items which account for the net increase.

It now appears to be in order to consider the statement which Mr. Esquerré regards as the "true solution."

STATEMENT OF RESOURCES AND APPLICATIONS

(a) Increase of corporate wealth:			
(1) Through appraisal of land up to the market value thereof at 12/31/20— (credited to surplus)			$30,000
(2) Through acquisition of fixed assets:			
Tools		$2,000	
Buildings		55,000	
Machinery:			
New machinery acquired	$17,000		
Less old machinery sold	6,000	11,000	68,000
(3) Through increase of operating assets:			
Raw materials		$2,500	
Goods in process		1,500	
Accounts receivable (including advances to salesmen $500.00)		2,500	6,500
Total, 1, 2 and 3			$104,500

(4) Through the retention, as an asset, of the discount lost on bond issue		$2,000
(5) Through the release of liens encumbering assets:		
Cancellation of bank loans	$20,000	
Reduction of accounts payable	25,000	
" " notes payable	20,000	65,000
		$171,500

(b) Decrease of corporate wealth:

(1) Through decrease of assets:		
Investment in bonds	$25,000	
Finished goods	2,000	
Unexpired insurance	50	
Cash	3,200	$30,250
(2) Through consumption of assets by operation:		
Tools consumed by process		5,000
(3) Through amortization of intangible values-patents		2,000
(4) Through loss on machinery, resulting from sale.		1,000
(5) Through distribution of surplus earned in past periods		15,000
Total 1, 2, 3, 4 and 5		$53,250
(6) Through use of credit:		
Increase of liability for corporate bonds through issue thereof		100,000
Total decrease of corporate wealth		$153,250

(c) Net increase of wealth through reinvestment of profits of the calendar year as follows:

(1) Net profits after appropriations, i.e., net profit transferred to surplus		$8,950
(2) Appropriated out of current earnings:		
For depreciation of buildings and machinery	$10,000	
For increase of reserve for accounts received	300	10,300
		$19,250
(3) Deduct loss of surplus previously appropriated. Loss of reserve for depreciation of machinery and equipment		1,000
Net profits reinvested, to secure net increase of wealth		$18,250

In commenting on this solution which he submits on behalf of "the truth and sacredness of accounting principles" and "our beloved theory of accounting," Mr. Esquerré states:

"I beg to point out to your readers that this solution expresses a perfectly well known and eminently sound principle of business philosophy. It says that a concern obtains new wealth by:

"(1) increasing its assets,

"(2) relieving its assets of the liens which encumber them.

"It says, further, that a concern diminishes its wealth by

"(1) decreasing its assets,

"(2) using its credit,

"and it ends by saying that the net increase of wealth obtained in a period results from the net increase of assets, made possible by the reinvestment of profits, as measured by the net increase of surplus."

In regard to the heading of Mr. Esquerré's statement, it is of course a trifling matter, but the editor has had so much difficulty in impressing on the members of his various classes the importance of always showing the date of a statement or the period covered by it that he regrets the fact that Mr. Esquerré has lent the weight of his authority to the omission of this information.

An inspection of the statement shows that it consists of three main sections:

(a) Increase of corporate wealth
(b) Decrease of corporate wealth
(c) Net increase of wealth through reinvestment of profits of the calendar year.

The items which appear under the first two of these captions are said to be in accordance with a "perfectly well known and eminently sound principle of business philosophy", namely that a concern obtains new wealth by:

(1) increasing its assets,
(2) relieving its assets of the liens which encumber them,

and that a concern diminishes its wealth by:

(1) decreasing its assets,
(2) using its credit.

Before this "principle" can be allowed to enter into the company of "sacred principles," it appears to be necessary to come to an understanding as to what is meant by "corporate wealth." The natural assumption is that it means net worth, and this assumption seems to be in accord with Mr. Esquerré's use of the expression, because of the fact that the balance of the third section is called both "net increase of wealth" and "net profits," and because, in the last part of his declaration of the principle underlying the statement he states that the "net increase of wealth" . . . is "measured by the net increase of surplus."

Assuming, then, that corporate wealth is to be interpreted as net worth, and increase in corporate wealth as net profit or increase of surplus, it is pertinent to inquire whether the items appearing under the captions of increase and decrease of corporate wealth really represent increases and decreases in net worth, and hence whether the "principle" is really as "eminently sound" as is claimed.

