Journal of Accountancy

Volume 69 | Issue 1 Article 3

1-1940

Valuation or Historical Cost: Some Recent Developments

George O. May

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
May, George O. (1940) "Valuation or Historical Cost: Some Recent Developments," *Journal of Accountancy*: Vol. 69: Iss. 1, Article 3.
Available at: https://egrove.olemiss.edu/jofa/vol69/iss1/3

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Valuation or Historical Cost: Some Recent Developments

By George O. May

At the outset let me say how much I welcome the opportunity of participating in this conference, which brings together students of accounting, including both teachers and practitioners. During the past year a large part of my time has been devoted to the work of the committee on accounting procedure of the American Institute of Accountants, and that work has brought me into closer contact than heretofore with teachers of accounting, some of whom are probably here today. I have been interested to find that though differences of opinion naturally arose in the committee, there was not a single occasion on which the line of divergence was between those who teach and those who practise accounting. Some of you may have noted that two teachers of accounting dissented from one of the pronouncements of the committee. It may, therefore, be well to mention that they dissented for exactly opposite reasons, one thinking that the committee had gone too far, and the other, that it had not gone far enough.

I have been asked to discuss developments in relation to the use in accounts of valuation and historical cost respectively. In preparing to do so I have naturally turned not only to the work of the committee of the Institute, but to the activities of the Securities and Exchange Commission and developments in the field of income taxation, both of which, of course, are constantly affecting accounting procedure. Recently, also, as a director of the National Bureau of Economic Research I have been disturbed to find an apparently widespread misapprehension on the part of economists (shared, perhaps, by some few accountants) as to the nature of the balance-sheet. I see great value in a closer mutual understanding between economists and accountants; and, therefore, at the risk of seeming to flog a dead horse, I shall restate some of the reasons why balance-sheets are not, and should not be, purely statements of values, but are to a considerable extent based on cost.

First, may I say a word about the work of the committee on accounting procedure. At an early stage, the committee considered the question of the nature of accounting rules or principles. On this question there are differences of opinion similar to those which have long existed in the field of law. The basic issue is the extent to which accounting (or legal) rules are to be deduced from broad generalizations deemed to be of permanent force; how far they are to be derived inductively from consideration of specific cases, and how far they should be regarded as properly responsive to economic and social change. Upon this issue the committee reached a decision which is embodied in its first bulletin in the following language:

"The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the stand-

Note.—An address delivered before the Michigan Accounting Conference, November 10 and 11, 1939, at Ann Arbor, Mich., and reprinted from *Michigan Business Papers No. 6* by special permission.

point of society as a whole—not from that of any one group of interested parties.

"The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet such changes as they occur."

The committee in taking this position followed, I believe, in its humbler sphere the mode of thought accepted by such jurists as Holmes and Cardozo in the field of law. In his address last month to the Controllers Institute,[1] Chairman Frank, of the Securities and Exchange Commission, commended to accountants the classic statement of Holmes: "The life of the law has not been logic; it has been experience." Cardozo, in *The Nature of the Judicial Process*, quotes and concurs in this statement. He says, also:

"The common law does not work from pre-established truths of universal and inflexible validity to conclusions derived from them deductively. Its method is inductive, and it draws its generalizations from particulars."

Cardozo not only distrusts generalizations but also recognizes that some of them may conflict with others having equal validity. He goes on to discuss three great directive forces of our law: logic or philosophy, history, and custom, and concludes: "Finally, when the social needs demand one settlement rather than another, there are times when we must bend symmetry, ignore history, and sacrifice custom in the pursuit of other and larger ends." We face the same problems in accounting, and our committee is trying to solve them in the same spirit.

In a day when accountants are being criticized for the lack of certainty in accounts, we may perhaps find comfort in the statement of this great jurist in regard to his own experience: "I was much troubled in spirit in my first years upon the bench to find how trackless was the ocean on which I had embarked; I sought for certainty; I was oppressed and disheartened when I found that the quest for it was futile . . . As the years have gone by and as I have reflected more on the nature of the judicial process I have become reconciled to the uncertainty, because I have grown to see it as inevitable."

