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Comments on "A Statement of Accounting Principles"

BY WILLIAM A. PATON

IN VIEW of the distinguished authorship of this statement, I was expecting a report which would be outstanding in scholarly approach, in clarity of expression, and in sound and constructive formulation. Perhaps my hopes were unwarrantedly high. In any event, my general reaction to this statement, notwithstanding its many obvious merits, is one of keen disappointment. Some of the reasons for this attitude I shall try to indicate.

In the first place, it appears from this statement that accounting as such has little or nothing to offer to the business world by way of substantive recommendations. In general, what the authors seem to be saying to business management is, "Give the problem careful consideration and then do as you think best, subject to legal limitations." Statements indicating this general position abound throughout the report. "Neither the company accountant, nor the public accountant . . . is called upon to judge and review the facts under survey, but only the manner in which the company officers are reporting those facts . . . " (p. 4). "Whether such gains or losses should be wholly included . . . wholly excluded . . . or apportioned . . . is a matter to be determined by *sound business management* * . . . when *sound business management* * dictates . . . it is proper to carry it . . . unless and until *sound business management* * dictates . . . " (all from two consecutive sentences in comments on capital gains and losses, pp. 38–39). "This decision may be left to competent management . . . " (p. 42). "If the management wishes to go further . . . this should be regarded as well within its province" (p. 43). "The statutes and judicial decisions have, in general, left to . . . sound business judgment . . . " (p. 46). "Within the limits of the several statutes, the amount to be credited to capital stock is a matter for the determination of the management." Such abnegation, such subservience, is discouraging to any one who would like to see the accountant enhance his professional standing by formulating and expressing his seasoned

* Italics are mine.

convictions clearly and courageously; it is, moreover, quite unnecessary in view of the position already achieved by the accountant as a counselor upon whom business managements (and business lawyers) may depend for *positive* and constructive advice.

Depreciation

In the second place, as might be expected in the light of the foregoing, the treatment of a number of important topics is feeble, and lacking in consistency and clarity. Take, for example, the discussion of depreciation in relation to the income statement on pages 31–34. The authors state, as would most accountants, that replacement cost is a "less desirable base for computing depreciation than the known original cost," but the only excuse offered for this stand is the "uncertainty of any estimate of replacement cost." This question is so important, so unsettled, and so complex, that it deserves at least a page or two (out of 138) in which are carefully outlined the principal conceptions and considerations, including at least mention of the problem of defining actual cost in the face of changing money values. A bare statement of position without the trivial comment made, would be better. Allocation of depreciation is dismissed by referring to the reducing-balance method, a wholly arbitrary and generally useless device, as the alternative to straight-line depreciation. No mention is made of a really important alternative, the output or service approach, and the unsettled question of the modification of the depreciation charge in terms of business expansion and recession. And can this be the Professor Hatfield of "What they say about depreciation" * who says that it is satisfactory to arrange the income statement either "with depreciation expense definitely included in operating expense" or "with depreciation not so treated"! Or who says that "the maintenance of original investment, by adequate charges against earnings is the principal means by which the physical plant itself is kept in up-to-date operating condition"! Most accountants and most corporate managements have finally decided that a reasonable charge for depreciation is an unquestioned operating expense, and should be so reported. Why, then, this discouraging ambiguity and pussyfooting? Too, many people feel that the

* The Accounting Review, March, 1936, pp. 18–25.

booking of depreciation regularly has much less to do with the physical condition of plant than the volume of revenues, the conditions of use, the plans for the future, competing demands for funds, and other factors.