For instance, certain fixed assets have been increased, and these increases appear in the statement as increases of corporate wealth. But does it necessarily follow that a concern has increased its wealth by merely increasing its tools, buildings and machinery? Is it not more likely that the concern has merely exchanged one asset for another, or bought the property on credit? In either of these cases it can not be said that the wealth or net worth has been increased. The application of this "principle" in a statement such as suggested would appear to be very useful, however, in instances in which corporations have received fixed assets as gifts.

Also under the caption "increase of corporate wealth" there appears the following item:

"Through the retention, as an asset, of the discount lost on the bond issue..$2,000"

That is to say, in accordance with "a perfectly well known and eminently sound principle of business philosophy" all that a company needs to do in order to increase its corporate wealth is to sell $100,000 of bonds for $98,000, and not write off the discount.

Also under the caption "increase of corporate wealth," Mr. Esquerré shows:

"Through the release of liens encumbering assets:
"Cancellation of bank loans........................$20,000."

That is to say, by paying your debts you increase your corporate wealth. Only the forgiveness of your debts would appear to accomplish that result. Mr. Esquerré's statement would be singularly useful to companies whose bank loans are cancelled by the bank without payment.

Showing decreases of assets under the caption "decrease of corporate wealth" does not appear to be based on any sounder theory, for the decrease in assets is usually accompanied by an increase in other assets or a decrease in liabilities, leaving the wealth unchanged except to the extent of any profit or loss on the transaction.

It will be noted that Mr. Esquerré shows the depreciation of tools and the amortization of patents as decreases of corporate wealth, while the provision for depreciation of building and machinery is shown as part of the net increase of wealth. As already stated, the editor is not convinced that two items of decrease in the value of fixed assets, caused by their use in operations, are essentially different in nature merely because one is computed by using a rate per cent while the other is computed by appraising the property at its depreciated value, or merely because one item of decrease is recorded by a credit to a reserve while the other is recorded by a credit to the asset account. Certainly there does not appear to be so fundamental a difference between two such items of depreciation as to make one a decrease of corporate wealth and the other a part of the net increase of corporate wealth.

Since the question of sacred principles has been raised, attention is directed to the somewhat iconoclastic attitude toward the relation of depreciation and net profits which seems to pervade Mr. Esquerré's communication. The accountants of the past generation, not without some struggle, finally obtained a general acknowledgment of the principle that depreciation is an expense and that the net profits are not net until after provision has been made for depreciation. And yet, in Mr. Esquerré's letter,

(Page 427) The profits are said to be $18,250, which is the sum of $8,250 transferred to surplus and the net increases in the depreciation and bad debt reserves.

(Page 429) The amounts credited to the depreciation and bad debt reserves are called amounts appropriated out of current earnings.

And the reserves are regarded as still a part of surplus, and not, as accountants usually regard them, a reduction of the value of the assets. This attitude toward the reserves is indicated by the following:

(Page 429) The loss on the sale of machinery sold during the year, which has been charged to the depreciation reserve, is referred to as a "loss of surplus."

(Page 429) The sum of the net profit of $8,250 and the increases in the reserves is referred to as "the net increase of surplus."

This attitude toward depreciation and bad debt reserves as still constituting a part of the surplus seems to be diametrically opposed to the theory usually accepted that such reserves represent an estimated decrease in the value of assets. Are we being asked to go back twenty, thirty or forty years to the time when depreciation was not recognized as an inevitable expense—to a time when "net profits" were computed without regard to depreciation; and when the amount of the depreciation to be "appropriated" was determined after ascertaining how much depreciation the profits of the year could bear?

Finally, the editor desires to reiterate his statement that the columns of this department are open to any contributions which will tend to the improvement of the form of the statement of application of funds; but he cannot rest gracefully in the position in which Mr. Esquerré's letter seems to place him, of being responsible for the form of the statement now in somewhat general use. The honor of evolving that statement belongs to an accountant of some previous generation. If blame attaches to any one for its defects, that blame must attach to all of us who have used the statement, recognized its limitations and yet not bestirred ourselves to improve it. The editor accepts his due proportion thereof and he recognizes that Mr. Esquerré has now done what he can to absolve himself from his portion of the general censure.