Another question which the committee on accounting procedure was called upon to consider is also touched upon in Chairman Frank's address. It grows out of the facts that accounting is necessarily in large part conventional, that accounts are required for many different purposes, and that the same conventions are not equally appropriate for all the different purposes for which accounts are required. In the past, the Commission, or some of its members, have at times been unwilling to agree that an accounting treatment conceded to be proper for one purpose was not equally appropriate for all others which lay within the field of what we may call general financial accounting. For instance, a difference between a depreciation charge shown in a report to the Commission and the depreciation claimed on an income-tax return has been regarded as calling for explanation, if not for a restatement, of one or the other account.

The present chairman of the Commission himself raises the question whether "general purpose" accounts are adequate to meet all the different purposes for which accounts are required, or whether it may be desirable for the Commission to call for "special purpose" accounts to meet the particular needs of the public interest which it is called upon to protect. The chairman makes it clear that that interest means primarily the interest of the investor who contemplates buying or selling stocks on the market. He expresses the

[1] Reprinted in November, 1939, THE JOURNAL OF ACCOUNTANCY.

opinion that the account of primary importance is the income account, and that the primary usefulness of that account is not historical but the light which it throws upon expected earnings in the future. It should be said that the Commissioner was at pains to make it clear that he was deliberately overstating the case for the purpose of emphasizing the problems which in his view require solving.

The committee on accounting procedure in its first bulletin had recognized the change of emphasis from the balance-sheet to the income account, and from the long-time investor to the investor who is always on the alert to buy or sell. "Problems," it said, "have come to be considered more from the standpoint of the current buyer or seller in the market of an interest in the enterprise than from the standpoint of a continuing owner." The question whether the needs of such persons should be met by special-purpose accounts is one to which the committee will no doubt give careful consideration. Such a solution may be preferable to the alternative of allowing the form and content of general-purpose accounts to be unduly influenced by the needs of buyers or sellers in a market. The corporations whose securities are listed on any exchange number less than 3,000 out of the several hundred thousand corporations which make income-tax returns; and if we exclude railroads and other utilities, the proportion of the industry of the country owned by listed companies is not, I think, as large as is sometimes suggested.

Although the committee on accounting procedure decided to proceed inductively in the consideration of specific questions, certain major problems immediately emerged from its studies. It became clear that many of the difficulties and uncertainties of accounting are due to the fact that in the balance-sheet two different principles are being applied—that of historical cost and that of valuation—and that at least two different principles are employed in the preparation of the income account: (1) that of accrual, under which come broadly not only the treatment of interest, rents, and taxes, but also provisions for depreciation, amortization, etc.; and (2) that of the completed transaction (which determines when income from sales, for instance, is brought into account); and, finally, that the balance-sheet and income account have in some way to be tied together.

The use of the different principles is born of necessity and it is therefore inescapable. It is, however, one of the major problems of the profession, I think, to make clear why different principles are employed and in what circumstances each is properly applicable. I think, also, we should strive to secure a better integration of the balance-sheet and the income account.

The question of the use of historical cost and valuation is, you will see, a phase of one of the major problems which I have enumerated. In discussing it I am going to make a departure from the usual terminology which may, I hope, tend towards clarification.

In an address to the American Institute of Accountants at Boston in 1935, I quoted Oscar Wilde's definition of a cynic as a man who knew the price of everything and the value of nothing. We accountants are, I am afraid, in the position of the cynics—we know, or can find out, something about prices; we are less able to determine values.

In common usage (I am not attempting to talk the language of the economists) a price is the amount of money for which something can be bought or sold. It may be a buying price or a selling price; it may or may not coincide with value. An event having no bearing on the value of a share of capital stock may affect the market price of that stock 5 per cent or 10 per cent in an hour. In this discussion I propose to

talk of the *prices* at which inventories are taken rather than the amounts at which they are valued.