Maintenance

The discussion of the related question of maintenance charges (pp. 34–36) contains this surprising statement: "Broadly speaking, a plant should be maintained out of revenue in a state of efficiency corresponding to the normal progress of the manufacturing arts in that industry. Whether the charge be carried through the maintenance or the depreciation accounts is secondary." This represents endorsement of an old theory which I had supposed was long ago exploded, at least in the industrial field. It is, moreover, quite inconsistent with other statements by the authors. To accept this doctrine is tantamount to insisting that the recorded plant assets of a company should neither be expanded nor contracted, even though completely replaced at higher or lower prices, provided the condition of the plant is kept precisely on the level of the normal progress in the industry. The statement also clearly implies acceptance of the fallacy that the integrity of plant capital is almost automatically maintained by taking care to insure a proper scale of charges to revenue.

Gross Profit

It is less surprising, but nevertheless disappointing, to find our old friend, "gross profit," accepted as a fundamental element of the general income statement (I grant it some significance in departmental accounting), particularly in view of the tendency evidenced in recent years by many important corporations, and some prominent trade associations, in the direction of the elimination of this definitely misleading balance. With the exception of a few cost men, accountants have been slow to recognize the fact that all costs of production (or operation, in the broad sense), including administration and distribution charges, are on substantially the same level in their relation to revenue, that no type or class of cost is in a preferential position with respect to recovery from customers or in any other vital connection. And it follows that it is poor reporting—no matter how common—to

strike a balance and give it a prominent position with the term "profit" attached, when only a limited portion of the total of the unquestioned costs applicable to revenues has been deducted. In the face of the complex array of business enterprises of the present day, trying to preserve—as a fundamental element of the income statement—the shadowy line between "cost of goods sold" and other bona fide costs of operation is one of the most unfortunate chores attempted by the accountant. Incidentally, the vagueness is illustrated here in that the authors on page 33 show a computation where "gross operating profit" is determined by deducting "costs of sales and other operating expenses including depreciation," while on page 36 they define gross profit in the trading field, for example, as the difference between "gross revenues" and the "purchase invoice cost of the merchandise plus freight."

Inventory

On page 16 the authors quote, with apparent approval, the following statement from Arthur Andersen: "The practice of equalizing earnings is directly contrary to recognized accounting principles." But on page 43 (and elsewhere) they go out of their way to support a European practice, the base-stock inventory method, which was strongly urged on the Treasury Department by three or four corporations in 1918–1919, and has been vigorously revived and sponsored in recent years under the "last in, first out" label, which represents nothing more nor less than a major device for equalizing earnings, to avoid showing in the periodic reports the severe fluctuations which are inherent in certain business fields. Here is a truly serious matter. The very essence of the stand of the professional accountant is the maintenance of the integrity of the periodic statements. And are we going to foster, through a supposedly well considered statement of fundamental principles, specious devices designed to nullify the best efforts of the accountant to develop the art of periodic reporting on a significant basis? Actually, we do have good years and bad years in business, fat years and lean years. There is nothing imaginary about this condition—particularly in the extractive and converting fields, where this agitation centers. Like the authors, I do not favor "a narrow adherence to the conditions and figures for the one year"; like the authors, I strongly

feel the necessity for "recognition of the fact that the year is simply a chapter in the company's history." But acceptance of these propositions should lead to a stress upon the importance of comparative statements, cumulative statements, and average statements as accompanying background for annual reports, not to support of a statistical method for destroying the integrity of the periodic statement itself. It may be that in some situations the year is too short a period through which to attempt to determine net income (as surely the month and quarter often are), but if this is the case, the solution lies not in doctoring the annual report, but in lengthening the period. Certainly it is not good accounting to issue reports for a copper company, for example, which make it appear that the concern has the comparative stability of earning power of the American Telephone and Telegraph Co.

Terminology

In the third place (page Professor Hatfield) the authors have not been sufficiently careful in their use of terms. At one point, expenses are a charge against "income," at another a charge to "earnings," at another a charge to "revenue," at still another a charge to "gross revenue." In this connection, I cannot forbear referring again to the partial income statements shown on pages 33–34 to illustrate a variation in the method of reporting the depreciation charge. The arrangements presented and the terms employed are highly inconsistent (aside from the question of depreciation). Why "net sales" in one and "net sales billed" in the other (not a serious matter to be sure)? Why "cost of sales" in one and plain "cost" in the other? Why "other operating expenses" in one and "expenses and all charges" in the other? Why "gross operating profit" in one and "net income from sales" in the other? The excuse, I suppose, is found in the statement to the effect that the arrangements are taken from published reports. But in view of the fact that the examples are artificial with respect to figures and general appearance, they will be confusing and misleading, especially to young readers looking for the true gospel.

