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The Need for Single-Purpose Statements

BY VICTOR Z. BRINK

THE events of recent years have served to bring accounting into a position of prominence in an unprecedented manner. The development of the corporate system has made possible the modern large-scale enterprise with its more complex management problems and greater dependence upon accounting data. At the same time the development of our corporate system has through the issue of securities in small units brought into existence large and ever-expanding groups of the holders of these credit and ownership instruments. Under such circumstances these latter groups have found that they needed information about the enterprises in which they were investing, and the pressures originating because of these needs have exerted—and continue to exert—great influence upon the methods and practices of accountancy.¹

The recognition of the needs of the new groups of security holders and of the individuals considering investment have led to the enactment of much protective legislation. The enactment of this legislation and the administration of it has served to focus attention on the accounting aspects of corporate operation as never before. More recently the disclosure of the McKesson-Robbins irregularities has provided the impetus to a critical and analytical review of the services of accounting by the public in general and within the profession of accountancy itself.

The review and critical appraisal of accounting concepts and practices thus engendered has perhaps assumed greater

proportions because the great majority of those outside the accounting world hold erroneous views regarding the nature and meaning of accounting data. Most laymen, for example, believe that accounting results are based upon universally accepted rules or standards, that the work of the accountant has a precision and exactitude which is quite uncanny, and that they may, in the absence of deliberate fraud, rely upon data as a basis of all decisions relating to the particular business enterprise. They usually believe, moreover, that accounting values as presented in the statements reflect in a fairly reliable way the worth in the market place—the values in terms of current replacement—and they therefore regard them as a proper criterion of investment in the enterprise.

When these individuals then find that the presentation of accounting data is actually based upon a great deal of judgment, as in the case of depreciation and the distinctions drawn between capital and revenue expenditures; that the procedures of the accountant rest in many cases upon conventions or rules which are disputed and differently applied by individual reputable accountants; and that the generally accepted conventional basis of valuation at historical cost makes no effort in the case of certain assets to recognize current replacement values, their general conclusion is one of disappointment regarding the services provided by accountancy.

Among this group we find those extreme voices which denounce accountancy as an obsolete and antiquated system of thought and procedure, a hodge-podge of conflicting and illogical conventions, and in general a basis for misleading those individuals who rely

¹ This development has been clearly recognized in the opening paragraphs of Accounting Research Bulletin No. 1 prepared by the committee on accounting procedure of the American Institute of Accountants.

upon the data provided.² Other voices are more moderate and, while recognizing the great services of accountancy, point out the apparent inadequacy of accounting data as a basis for making intelligent decisions as to the real worth of particular enterprises. They likewise criticize accountancy for its lack of uniformity as a condition which impairs the usefulness of accounting data and precludes intelligent comparisons between companies. They cannot understand why accounting cannot provide information which is needed for their various purposes and why these data cannot be developed within the framework of uniformly accepted rules, standards, and principles.

More recently Jerome N. Frank, chairman of the Securities and Exchange Commission, has called attention to the special needs of the investor with respect to the accounting data displayed in corporate reports. In this regard Mr. Frank points out the major need of the investor for information bearing on prospective net earning power and asks for a greater recognition in accounting statements of this principal interest of the investors. In the words of Mr. Frank:³

"In sum, I do not mean that the present financial statements should be replaced by earnings forecasts. But I do mean that financial statements intended for investors should be designed with a view to their ultimate use in appraising earnings prospects. That should be the focus of the accountant's attention in preparing reports for investors."

It is because of such expressions of critical appraisal that our present inquiry into possible constructive devel-

opments within the profession of accountancy takes on special meaning.

THE INADEQUACY OF MULTIPLE-PURPOSE STATEMENTS

One of the major difficulties which has always surrounded accountancy in modern times is that the financial statements which are prepared must serve a number of purposes. The same financial statement, in varying degrees of detail, is prepared for the management, the owner, the prospective investor, the trade creditor, the banker, and the like. But each of these groups have different needs because the decision or decisions which they are endeavoring to make rest upon particular factors, aspects, or elements of the company's operations.

