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Accounting in Evolution

BY HAROLD A. EPPSTON

I

BLACKSTONE, author of the famous *Commentaries*, in writing of the law of evidence, noted that occasionally a technical rule of evidence would be abolished as a historical anachronism. Soon after, Blackstone pointed out, experience would reveal the urgent necessity for the rule and necessity would compel the re-establishment of the rule as a guide in the trial of causes.

Similarly, there are impatient critics who would relegate to the scrap heap many of the principles and practices of accounting. They point to logical inconsistencies and imperfections. Could these critics create the financial facts with which accounting concerns itself, no doubt they would arrange them under a system of universal laws. We need not doubt the intellectual integrity of some of these critics. Perhaps the kind of vanity described by Cicero motivates them.

"Cicero has remarked that the greater part of the disputes between . . . the Stoics and the Academics were founded only in the ambiguity of words,—the Stoics having delighted, in order to elevate themselves, to take several terms in a different sense from others. This created the belief that their morality was much more severe and perfect, although in reality this pretended perfection was only in words, and not in things." (Antoine Arnauld, *Port Royal Logic*, p. 319)

Many of the principles and practices of accounting, were they abandoned, would be sorely missed; and the critics, no doubt, would tumble over themselves in their haste to restore them. They will have learned that, after all, these principles and practices were not created by an *a priori* philosophy. They

were hammered out by stern reality on the anvil of time. Accounting is part of all that it has met; its principles are forever in the making and cannot, therefore, ever attain sublime perfection. It is deeply embedded in the matrix of the institutions of the business world and the economic system. A search for simplicity and perfect order in accounting, or in the industrial and commercial purposes which it serves, is doomed to frustration from the very start.

The institutional and pragmatic development of accounting theory has prevented it from escaping from reality and ascending to that rare atmosphere in which metaphysicians dwell. Accounting theory was influenced, indeed, by the classical economists but these men had woven the fabric of their theories from the historical necessities of the times. We must be careful lest we, in our impetuosity, cast away a necessary principle or a desirable practice like a creed outworn. Many apparent flaws in accounting theory may be due to our own lack of understanding rather than to the fact that history is ready to relegate long-accepted principles to the limbo of forgotten things.

Yet time does change with ever-increasing speed. Theory often lags behind historical change. A new society is ever in the making. In addition to the self-generating forces innate in our society many external factors, political and sociological, have appeared to disturb the business world and those who serve it.

These changes have revealed weaknesses in the body of accounting theory and in practices that have grown up in less turbulent times. Accountants have not been derelict in their responsibility to meet the demands of the changing times. That their science and their art

have not developed speedily enough to fully appease all the demands of investors, the Government, economists, and a host of others who use financial and economic data to light their feet along the new paths of life, can be attributed to the phenomenon of social lag over which they have no absolute control.

But the keener critics realize that all this does not call for a wholesale abandonment of knowledge wrung from hands of time. They know that we must not spurn our modest possessions in our eagerness for great intellectual riches. They realize the great values of accounting and its conventions. They know that accounting possesses a scheme of notation, a language of numbers, and other empirical devices that emerged long ago out of the necessities of business. They know that some of these conventions are tacit understandings while some are formal; yet all are compellingly articulate because of the meaning with which time has enriched them. Accountants always have been aware of the conventional character of their work, and the literature of accountancy abounds with the recognition of this fact. Again and again accountants have pointed to them and warned of their limitations.¹

Typical is the following statement, written immediately before a confidentially published piece of passionately iconoclastic literature bearing an innocuous title, was boosted into prominence.²

"It [accounting] has provided reasonably consistent and uniform methods of describing transactions, . . . expressed in conventional units and by

conventional means. It is folly, and dangerous folly, to attempt more." (Maurice E. Peloubet—THE JOURNAL OF ACCOUNTANCY, January, 1935, in a review of Arthur Stone Dewing's *The Financial Policy of Corporations*.)

"Since all the world is aware of these conventional units and conventional methods, nobody need be misled. . . . Fortunate, indeed, are the 'interpreters' that accountants agree so much as to conventions. . . . It is better sometimes that certain rules and guides be 'fixed' rather than theoretically correct and true. That goes for . . . the calendar, the foot-rule, the clock and the whole field of law." (Letter of Harold A. Eppston, dated January 7, 1935, and published in THE JOURNAL OF ACCOUNTANCY, May, 1935.)