Another very unsatisfactory feature of the report is the treatment of "the principle of conservatism." Being a good Scot, I am all for conservatism, but I see no reason why conservatism shouldn't be clear-cut, straightforward, consistent, even logical.

The worship of an idea or procedure *merely* because of its age, or because it represents tradition, is not identical with sound conservatism. It would not be conservative in any field of mechanics, for example, to insist on carrying out a time-honored method which had been demonstrated to be inferior to a newer method. It would not be conservative today to insist that the sun revolves around the earth (although men have so insisted throughout most of their history). It was not conservative, just a few years ago, for the medical "profession" to scoff at and persecute Joseph Lister for his emphasis upon the demonstrated value of disinfection and antisepsis. In other words, conservatism, in accounting or elsewhere, is not standpattism, is not a determined allegiance to prevailing practices, regardless of their merits.

Conservatism

The authors support—not without some hesitation—the general doctrine that minimizing asset values in "recognized" ways is conservative and hence sound. That this position is unjustified in theory or practice has been demonstrated again and again. Asset valuation is a two-edged process. From an immediate balance-sheet standpoint, the understatement of assets is reflected in a reduced net worth. This has a flavor of conservatism, although it does not follow that the resulting balance-sheet is a good report. From the standpoint of succeeding income statements, on the other hand, the understatement of assets (of the cost type) very definitely and literally brings about a decrease in reported operating expenses and a corresponding increase in net —a result to which no vestige of conventional conservatism attaches. Indeed, as every accountant knows, the favored method of padding the profits of future periods is that of the extraordinary write-off of inventories or plant costs—a fact which helps to explain the ready acceptance by many managements of the so-called conservative devices of the accountant.

An outstanding example of unsound and nonconservative practice masquerading under the guise of sainted conservatism is the "cost or market, whichever is the lower" rule of inventory valuation. (This has been very effectively demonstrated by no other than Professor Hatfield, one of the authors of this report.) This practice, imported from Europe, did not make marked headway in this country until the advent of the Federal income-

tax program. Originally, in fact, it was not officially recognized as a sound practice by the United States Treasury Department. The early American enthusiasm for the device—among trade associations, business managements, and corporate accountants—was not a tribute to the merits of the scheme as a worthwhile accounting mechanism, designed "by accountants of larger mold" for the purpose of emphasizing "the broader aspects" and "indicating the unfavorable possibilities" of the future, but as an immediate method of reducing taxable income. (And some concerns paid heavily for making the shift just before a higher level of tax rates appeared.) In other words, the wide use of the rule in the United States is not as time-honored as many think, and it waxed on account of considerations far removed from the development of sound accounting.

The authors state that the rule was devised "as an aid to prudent business management and for the protection of investors, and not for tax purposes." As a matter of fact, no one knows the precise conditions and purposes associated with the initial formulation and use of the rule, but we do know the circumstances under which it first gained wide acceptance in this country.

Objections to "Cost or Market"

No writer has ever been able to find a single definite point supporting the proposition that "cost or market, whichever is the lower" is a sound accounting rule, while the array of clear-cut objections is overwhelming. In general, the recognized concepts and procedures of accounting are entirely out of harmony with this device; by implication it is constantly under the fire of the professional accountant himself. Briefly the objections are as follows:

1. Consistency is one of the three or four most emphasized characteristics of sound accounting procedure, and yet in this rule inconsistency is made a virtue. With no apparent realization of the humor involved, the authors state that "the accountant should apply this rule reasonably and consistently."