The banker in extending a short-term loan is interested primarily in a short-run financial program and is concerned with those values which relate to the degree of assurance that the proposed loan will be liquidated when it matures. The bondholder is, on the other hand, interested in a long-run program. He is concerned with the ability of the concern to operate efficiently and to earn a profit which will assure adequate coverage of the interest requirements. He is also interested in the current and future worth of the assets back of the bond issue as security. Similarly the investor has special needs. He wishes to know what is the net income on a basis which will provide an intelligent capitalization of earnings over a reasonable period of years, what are the present replacement values of the capital assets in use, or of the assets with which they could be replaced, and other facts pertinent to the future prospects of the concern.

In all of these cases the accountant in preparing his financial statements has been aware of the possibility that the statements may be used by any of these individuals and for a variety of special purposes. Even with this knowledge he has obviously been unable to meet the

² For an extreme statement of this point of view see Kenneth MacNeal, *Truth in Accounting* (Philadelphia: University of Pennsylvania Press, 1939).

³ Jerome N. Frank, "Accounting for Investors," *THE JOURNAL OF ACCOUNTANCY*, Nov., 1939, p. 301.

requirements of all, because the various needs often require bases of valuation or other treatment in the statements which are conflicting. In such cases the accountant has been faced with the necessity of compromising to some extent—of serving the needs of one user at one point and those of a different user at another—the particular decisions resting usually upon the relative importance of the needs of the individual user and the extent to which the provision of the information wanted was deemed practicable by the accountant.

The result has been to a substantial extent a presentation which is illogical when viewed as a whole and composed of conflicting bases and conventions. Because of the necessity of supplying a general-utility set of statements, the ability to serve a particular set of needs completely and effectively is often impaired.

The general limitations of the general-utility or multiple-purpose statements have existed as long as accounting statements have been prepared, but the rise of the new investor class—the holders of securities on a more or less transitory basis—has brought the problem into clearer relief. Here we have a new and increasingly important class of individuals who have a need for information which is not effectively satisfied by the bases and conventions commonly used in the multiple-purpose statements. While, for example, historical costs may serve a useful and necessary function for particular or general purposes, they may be positively misleading as a basis upon which to make the decision as to sale or purchase of shares in the company. Similarly the calculation of depreciation based upon historical cost may be satisfactory for given purposes but may be highly inaccurate for the purpose of determining net income for the capitalization of these earnings as a method of valuation.

Particularly would this be true where the advantage from having low-cost plant and equipment were only temporary and would disappear in the near future when it became necessary to replace the assets at current prices.

The needs of such a group of individuals as investors, as well as those of other important groups, provide a challenge to accountancy. What can be done to overcome the present limitations that exist and to serve more effectively the needs of particular groups which must be guided by accounting data? What are the problems involved and how can these obstacles be overcome without sacrificing the present utilities provided by accounting data, and at the same time giving due recognition to the practicalities of the situation?

The solution to these problems and questions is admittedly complex and must be effected gradually over a considerable period of time.

Our immediate interest, however, is with one special means of attacking these general problems. This is the proposal that separate and individual financial statements be prepared to serve the special needs of the various important groups which use accounting data.

Mr. Frank suggests this possibility when he says:⁴

“Would it not be feasible to construct single-purpose balance-sheets and possibly income statements which would reflect the enterprise in the terms and categories which would best serve particular purposes and then in a separate column make the necessary reconciliation between the various statements? Or the all-purpose historical balance-sheet might be made more meaningful to the investor by supplementing it with a special-purpose financial statement designed to serve the particular interests of the investor.”

⁴ *Op. cit.*, p. 301.

The Need for Single-Purpose Statements

SPECIAL PROBLEMS OF SINGLE-PURPOSE STATEMENTS

The general plan of single-purpose financial statements is that separate statements would be prepared for particular groups of users and that the bases of valuation or other standards observed would be chosen in the light of best serving the particular purposes for which the statements were to be used. Professor Bonbright has well stated the plan which might be followed when he says:⁵

"A good beginning could be made by assuming, first, that no use will be made of the company's reports except by buyers and sellers of the corporate stock. In the light of this single assumed objective, all of the alternative procedures of accounting, such as the valuation of fixed assets at original cost versus replacement cost, the use of straight-line versus sinking-fund methods of depreciation, the booking of current assets at cost versus the lower of cost or market, and so forth, might be subjected to a critical rating of their relative merits. This task having been accomplished, the accountant might then forget the stockholder and assume that an 'ideal' set of financial reports is such a set as will best fit the needs of the credit department of a commercial bank. Still other objects, such as that of the company management in the determination of its price-making policies, or such as that of the management in its decisions as to whether to increase this line of business and to drop that line, would be taken up in turn."