It is not necessary for me to attempt to set forth in detail for this audience the bases on which different assets are commonly stated in the balance-sheets of going corporations. During the year, however, a development occurred which is of substantial importance in itself and also significant in its bearing on the use of historical cost or valuation in the balance-sheet. In the revenue act of 1939, Congress authorized employment of the "last-in, first-out" method of inventorying. The outbreak of war and the resulting rise in prices make it probable that this method will be availed of to a greater extent than would otherwise have been expected. Before proceeding to discuss it I draw your attention to the fact that the right to adopt this method is conditioned in the act on the employment of no other method by the corporation in any other accounting report. This provision seems to indicate a Congressional point of view sharply different from that of the chairman of the Securities and Exchange Commission to which I have already referred.

If this language were interpreted literally, the development would be of very great significance, because it would mean that every corporation adopting it would be required to carry its inventory at cost determined on the "last-in, first-out" basis, even if that cost were in excess of market. However, the report of the Senate committee on the bill seems to make it clear that Congress did not intend to prohibit the continued use of the time-honored, if illogical, method of carrying inventory in the balance-sheet at cost or market, whichever is lower.

I propose to consider the new method, first, from the standpoint of the income account, and particularly of the income account as a guide to prospective earning capacity.

The great merit of the "last-in, first-out" method is that it tends to flatten out the curve of earnings in periods during which prices successively rise and fall. Most accountants would, I think, agree that to this extent it is meritorious. Whether it results in a more accurate reflection of income is, however, open to question. It may do so in the case of merchandising companies which keep relatively stable stocks and purchase replacement as goods are sold. If the corporation has on hand an article for which it paid $10, sells it for $20 and immediately purchases a similar item for $15, it is perhaps proper and conservative to regard the gross profit realized as being $5 instead of $10.

Similar considerations apply in the case of corporations which habitually carry large stocks of substantially identical raw materials for use in manufacturing processes, but in this case the basic-stock method is, perhaps, more appropriate and more effective than the "last-in, first-out" method. However, in the case of corporations which, when they make a sale contract, as a rule contract also for the raw materials necessary for its performance, the appropriateness of the method is less apparent; indeed, in such cases, where the last goods received are high-priced raw materials which have been acquired in connection with high-priced sales contracts on which deliveries have not yet been made, the employment of this method will result in understatement of income.

The Treasury regulations to give effect to the new rule have not yet been issued, but I was interested to observe in a recent article on the revenue act of 1939 the statement that in discussions between interested taxpayers and the Treasury one point raised was that purchase and sale commitments should be included in inventory determined on a "last-in, first-out" basis when they are necessary to balance accurately

current costs against current sales.

If this principle is adopted in the regulations, the case which I have just mentioned would presumably be one to which it would be applied. It must be recognized that the line between inventory and commitments is often a narrow one, and the question of disclosure of commitments is one which will, I believe, call for more consideration in the near future than it has received in the past—particularly if emphasis is to be placed on the use of accounts for the purpose of foreshadowing the profits of the immediate future. One great difficulty is, of course, that frequently what are called sales contracts are, in practical effect, no more than buyers' options, and will not be enforced if the market falls.

Turning, now, to consideration of the method as it affects the balance-sheet, if the last goods purchased are deemed to be the first used or sold, the figure carried forward in the inventory will, of course, reflect the cost of earlier purchases, and as time passes the inventory will come to reflect a price level of an increasingly remote period.

The possible effects may be illustrated by considering the case of a company formed to take over a previously existing business and acquiring an inventory at current costs at the date of its formation. So long as the volume of sales and inventory remain approximately the same, the inventory to which the "last-in, first-out" rule is applied will continue to be carried substantially at the price level existing at the formation of the company. Only to the extent that the inventory increases will it be carried at a price level of a later date. If you study the fluctuation of price levels of a period in the past, it is easy to see how crucially important may be the date of initiation of the inventory practice. For instance, if we assume a rubber company to have been formed and to have applied the "last-in, first-out" rule from its formation, and further assume for the sake of simplicity that its inventory today is the same in quantity as at the date of its formation, we find that that inventory would be carried at something in the neighborhood of 10 cents a pound if the company were formed in 1930; 6 cents a pound if it were formed in either 1931 or 1933; 3½ cents a pound if it were formed in 1932, and 13 cents if it were formed in 1934.