If more formal proof of the awareness of accountants of the conventional nature of accounting and its limitations is desired, it could be found in the many formal reports and statements of professional bodies. An example is the *Audit of Corporate Accounts*, published by the American Institute of Accountants, January 21, 1934. Typical statements are:

"Since the conventions which are to be observed must, to possess value, be based on a combination of theoretical and practical considerations, there are few, if any, which can fairly be claimed to be so inherently superior in merit to possible alternatives that they alone should be regarded as acceptable." (*Ibid.*, page 8.)

"There is no need to revolutionize or even to change materially corporate accounting, but there is room for great improvement in the presentation of the

¹ Of these limitations Thomas Carlyle (1795-1881) too, was aware. He says, in his *Past and Present*: "Bookkeeping by double entry is admirable, and records several things in an exact manner. But the Mother-Destinies also keep their Tablets, in Heaven's Chancery also there goes on a recording. . . . The statement and balance . . . in the Plugson Ledgers and the Tablets in Heaven's Chancery are discrepant exceedingly, which really ought to teach . . . a thing or two."

² I refer to the monograph (March, 1935),

"The Cost Formula For Price," written by Professor Walton Hamilton of Yale Law School and his associate, Miss Irene Till. Later Messrs. Kaplan and Reaugh, Yalensians, in an article in the *Yale Law Journal* dignified the monograph as "undoubtedly the outstanding piece of critical writing in accountancy." Its influence spiraled upward further when another distinguished member of the Yale group, Chairman Jerome Frank of the S.E.C., highly commended the article of Messrs. Kaplan and Reaugh.

conclusions to which accounts lead. The aim should be to satisfy . . . the investor's need for knowledge, rather than the accountant's sense of form and respect for tradition, and to make very clear the basis on which accounts are prepared. But even when all has been done that can be done, the limitations on the significance of even the best of accounts must be recognized. . . . Accounts are essentially continuous historical record; and, as is true of history in general, correct interpretations and sound forecasts for the future cannot be reached upon a hurried survey of temporary conditions, but only by longer retrospect and a careful distinction between permanent tendencies and transitory influences." (*Ibid.*, pages 11-12.)

II

Accounting theory and practice, to a very large extent, has developed with the growth of capitalism. It has been a great instrument for what has come to be termed "rationalization," that is, the use of reason to make the most efficient use of the factors of production. The emergence and development of book-keeping and accounting were undoubtedly prerequisite to the evolution of capitalism, and they in turn grew and developed from the demands made upon them. That growth, at an ever accelerated pace, still continues; and just as accounting served capitalism in its commercial phase, its industrial phase, and in the phase of finance-capitalism, it will continue to grow to serve the new demands made upon it by new social changes. Accounting developed when the seeking of profit was the motive force of capitalism. The minimization of costs, therefore, was essential, and accounting developed techniques and devices for the analysis and control of costs for the interpretation of the data gathered. These devices will continue to serve in any social set-up for they have no emotional content, no social predispositions and no political predilections.

In the earlier stages of economic development the investor, the entrepreneur, and the manager were practically always one and the same person. The conventional forms of accounts, balance-sheets, and operating statements, springing from the needs of the times, proved very satisfactory. The separation of ownership and management, and a consequent diversification of interests, have brought about greater demands for financial information. Those who have not yet read Berle and Means' monumental work on *The Modern Corporation and Private Property* are urged to do so to understand the implications arising out of the separation of ownership and management.

More and more governmental intervention has become the rule in business and louder has become the clamor for essential information that can become articulate mainly through the reports of the accountant.

It is not intended here to elaborate on the new demands made by such a separation of interests on accounting theory and practice. That is a field for more analytical study. Many suggested solutions are offered, a frequent suggestion being the preparation of single-purpose statements. There is grave danger in many of these proposals, for in attempting to meet new situations these proposals disregard essentials that are old yet still necessary. The economic scene may have changed but it retains all over the imprints of its past. It is by no means wholly new, and the instruments that evolved to serve it cannot be wholly old.

III

As an illustration let us examine the vexatious problem of valuation of fixed assets. When an entrepreneur wishes to engage in an industry which is already in existence, he will be interested, of course, in its accounting revelations. But although both the historical basis for valuation of fixed assets and the re-

placement value may be of interest to him, he will be primarily interested in the physical requirements of the new plant he is about to build. Such a new plant may be entirely different from those already prevailing in the industry. Even if there have been no technological changes, no new knowledge, economic considerations may and very often do demand a plant that is qualitatively and quantitatively different from those built in an earlier day.