It is not to be supposed that, even when one of these single-purpose statements is being prepared, the choice of valuation bases or other accounting standards would be clear or subject to universal agreement among accountants or the users themselves. Questions would still undoubtedly arise as to the

manner in which the single purpose could best be served and the basis would not be hereby provided for the much needed uniformity of accounting practice. But it seems reasonable to assume that the area of disagreement would be considerably reduced and that some progress would be made in this direction. To a considerable extent the variations which now exist have their roots in the desire to serve particular purposes which are often conflicting in a multiple-purpose statement. Questions will frequently arise, in the event of such a conflict, as to which purpose is the most important, so that in the present situation a major obstacle exists to arriving at acceptable decisions. It is therefore probable that a restriction of the problem to the preparation of a particular single-purpose financial statement will serve as an important means of promoting greater agreement and uniformity in choices of procedure.

The preparation of single-purpose statements immediately raises the question of the manner in which the basic accounting record should be kept. Accountants have generally adhered to the belief that the record in terms of historical cost represents the most useful type. This is a record based on actual business transactions which, despite the special and unusual conditions under which transactions often arise, does provide something definite which can be measured, and constitutes a necessary record of the financial changes as they occurred at particular times. In some cases other modifications have been made in the basic accounts which depart from the historical-cost basis, but these changes are generally resisted and are recognized ordinarily only under the pressure of sufficiently powerful considerations. There has been furthermore a substantial conviction among accountants that the statements as prepared should agree with the basic accounts, and it is usually specifically

⁵ James C. Bonbright, *The Valuation of Property* (New York: McGraw-Hill Book Company, Inc., 1937), p. 253.

stated that the data as exhibited in the financial statements are in agreement with the books.

The general merits of keeping the basic records in terms of historical cost are indeed great, and it does not seem desirable that any plan of preparing single-purpose statements should eliminate the basic-cost record. In fact it may very well be said that cost is the most satisfactory single record—including, of course, the necessary amortizations between accounting periods for income-statement purposes—and that no departure should be made from it at any time. It would seem desirable that a record in terms of historical cost should be consistently on that basis and not modified by write-ups or write-downs arising out of revaluations or other circumstances, regardless of how well considered the changes appear to be.

It does not necessarily follow, however, that the modifications required for the preparation of single-purpose statements cannot be made in the form of auxiliary records of supplementary calculations outside and independent of the basic-cost record. If this were done, the accounting statements so prepared would not be in agreement with the basic accounts kept at cost, but they could nevertheless be based upon reliable estimates or calculations and as such could be presented for the special purpose to be served. Even in these special cases, however, the basic-cost record would serve important and useful purposes. This record—both from the standpoint of quantities and of values—could to a large extent function as a basis of control over the supplementary calculations and could thus help to insure their accuracy.

The question may very well be raised that such auxiliary or supplementary calculations would involve, practically speaking, the multiple duplication of accounting systems and that the cost of providing these extra records would be

prohibitive. It cannot be definitely said to what extent this would actually be true. There would unquestionably be additional accounting effort involved but it is doubtful whether there would be substantial duplication. Certain accounting operations would certainly apply to all bases of statement presentation, some calculations would be necessary only at balance-sheet dates, and many calculations could be made in a less detailed fashion than is necessary in the case of the basic record. Suitable experimentation and research would be required to find the point to which such procedures could justifiably be developed.

But the dissenter may say that even if these supplementary records are feasible and practicable as a basis for single-purpose statements, they take the accountant into a realm where he is not qualified to act. It is frequently asserted that the accountant is a recorder and not a valuer and that where, for example, the bases of valuation concern replacement values, the accountant goes beyond the scope of his authority and capacity. Certainly the requirements as might be here involved appear to be extreme when judged by conventional standards. It may be pointed out, however, that the accountant even now does not completely avoid these problems. In most cases he must appraise the reliability of inventory-replacement values when these are below cost, he must appraise the adequacy of bad-debt provisions, and questions of reasonable depreciation allowances continually confront him. Particularly in the case of inventories the professional accountant has been forced by the needs of the times to concern himself with the physical aspect of stocks in a manner which would scarcely have been deemed appropriate a decade ago.

