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Arthur W. Hanson

Roy B. Kester

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Comments on "An Introduction to Corporate Accounting Standards"

[At the request of the editors, Professor Arthur W. Hanson, of the Harvard Graduate School of Business Administration, and Professor Roy B. Kester, of Columbia University, have prepared the following comments on the American Accounting Association monograph, *An Introduction to Corporate Accounting Standards*, by W. A. Paton and A. C. Littleton.]

COMMENTS OF ARTHUR W. HANSON

Comments made at this time must in the nature of the case be somewhat tentative since *An Introduction to Corporate Accounting Standards* is a work which has been given serious and prolonged attention by numerous persons over a ten-year period. This monograph expresses admirably one point of view with respect to current developments in accounting, and for this reason it warrants continuing appraisal in terms of the light it throws on accounting problems.

So much criticism has been directed in recent years toward accounting statements that all of those who, like Professor Paton and Professor Littleton, attempt to furnish guideposts whereby accounting reports may rest upon logical bases are entitled to the sincere thanks of the profession. Prior attempts to provide standards have, to a large extent, dealt with isolated items and have based standards on practice. This empirical approach, although it has been the method whereby progress has been achieved in those fields of science, like medicine, where the most pronounced advances have been made, has the disadvantage of lacking a coördinating thread. It begets inconsistencies which are difficult to explain satisfactorily to those who look upon accounting as a science in the sense that it is "accumulated and accepted knowledge systematized and formulated with reference to the discovery of general truths or the operation of general laws."

The present study has the merit of being a "coherent, coördinated, consistent body of doctrine" all of whose standards flow naturally from the premises assumed. If objection be raised that the study smacks of having been carried on in the cloister far from the madding realities of business, who can say that this is not one very fitting approach to a solution of the problem in hand? The *a priori* road may be as logical as the empirical and may produce its own rewards. Perhaps the theorist's best contribution can be attained in this manner. Then practice can bring forth its arguments and objections, and finally, let us hope, a consistent and practical body of doctrine will emerge which can be defended on some better grounds than those of "conventions" and "conservative treatment," which, in truth, have not always seemed convincing. Of course, Professors Paton and Littleton tell us that practical accountants both from the public and industrial fields have helped in the development of the results enunciated, but other practical men may disagree with some of the conclusions reached.

If the premises of the authors can be accepted, very little fault can be found with any of the conclusions reached in the study. In fact a critical reader will probably be surprised to note how few of the statements made in the 142 pages of text he can reasonably mark for criticism and discussion. The reader may believe in a few instances that there has been useless repetition, but closer analysis will show that the repetition was consciously included in order to provide full and complete treatment of each of the several topics discussed.

Can the premises be accepted? Once again the fact must be faced that typi-

cal accounting statements cannot serve all purposes at all times. It has become rather commonplace to acknowledge that the income statement is today of more importance and significance than the balance-sheet. What is there more revealing for the managing officers to report than an account of their stewardship, the story of their success in handling other people's money? Information along these lines should be of interest not only to stockholders but to labor, actual or potential sources of borrowed capital, the government, and the community at large. This premise lies at the base of the present study. It is quite generally accepted in practice. Its formal statement may help clarify objectives and it may stand until it causes a better general purpose for accounting reports to be evoked. Adherence to it will allow the production of income statements and balance-sheets both resting on the same body of doctrine; the balance-sheet properly subordinated to the income statement and serving largely as a mere connecting link between successive income statements and a report on stewardship temporarily stopping in transit. The income statement produced in this way is probably most useful; the resulting balance-sheet can easily be made to be more helpful by limited parenthetical and footnoted information. In fact it can be made just about as useful for ordinary purposes as any balance-sheet.

The income statement resulting from the application of the doctrine approved by this study will not differ essentially from those produced today by competent accountants except that ending inventory will be credited to the period in question at cost, as compared with a lower market figure. For purposes of control and stewardship this treatment of the inventory may be superior, since it does not allow operating results to be hidden by extraneous change. If believed necessary, reduction to market may be affected by a deduction in the nonoperating section, thus getting inventory in readiness for inclusion in the balance-sheet in the more customary manner of cost or market, whichever is lower. But it must be understood that such action is a departure from adherence to a body of consistent doctrine which attempts to measure costs, as well as they may be ascertained, with corresponding revenue.

The resulting balance-sheet will differ from that which recent custom has decreed chiefly as to the showing of inventory, which will appear at cost. In lines of business where the inventory is sufficiently homogeneous and the method practicable, revelation of the quantity of units involved and the average cost of them might be revealing as to the success of the stewardship in acquiring goods to be sold under favorable conditions. Parenthetical expression of market values would doubtless be of assistance for this purpose also, as well as making feasible the computation of a current ratio for short-term credit purposes. By some such device the method advocated can be caused to make allowances for variations in conditions.