2. The rule assumes that current market values are important to the creditor, proprietor, or manager, *only* when they happen to be less than costs, and particular recorded costs—a most amazing assumption. Actually the business world is vitally concerned

with market values at all times, whatever their relation to recorded values; it is simply impossible to deny this obvious fact of everyday business experience.

3. The rule is not conservative, in that it is satisfied if the resulting inventory value is *barely* below recorded cost, and thus fails to take account of the possible consequences of a sharp downward trend in effect at the inventory date.

4. The rule is not conservative, in that the understatement (as compared with cost) of operating net in the current period is matched by *overstatement* in the following period or periods.

5. It is definitely in conflict with the theory that, for the typical concern, revenues should be measured by the volume of completed sales of goods or services; inventories must be taken at recorded cost to give effect to this principle in the amount of operating net.

6. It represents the acme of inconvenience and expense in inventory procedure. If literally applied (as the Bureau of Internal Revenue, for example, ostensibly requires), it means the computation of the actual cost of the inventory, item by item, class by class, and the estimate of market value (usually replacement cost) of each and every component element. In the case of work in process, for example, the complete application of "market" to the factor of overhead would presumably require the making of a special estimate of depreciation cost, maintenance cost, etc., on a replacement-cost basis—a very considerable task.

7. In practice, as need not be surprising, the rule is often employed with the utmost crudity, and there is a wide variation in the interpretation given the rule by different concerns. In fact, it is precisely this sort of device which encourages arbitrary estimate and variable policy.

8. Like the New Deal, the rule does not represent a distinct and straightforward policy. Instead it opens the door to the use of cost inventories in one period, a shift to market values in the next, and so on. This is the very antithesis of sound accounting.

9. It impairs the value of comparative income statements for the business as a whole or for particular departments through the distortion of the figures for cost of sales and operating net. In extreme cases the distortion may be so serious as to throw the

curve of net completely out of line with the course of gross sales. (See example below.)

10. If literally applied to inventories in connection with monthly and quarterly reports, it will on occasion force recognition of profits not realized by sale. This occurs when goods which have been marked down sharply appear in a later inventory following a partial recovery in prices. (I realize, of course, that accountants have a special way of defining "cost or market" designed to meet this objection, but it remains a weakness of the method as conceived and stated.)

11. It shifts the emphasis from the records of actual cost—the recognized foundation of all accounts—to the field of estimate and conjecture.

12. After all these years there is much confusion and difference of opinion with respect to the meaning of the rule and its detailed application. Witness the recent activities of the Institute's committee on inventories!

Undoubtedly, the most serious of the objections to "cost or market" is the juggling of the income account which results from its application. For example, assume that the data of merchandise cost, sales, and inventory for the M Co. for the first three periods of operation are as follows:

	1st Period	*2nd Period*	*3rd Period*
Purchases	$100,000	$ 40,000	$ 45,000
Sales	80,000	60,000	100,000
Inventory—cost	60,000	70,000	65,000
Inventory—market	40,000	75,000	50,000

Using cost values consistently, the operating incomes for the company (ignoring costs other than merchandise) are determined as follows:

	1st Period	*2nd Period*	*3rd Period*
Opening inventory		$ 60,000	$ 70,000
Purchases	$100,000	40,000	45,000
	$100,000	$100,000	$115,000
Closing inventory	60,000	70,000	65,000
Cost of sales	$ 40,000	$ 30,000	$ 50,000
Sales	80,000	60,000	100,000
Operating income	$ 40,000	$ 30,000	$ 50,000

With this inventory treatment, the operating income moves with the sales figure; as sales fall, the operating margin contracts, and as the volume of business increases, the margin expands. The showing of the operating account, in other words, is what might reasonably be expected in view of the course of the primary activity of the business, aside from the possibility of changes in the relation of buying and selling prices.