The accountant's lack of specialized ability in matters not of a strictly historical-cost nature must, however,

The Need for Single-Purpose Statements

be recognized, and no ultimate good can come from shifting functions to the accountant which he is not qualified to perform. A possible solution does, however, exist in the opportunities which are afforded for the employment of experts, or of general coöperation with them. It is customary even at the present time to enlist the aid of legal counsel to appraise the extent of liabilities existing under the company's legal contracts. The services of the engineer are often utilized in passing upon the reasonableness of depreciation methods and rates used. It seems reasonable to suppose that the use of experts in various fields could be further employed in the development of the needed supplementary estimates and calculations involved in the preparation of single-purpose statements.

It does not necessarily follow that the accountant would accept the responsibility of the conclusions of all of these experts. He could, as a matter of fact, merely present these conclusions without certifying as to their correctness. His major service in such cases would be the coördination and correlation of these specialized efforts—the combining of their conclusions into complete, informative presentations which are consistently and properly expressed in the particular set of financial statements. His ability with respect to the classification and analysis of financial data should admirably fit him for this task, and his familiarity with the basic accounts maintained at historical cost should enable him to correlate these supplementary data to the maximum extent with the basic-cost records. It seems, therefore, that great potentialities for the greater use of accountancy exist in the accomplishment of these additional services.

As a final matter to be considered here, there is the very fair question of whether the presence of more than one set of financial statements would lead to confusion or misinterpretation. Ed-

ward B. Wilcox has pointed out this danger,⁶ and it is a very real one. It does seem, however, that most of the confusion could be eliminated by clear and informative headings on the individual statements which would state clearly the purpose for which the report in question has been prepared. The greatest danger, perhaps, is that the user of the statement might feel, because of the special-purpose preparation, that he could use the information with less judgment than was in fact necessary, and he might therefore draw unwarranted conclusions from the report. There would, under such circumstances, be an even greater need of educating the user to the proper use of accounting data than now exists.

PRELIMINARY SUBSTITUTES FOR SINGLE-PURPOSE STATEMENTS

The use of single-purpose statements in an extended and universal fashion must, because of the complexity of the problems involved, be developed over a considerable period of time, as Norman J. Lenhart has reminded us, when he quotes with approval the words of the subcommittee on audits and audit procedure of the New York Stock Exchange:⁷

“ . . . accounting and auditing procedures are in their very nature not final but evolutionary, both in themselves and in their adaptation to a continuously evolving business world, and that new developments should be introduced only where their practicality is reasonably established.”

Accounting is necessarily a reflection of the needs of our economic society, and its practice must be weighed in the light of the benefits provided as compared to the costs of those benefits. Granting that single-purpose statements represent an ideal goal toward

⁶ “Single-Purpose Statements,” *THE JOURNAL OF ACCOUNTANCY*, March, 1940, p. 189.

⁷ *Op. cit.*, p. 186.

which accountancy should strive, there still remains the desirability of briefly considering what can be done in a preliminary way to move in the right direction, yet at the same time to avoid a too radical break with the customary procedures of the day. The preparation of one set of financial statements is too deep-rooted a practice to be easily overthrown and will undoubtedly be continued for many years to come. The realities of the situation thus indicate that the more immediate progress must be worked out through the medium of the single set of financial statements. Assuming that this must be the case, there are several possibilities of attacking the general problems previously discussed.

For a first step it is desirable that the users of financial statements as currently prepared be fully informed as to the basis and scope of the data actually presented. This is simply to say that the users should not try to employ the data for purposes for which the data are not suited or draw conclusions from them which are not warranted. They should be more fully educated as to the general purposes of accountancy, the customary procedures followed, and the limitation of these data in given directions. Persons using financial statements could in addition be given the reasons why the major accounting conventions are followed and the problems which a modification of these conventions would involve. They would then have a greater understanding of the accountant's problems and a better appreciation of the unavoidable limitations of accountancy. Accountants as a group are keenly aware of this need and are making a creditable effort to meet this problem, but there is still much to be done.

As a second step the rule or standard of disclosure should be more completely observed. This includes the presentation of sufficient detail to enable the reader of the statements to make a

reasonable judgement regarding the item in question and to avoid being misled. Furthermore, it includes the declaration of bases actually used or procedures followed in the calculation and presentation of the data. Current corporate reports, though being constantly improved, are subject to much criticism in these respects. The result is that the user of the particular statement has no way of determining what the data actually mean. He cannot depend upon given conventions because these are frequently modified, and the possibility of making erroneous assumptions as to the bases of valuation used may necessitate a complete rejection of the data in making the decisions at hand. Progress in this direction would certainly seem to be a basic minimum and is certainly within reasonable reach of current practice.