Why? Because external factors may have changed the economic milieu and the efficient entrepreneur must assemble the factors of production in an entirely new way. The present reproduction cost of an old plant may be of little interest to him. When the old plant was reconstructed, there may have been no large realty taxes, personal property taxes, payroll taxes, or workmen's compensation laws. The new entrepreneur may want to use more capital and less labor; that is, more or different building and machinery per unit of labor. The entrepreneur about to assemble a new enterprise would try to take into consideration all the technological and economic changes that have accrued. Though he would be very interested in the financial and economic history of the industry, he would not be likely to reproduce exactly a plant constructed in a prior period to meet the dictates of another combination of considerations.

The entrepreneur would be very interested in the operating statement of the older concern, not only to discern the trends of earnings but to judge the relative stability of the business. It would be confusing to him if such operating statement were influenced by provisions for depreciation on continuously changing bases for valuation of fixed assets. That would be especially true if the valuations were periodically changed whenever reproduction costs change. Such costs change frequently because of the vagaries of political conditions, monetary changes, or be-

cause of influences manifested in the phases of the business cycle. We may conclude, therefore, that for the entrepreneur a historical basis for valuation of fixed assets is more revealing than valuations based on changing replacement costs. If the historical cost valuations are known, supplementary economic data are readily available as to price levels or other aids for judgment or analysis.

The manager is in a position somewhat different from that of the entrepreneur. Having built a plant at any one time, the flexibility in the use of the factors of production is greatly reduced. When a period of time has elapsed after the plant has been built, new knowledge might dictate a change in type were it built *anew*. Changing conditions, such as a heavy payroll tax, might dictate a greater use of capital. But the plant has already been built and the management is presently concerned with its most efficient use. Consequently, the replacement cost of the old plant under new conditions is of little interest since no one would precisely duplicate such a plant at the new point of time. It is an error to assume that a provision for obsolescence³ has provided for such a

³ Obsolescence has always been a nebulous term. It suffers from a common affliction whereby one word must bear several meanings none of which is clearly defined. "All ambiguities resemble each other in that they slur over some distinction that sound reasoning requires to be made explicit." (B. H. Bode, in *Elementary Lessons in Logic*, pages 27, B.) Accountants, dealing with realities always, have sought to avoid predictions. Since a provision for obsolescence requires a prediction they have sought to limit the provision to empirically tested estimates of retirement of fixed assets by changes brought about by progress of the arts and sciences. For tax purposes reasonable predictions that can be made with reasonable accuracy allowing for changed economic conditions, legislation, shifting business centers, or otherwise, may be included in the provision for obsolescence.

However, machinery and plant must be retired for long periods of time and often permanently as a result of cyclical changes in business. Also shifts in the production functions, apart from those of a cyclical nature, induce the retirement of much existing plant and equipment.

contingency. The shifting around of the factors of production cannot be provided for by any bookkeeping device since they are unpredictable. These changes are brought about by a variety of forces. But whether war, sun spots, cosmic rays, a cluster of inventions, or sheer accident engenders a shift in the production functions, the fact remains that these functions do change and, consequently, it is unlikely that the revaluation of an old plant at present replacement cost can have much significance.

But, it is alleged, times have changed and, while the entrepreneur and the manager are close to the enterprise, the investor is at a distance and is in the dark. He relies on the balance-sheet and operating statement, and historical valuations are just history to him and do not tell the truth about the contemporary situation. The long-term investor wants to realize on the unearned increment, if the land and similar holding have appreciated in value. The short-term investor would like to know present values as an aid in a discriminating selection of securities for purchase or for sale. These and similar needs should be met, but unfortunately, the usual method suggested, namely, the annual or periodic revaluation of fixed assets on the basis of reproduction cost or replacement cost, less provisions for depreciation and obsolescence, are misleading and unsound.

Such a value as Mr. May has pointed out, "if ascertained, would be irrele-

vant. What the investor is interested in is the value of the enterprise in which he is acquiring an *interest as a whole* [italics mine]; 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, are negligible."