It is apparent that this constitutes a striking extension of historical principle in inventory valuation. It is apparent, also, that unless accompanied by explanations, the inventory figure will have a far less definite significance than an inventory taken at cost on the "first-in, first-out" basis.

This brings up the question which has been raised in the past in the case of those companies which employ the basic stock method or the "last-in, first-out" method, whether the value of the inventory at replacement prices should not be indicated on the balance-sheet. Those who still look on the balance-sheet as of substantial, if not primary, importance will certainly make such a demand, and some, whose interest is mainly in the income account, will urge that the information should be given so that those who desire to do so may restate the accounts on the "first-in, first-out" basis which in the past has been the prevailing one. It may be answered that the value of the business is determined by its income; that the income is best measured on the basis of the most recent costs, and that the replacement value of an inventory which must be substantially maintained so long as the business is conducted has no more practical bearing on the value of the business than the replacement value of the plant itself. It seems likely, however, that the demand for some supplementary information will prevail.

Where companies which in the past have employed another method of determining cost now adopt the "last-in,

first-out" method, the auditor has an interesting question to consider in regard to that part of the certificate which states whether accounting principles have been consistently maintained. The common practice, where any substantial change in the method of application of a general principle has taken place, as in this case, is to indicate whether the results shown for the year have been appreciably affected, and if so, to what (approximate) extent.

Obviously, the effect can be measured in one of two ways—either by considering what would be the result if the inventory at the beginning were placed on the same footing as that at the end of the year, or by measuring the difference between the results of applying the two methods respectively to the closing inventory. Seeing that prices near the first of January, 1939, were relatively stable, and that there has been a considerable rise in prices during the latter part of this year, the difference shown by making the change as at the first of the year will as a rule be much smaller than the difference between the results of applying the two methods of pricing at the close of the year. It seems to me that provided the method of computation is clearly disclosed, that which results in the smaller figure is to be preferred, since there are sure to be some wishful thinkers who will add this difference to the profits shown for the year to arrive at the earnings of the company.

Having now discussed the direct significance of this development and some of the problems to which it gives rise, I propose, next, to consider an important implication to be drawn from it. If it is in conformity with good accounting principles that inventories should be taken at the prices paid for *similar* goods at various times in the perhaps distant past, *a fortiori* it must be in conformity with the requirements of good accounting that fixed assets should be carried at the prices paid for the *actual* property at various times in the past. Thus, the adoption of the "last-in, first-out" method for inventories lends strong support to the use of the historical-cost basis for fixed properties.

I turn, now, to the suggestion sometimes made that balance-sheets should reflect current values, and to the belief sometimes entertained that they do. In my judgment, the reasons why balance-sheets do not and should not attempt to reflect values of fixed assets are, first, that it is impracticable for them to do so, and, second, that such values are irrelevant. The most plausible argument for making the attempt is that the information would be valuable to the person who is contemplating buying or selling capital stock of a corporation, and I shall, therefore, consider the question from the standpoint of such a person.

It is a common error to assume that valuation is practicable because it is possible to compute the cost of replacement and to make an estimate of accrued depreciation. This assumption, however, begs the main question. I would ask each one of you to consider in regard to the plants of his clients whether if they did not exist as they are, where they are, and under the management which controls them, it would be economically wise to create them substantially as they are, where they are, and under that management. In any case in which you cannot confidently answer "yes" to that question, the replacement cost, less depreciation of the property, is not a measure of its value.

In the second place, the value, if ascertained, would be irrelevant. What the investor is interested in is the value of the enterprise in which he is acquiring an interest as a whole; and the cases in which the value of the enterprise would even approximate the figure arrived at by valuing the assets separately and deducting the liabilities, is negligible. If the enterprise is profitable, its value will

be determined mainly by consideration of its earning capacity and the probability of that earning capacity being maintained.