These measures are, however, largely negative. Useful as they may be in precluding the use of accounting data for unsuitable purposes, little is actually contributed to the major problem with which we are here concerned—that of providing the data needed for particular purposes. A practice which would more positively further these objectives would consist of disclosing other important bases of valuation for the individual items in the statements in addition to the bases actually used in the basic totals. Here again Professor Bonbright offers a suggestion when he says: ⁸

“Further research would consider the question whether a workable multiple purpose scheme of accounts might not be so devised that, by the aid of a pencil and paper, a reader could reconstruct the accounts to fit his own requirements. (For example, such a multiple-purpose balance-sheet might report a valuation of current assets at the lower of ‘cost or market’ but with a footnote indicating the cost on the one hand and the current market price on the other hand.)”

⁸ Bonbright, *op. cit.*, p. 254.

The Need for Single-Purpose Statements

Such a procedure would have the distinct benefit of providing the user of the statement with additional information which he could then utilize in such manners as he deemed appropriate for his own purposes. It would of course entail some inconvenience on his part, since in a sense he would then be compelled to more or less construct his own single-purpose statements. It assumes, moreover, that the user has the ability to develop such statements. These objections do not appear to be of too great an import when one considers that the major need is to make the basic data available to the user—a situation which under present conditions does not exist. Those individuals who analyze corporate financial data would undoubtedly feel very well treated if they were provided with the necessary data from which to construct their own special-purpose calculations.

Procedure along this line would have the distinct advantage of making it possible to issue and certify a single set of financial statements. Public accountants as a whole would undoubtedly prefer that kind of an arrangement. A second difficult problem would also temporarily be avoided in that definite decisions would not have to be made by the accountant as to which bases or procedures did actually best serve the needs of a particular type of user. This selection would, under the procedure here proposed, be left up to the user himself. It would, however, raise many of the problems which we have previously found to exist in the case of regular single-purpose statements. There would still be the question of how many bases of valuation should be indicated, and to what extent the effect of alternative treatments should be indicated. There would remain the very great problem of supplementary estimates and calculations, which would involve the utilization of specially qualified experts in connection with particular matters. All in all, however,

the procedure of indicating alternative bases or treatments on a single set of financial statements would to a substantial extent accomplish the purposes of single-purpose statements without involving such a radical departure from current accounting practice.

The practice of providing supplementary information to the basic statement data is not entirely new. There are numerous cases of current financial statements in which additional information is provided with respect to particular balance-sheet items. And it is not uncommon for the accountant to disclose in the income statement the effect of some changed procedure and what the results would have been had the original, or perhaps more orthodox, procedure been continued. It is presented here rather as a course of action which could be more widely adopted and which it is believed would do much to remove some of the limitations which now hinder effective use of accounting data by individual groups of users.

CONCLUSION

The objectives of accountancy are to serve social purposes in the most effective manner. It does this primarily by supplying information of various types in the required detail and, at the proper times, to the individuals or groups of individuals who have needs which can to some extent be served through accounting data. The function of the accounting data is to enable these individuals to make the most intelligent decisions possible and to exercise the best judgment in the administration of our economic system. The major problems of accountancy therefore center about the manner in which information can best be supplied so that the individual needs may be served in the most effective fashion.

Judged by these standards, single-purpose statements appear to be a means of achieving a noteworthy advance in the furtherance of the ad-

mitted objectives. They deserve the attention of all accountants interested in the welfare of their profession and its contribution to society. There are, of course, complex related aspects which prevent an immediate attainment of the progress which these statements involve. The cost of providing additional services must in all cases be carefully considered, and changes must be gradual to avoid breaks with customary procedure to the extent that they may be confusing or otherwise harmful. In short, the problems involved in the use

of single-purpose statements or in the use of the preliminary substitute methods must be worked out in a well-considered manner. Finally, no single development or set of procedures in accounting can ever be a panacea or final solution to the problems of accountancy or insure its effective functioning.

The important thing, however, is that goals, properly recognized and based on sound considerations, can serve to generate current change in the direction of real progress.