An Introduction to Corporate Accounting Standards advocates subtracting bond discount from the face of the bonds outstanding to show more effectively the amount of the present liability. It has been argued rather effectively[1] that "This discount on bonds issued represents an asset—the right to keep the money of lenders without paying normal interest on it. The company pays for that asset, however, in paying at the maturity of the bonds more than it got for them at issue." With the same result others have held that the condition is not practically different from selling the bonds for face value and handing back cash to the amount of the discount—thus prepaying interest con-

[1] William Morse Cole, *The Fundamentals of Accounting* (Boston: Houghton Mifflin Company, 1921), p. 381.

tracted for in excess of the coupon rate. These arguments, plus the relative insignificance of the amount of discount in a typical balance-sheet, would indicate the undesirability of disturbing present well developed practice.

The Paton and Littleton study points to one area concerning which a word of caution is in order. On page 84 it is stated that "For example, the cost of a paint job which will be effective for a period of three years should clearly be applied to the production of the entire period; and this is just as true of a replacement job as of an original 'installation.' What is needed in this connection is more adequate classification of plant costs." Although there can be no dispute with this theory, costly hair-splitting with meager results should be avoided. This same tendency to undue refinement of the relatively unessential crops up elsewhere in the study, but probably it is expected that the accountant in practice will depart from the strict requirements of theory when the costs involved are not justified by the returns. The writer at times fears that eventually some few persons in the United States will be busy doing all the so-called real work to be done and everybody else will find enough to do keeping minute track of what these few do. Of course, this will help provide jobs for accounting graduates!

This study should do much to make all accountants confident of the merit of what they have been doing. With few exceptions it corroborates present practice and demonstrates that it is more logical than has sometimes been thought. By focusing attention on a single purpose, it may make it possible to adapt accounting reports to the analytical capacities of the ordinary reader. The trained analyst, if given a relatively small amount of supplementary information, can, nevertheless, derive all the help that he has been getting from statements thus produced, and perhaps more.

Comments of Roy B. Kester

The processes of human life, both physical and mental, are not measured, orderly processes from birth to the grave. Rather are they a series of eventualities of uncertain number, quality, and intensity—some of which are even cyclonic in their impact—the cumulative end-product of all of which is the individual man at any age or stage of his development. The processes of the social sciences—those dealing with the activities of man as a member of society, as contrasted with the physical sciences which are concerned with the processes and phenomena of life and matter in the abstract—are much the same as the processes of human life. Accounting is a social science in much the same sense as is the law. It cannot, therefore, ever be a finished product so long as there is a business society interested in and using its services. It follows, too, that, like the law, accounting is in a state of constant flux and must adapt itself to society's changing concepts of what it has a right to demand in the way of services from the agencies which it uses and on which it must depend in working out its various programs of welfare and betterment, for the latter are constant goals of society. The rate of flux or change varies greatly at different times. In the present period the rate is rapid—double-quick, at least. Such circumstances always provide the occasion for a re-examination of those social concepts and practices which have previously been accepted as almost unchanging truths. Economic society, and accounting as one of its agencies, is at such a point today. The very foundations of the science are being subjected to rigorous testing to see what, if any, modifications may be necessary to enable it to continue to serve as a social agency.

It is against such a background that Paton and Littleton's *Introduction to Corporate Accounting Standards* should

be read and appraised. It is a most worth-while attempt to find a reasonably consistent philosophy on which the practices and techniques of accounting may seek to establish themselves on a sure foundation. The authors are to be congratulated on a piece of work well done, well organized, and developed in an orderly manner. That the treatise is just that can be said without fear of contradiction, even though some may differ as to the authors' reasoning in places and also with some of their conclusions and implications. It is the sort of product which one has come to expect from the mental workshop of these men; there is little that is doctrinaire, and everywhere is evidence of mental honesty and sincerity.

In issuing this treatise I am sure they were aware that it would be subjected to the fine-tooth comb of criticism by both theorists and practitioners—and they will welcome it. In accounting, as in every other field, there are those whose interest is mainly in the basic philosophy of their field and those who are concerned chiefly with techniques and practices, the latter being content to practice the art as developed by others rather than being concerned constantly with a determination of the scientific principles on which the proper practice of the art must rest. Then there is a third class, those leaders and authorities who at all times endeavor to keep in touch with the scientific basis of the art—and even are chiefly instrumental in establishing such a basis—and at the same time practice the art resting thereon, always consciously using the one to supplement and test the other. Any profession needs all three classes, for they serve as appropriate balances, one against the other. The Paton-Littleton *Accounting Standards* and all similar treatises must be subjected to a thorough and critical testing by all three classes. This essay does not pretend to be such a critique; it is rather a brief comment on some aspects which an all too hasty reading seems to justify.

First, then, as to terminology. Every student, practitioner, and layman appreciates that one of the handicaps faced by the profession is its lack of a precise terminology, a handicap which, in the main, can be overcome only by education of its users as to the technical significance of the common terms used. There will be some criticism of this treatise in its use of expressions which are uncommon in the language of the businessman, particularly since with little greater word volume the common terms could have been made to suffice. The avoidance of the use of "rule" and "principle" and the frequent use of "standard"; "price aggregate" in place of "cost," "income," "expenditure," etc.—these are cases in point, the avoidance of which would have made for easier reading by the commoner, with little loss in precision of statement.