Applying the so-called conservative basis of pricing to these data results as follows:

	1st Period	*2nd Period*	*3rd Period*
Opening inventory...		$ 40,000	$ 70,000
Purchases...........	$100,000	40,000	45,000
	$100,000	$ 80,000	$115,000
Closing inventory....	40,000	70,000	50,000
Cost of sales........	$ 60,000	$ 10,000	$ 65,000
Sales................	80,000	60,000	100,000
Operating income....	$ 20,000	$ 50,000	$ 35,000

Under this treatment, the distribution of operating net shows no relation to the movement of sales. In the second period, with a 25 per cent. decline in the volume of business, income shows an increase of 250 per cent., and in the third period, with a 66⅔ per cent. increase in sales over the figure for the preceding period, there is a fall in net of 30 per cent. Granting that this is a purely hypothetical example, it can still be insisted that in actual practice the use of cost or market, whichever is lower, in pricing inventories often results in such distortion of comparative figures as to make the reports in which they are incorporated definitely misleading.

In view of these objections—all of which have been stated before in one form or another—it is most discouraging to have a halo placed over "cost or market" by Mr. George O. May, an outstanding practising accountant, by putting this rule in a class with the virtue of "laying down one's life for another" (THE JOURNAL OF ACCOUNTANCY, December, 1937). And it makes one fear for the future of accounting as a learned profession to read the uncritical comments on this subject in *A Statement of Account-*

ing Principles produced by such outstanding teachers and writers as Professors Hatfield, Moore, and Sanders.

Finally, there are an annoying number of cases where the authors of the report just miss doing a good job. For example, they admit that, when bonds are issued at a discount, "a contra item is involved," but are willing to permit the amount of the contra to be amalgamated with the actual cost of raising capital on the asset side of the balance-sheet. Then they list "prepaid interest" as an asset, in the same pew with genuine prepayments, although there is no such animal, unless one is using this label to describe bond or note discount. The proper treatment of treasury stock is recommended, and then the punch is taken out of the recommendation by the remark that "some circumstances seem to require, or at least to justify, its treatment as an asset." And the reader is given no intimation as to what these mysterious circumstances are. Throughout the report, the obvious tendency of the authors is to surround each proposition with hedging observations. The general flavor is decidedly suggestive of the certificate of the accountant who is manifestly trying to avoid all responsibility, and who thus gives the careful reader the impression either that he knows nothing about the concern in question or is too timid to express a definite opinion.

The report does not, in my judgment, represent a coherent, clear-cut statement of the underlying principles of accounting. The ideas expressed are not drawn together in any logical fashion. No distinction is made between fundamental concepts and assumptions (for example, the proposition that revenue is realizable only through sales) and minor rules and conventions (for example, the proposition—incidentally, of doubtful propriety—that the preferable method of reporting notes receivable discounted is to show the full amount as both asset and liability). A number of important problems of accounting theory (for example, the question of the significance of estimated interest on capital employed) are entirely neglected. Much of the report is devoted to very commonplace observations suggestive of a sketchy text on auditing procedure (this is true particularly of part III, pp. 55–97), of which we are already inflicted with a large number. Moreover, reasons are seldom given for such conclusions as are reached. It follows that any student, any accountant, or governmental body turning to this report with the hope

of obtaining real explanation and positive judgment with respect to the truly knotty problems underlying accounts and financial statements will usually be disappointed.

Desirability of Discussion

I am making these comments on the basis of the assumption that the report is presented by the committee as a more or less tentative formulation, and not as the final word on the subject, and that free discussion and criticism by the profession is welcomed. I am also assuming that the most useful form of comment is not the conventional praise—or damning with faint praise—of the typical book review, or a listing of the mass of points made by the committee with which we can all agree, but a forthright statement of objections. I trust that my good friends Professors Hatfield and Sanders (I haven't the pleasure of Professor Moore's acquaintance) will accept these criticisms on the basis of these assumptions, and as coming from one who, like themselves, considers the sound progress of accounting a matter of the utmost importance.