In computing this value, one factor may be the investment which any competitor in the business would have to make in order to be in a position to secure a part of the business of the corporation. But the figure that is significant for this purpose is not the cost of replacement of the property which the corporation has, but the probable cost of installation of equipment which would best serve the same purpose. From this standpoint, therefore, the cost of replacement of the existing plant is irrelevant.

If, on the contrary, the enterprise is unprofitable, its value depends mainly on two factors: first, the liquidating value of the assets, and, second, the degree of probability that liquidation will take place. The latter factor is often overlooked. I once read—I forget where—that a distinguishing characteristic of the bourgeois mind is an unwillingness to cut losses, and all of us who have had any extended experience can recall many cases in which assets have been dissipated in unprofitable operation for years before a management was found wise enough to throw up the sponge.

The point at which replacement price might conceivably be relevant is when the charge against gross income for exhaustion of property is being determined. I am convinced that the weight of argument is in favor of the charge against income for depreciation and depletion on the basis of historical cost as against the alternative of computing them on the basis of current replacement prices. Nevertheless, I should be willing to concede that there is a more plausible argument for the use of replacement prices to measure the charge against income than there is for using these prices as a basis for carrying the assets in the balance-sheet.

If the view is accepted that the primary purpose of the accounts of a corporation is to throw light on the reasonableness of the prices at which its securities are quoted on the market (which may be said to be the objective stated by Chairman Frank, translated into severely practical terms), it may be questioned whether replacement cost is, in theory, even the second choice. The significant figure to the investor is the effective cost of the property to him. I can best illustrate what I mean by taking the simplified case of a mining company whose mine stands on its books at exactly the same figure as its capital stock, its other assets and its liabilities being exactly equal. If the par value of the stock is $1,000,000, represented by 100,000 shares of $10 each, then the corporation as such will provide for depletion on the basis of a cost of $1,000,000. Assuming that 5 per cent of the ore is exhausted in one year, then the corporation will make a depletion charge of $50,000, or 50 cents a share. If, however, an investor buys stock in the mine at $50 a share, he must treat an additional $2 a share out of dividends which he receives as being a return of capital to him—in other words, his true income must be based on recognition of the fact that the effective cost of his interest in the mine to him is $50 per share, not $10. This principle is, as you all know, universally recognized and applied in the common case of iron mining companies, the whole of whose stocks has been acquired at a premium by steel companies. In this simple case the principle is not only clearly sound but easy of application. In more complex situations it will be impracticable of application but none the less valid in theory.

Examination of the balance-sheets of corporations and the market prices of their stocks will, however, show clearly that in many cases the effective cost figure will vary very greatly from the replacement cost of the corporation's

property. Sometimes, depreciation based on replacement cost of a plant would actually exceed depreciation on cost because of increase in construction costs, but depreciation based on effective cost to the stockholder would be the lowest of the three because the property is not worth replacing.

Before leaving this subject let me say that inventories of plant and equipment and estimates of the replacement costs thereof have varied and important uses in corporation practice, but employment as a basis for readjustment of capital assets in the balance-sheet is not one of them. I may say of them as I have often said of accounts, that their great usefulness should be recognized, but that it is wholly mischievous that the usefulness should be exaggerated or the limitations on the significance of the information be ignored.

I am convinced that the case for carrying fixed assets of corporations in general on the basis of historical cost, less depreciation, is well established, and that no more satisfactory alternative has yet been put forward. I believe that this conclusion will be reached whether the question be approached by the method of philosophy, the method of history, or the method of sociology—the three methods of approach considered by Cardozo in his study of the judicial process to which I have referred. In practice, the application of the method is sometimes defective, and special cases occasionally arise in which a departure from the method may be warranted, but improvement is, I think, to be sought in dealing with these minor phases of the problem rather than in attempting to make any change in the basic concept. We all know of cases in which historical cost is measured by the par value of stock issued, although that stock is not now and perhaps never was either worth or selling for the par value. The remedy is not to abandon the use of historical cost, but to encourage and perhaps in some cases force a readjustment of both par values and carrying figures for property to bring both into closer relation with reality.