With the basic concepts which the authors present there can be little serious disagreement. Failure to give some consideration to consequences that may well flow from the stated concepts may, however, cause real confusion and cast doubt on some of the conclusions arrived at. The concepts of "business entity," "continuity of activity," "measured consideration," and "effort and accomplishment" are all basic, but not thereby necessarily always controlling. In the early days when all business enterprises were comparatively small, with owners acting as the managers of enterprises in which there was little, if any, creditor or public interest, accounts were kept for the information and guidance of the owner-managers, and that is still their chief function. Over the years as these interests have been separated and as management has used creditor funds, as well as ownership capital, and as public interest has increased as a part of programs of social welfare, management has been compelled to assume re-

sponsibilities and obligations not recognized when much of the basic philosophy of accounting was established. That these philosophies have changed and are changing due to these influences is undoubtedly true. In an enterprise in which there is no creditor interest, or none of any consequence, continuity of activity may be a controlling basic premise on which to build a philosophy of accounting. When business success and therefore life are so uncertain—as the authors point out—and a substantial creditor interest is the usual situation in modern business, may it not be a necessary function of accounting to recognize that and give some reflection of it in the basic theories in accordance with which records are kept and reports made? Such present practices of recording debts, both short and long term, and the valuation of inventories at the lower of cost or replacement cost, undoubtedly rest on the legal rights of the creditor class because that is a better reflection of management's obligation than would be a strict present-cost valuation based upon the concept of "continuity of activity." The rights of the creditor interest in an enterprise may well be so compelling as to justify the above practices in the reporting of income.

The implication of the business entity is, in my opinion, broader than that accorded it by the authors. Inherent in it is the whole philosophy of individualism versus socialism in business. Business, as conducted in this country, is individualistic, although there is an increasing recognition of its social obligations. Flowing out of business individualism is the propriety of reflecting in its records its costs and its revenues and its operating data in accordance with the needs of its method of organization and its policies of operation. The necessity for so doing is more compelling than any considerations of the homogeneity of costs as viewed from the larger social standpoint. Thus, if an individual enterprise chooses to operate by the use of borrowed capital in large measure in place of owners' capital, the cost of that borrowed capital is just as much a cost of operation to *it* as is its payroll and other service charges. The situation is little different in the case of rent. If one enterprise chooses to borrow, and pay for, the use of a plant owned by another, it entails a rent cost; whereas another enterprise owning its plant entails maintenance and depreciation costs. These are merely different policies of management and it is the function of the accounts to recognize in the record, the individualistic quality of business operation. Similarly, a last-in, first-out method of costing sales and pricing inventories may be justified; as also may be justified the application of one method of pricing to one part of an inventory and a different method to another part; the use of an accrual method for some costs and income items and a cash method for other costs and income. Business operation and the record of its results must not be forced into the strait-jacket of an artificial philosophy of accounting resting on the concept of homogeneity. Realism in accounting, an accounting reflecting the realities of business, is far more important.

From this it must not be inferred that accounting may therefore be capricious, for implicit in business and accounting individualism is the obligation to maintain intelligible records and reports. This philosophy is inherent in the certificate's phraseology "in accordance with principles of accounting consistently maintained." As a corollary to this proposition is the obligation to report any change in accounting practice and its significance in order to provide a proper basis for interpretation. How far the setting aside of the individualistic viewpoint has gone is apparently reflected in the philosophy underlying the requirement by many

public-service bodies that the individual utility's recorded "cost" of plant property shall be the "cost" at the time a plant unit is dedicated to public service even though that cost may have been the cost to a predecessor company and not a real cost to the present owner.

Because of the breadth of coverage in the authors' treatise there is much that one would like to comment on but space is not available. This essay will therefore be brought to a close by listing a few points on which only brief comments can be made.

On page 66 the authors say, "recognizing depreciation is a technical process of assigning costs to revenues, not a financial process of accumulating funds." If there are sufficient revenues to cover depreciation, the one does effectively accomplish the other. Whether the funds so accumulated at the time will remain available for replacement of the asset is wholly a matter of fiscal policy.

On page 97, it should be noted that the use of current income for the absorption of "nonoperating, nonrecurring losses" must not be allowed to obscure the earning power of the business over the years, i.e., the treatment of such losses must not present a picture from which improper interpretation of violent fluctuations in earnings might result. There may be other methods of handling such losses which will give a better reflection of periodic earnings.

On page 113, the requirement that in a quasi-reorganization there should be "full disclosure of the adjustment in the immediately following statements and a reference thereto in succeeding statements" has a note of finality and almost a fervor that the corporation must be faced to its end with its past misdeeds and failures. Surely truth in accounting need not be so rigorous.

On page 118, the statement, "write-down of plant cannot be accepted when based upon nothing more than a desire to free revenues of the future from a portion of plant costs," raises the question as to when the remedy of a quasi-reorganization may legitimately be resorted to. Must management, and therefore accounting, wait until it has accumulated a deficit before that remedy may be employed, or may it be resorted to in the face of an early impending deficit? May it be used as a device of "preventive" medicine rather than of "curative" medicine?