Natural, social, political, or accidental causes, as we have seen, foster change. The dynamic forces bring about changes in the production functions.⁴ At two different moments in history, and under different circumstances,⁵ land, capital, labor, and management are likely to assume different relationships toward one another. Consequently, the present replacement value of an old plant may be meaningless and if used as a basis for judgment by an investor, might be fraught with serious error. The historical cost valuation would be a much sounder basis for investment analysis, for the careful investor can study economic data, other than that of the enterprise under analysis, to evaluate the changes that time has wrought or to seek light on the momentary value of the plant and equipment and the direction that earnings might take. These considerations lie outside of the field of accounting, and the information sought must be in the form of data to supplement the accounting facts.

The criticisms of investors are often supplemented by those unduly influenced by monetary theory. These critics assail historical valuations in the bal-

"Most inventions increase the demand for one factor (of production) in relation to that of others. . . . Since, in practice, the most important inventions are those which result in an increased or decreased application of machinery and, thus, in an increase or decrease in the proportions of capital used, the most important changes are those caused by inventions which substitute capital for labour and vice versa." (*Elements of Economic Theory*, Erich Roll, pages 233, 234.)

⁴"Technological data may be expressed . . . by a production function which links quantities of factors, such as labor, services of natural

agents and means of production . . . to the quality of the product which it is possible to produce by each of the infinite number of ways in which they can be combined for this productive task, technological practice and the whole environment being what they are." (Joseph Schumpeter, *Business Cycles* I, page 38.)

⁵These circumstances are numerous and their interrelation is extremely complex. It is, therefore, generally impossible to say with certainty which of the many possible causes has, in fact, produced a given result. Nor is it likely that quite the same combination of historical circumstances will ever repeat itself.

ance-sheet on the ground that the financial facts are measured by the variable yardstick of dollars which have a fluctuating purchasing power. Consequently, they argue, the balance-sheet is a hodgepodge of assets valued in dollars of varying purchasing power. The historical cost value of the fixed assets, they say, should be adjusted to reflect the present purchasing value of the dollar.

However, a balance-sheet with fixed assets valued at cost can be readily adjusted to reflect the point of view of these monetary-theory-intoxicated people without making wholesale or drastic changes in accepted accounting theory or practice. Those who are unacquainted with the technique of this prestidigitation may refer to books and articles on stabilized accounting.

But plausible as stabilized accounting seems, it is scientifically untenable and based on a misunderstanding of economics. For a going concern, a balance-sheet is intended to reflect the resources with which it intends to carry on. It is not a measure of what it will bring in liquidation. How will a periodic revaluation of fixed assets in terms of changing purchasing power help the situation? Moreover, the revaluation of *old* plant in terms of new and temporary units of purchasing power may be very misleading. It assumes that the only change was in the purchasing value of the dollar; that all else remains stable. But this *ceteris paribus* reasoning, while useful as a tool for analysis, cannot be projected into a balance-sheet without causing serious error. The change in the purchasing power of the dollar may itself be a manifestation of widespread changes in the production functions. The fixed assets that the "stabilizers" would revalue in terms of the new dollars might more fittingly be the subjects of a funeral dirge sung by the newer entrepreneurs.

Indeed, in these days of the management of money, arbitrary changes like

the devaluation of the dollar bring in their wake changes that may scrap whole industries, not alone a single plant! It is much too simple merely to rearrange the historical costs on the basis of the present price level.

Furthermore, the monetary jugglers assume that there is some way we can very accurately measure the purchasing power of money. As to the dubious reliability of price indexes, the reader is referred to the growing literature on the subject. But, assuming that we have a reliable general index of prices over a period of time, how can that aid us in adjusting historical valuations of *particular* assets to the current price level? It is well established that—even though the price level stays the same—because of advancement of knowledge, technological changes, and a host of other reasons, the prices of individual articles vary over a wide range. Public taste and demand change so that even the weighted items making up the statistical basis for the price index must be changed. Useful as the knowledge of price levels may be for broad economic analyses, how can we reliably use them for revaluation of a single plant?

IV

What can be precipitated from this discussion? First, we can say that no single form of financial statement can satisfy the rapidly multiplying needs of various interests. Secondly, suggestions for changing the present conventional statements, in the main, are ill considered. Thirdly, the conventional balance-sheet and operating statement have the advantage of having grown up to meet the needs of many groups that have emerged in the economic world and consequently, are probably the best general forms of statement that have been devised. Moreover, the conventions on which they are based are understood; any material change would involve a period of intellectual readjustment. To conclude, let us remember that all

statements are subject to a changing evolutionary process, caused by the changing economic and social climate, and the criticisms made of the statements in current use are a contributing cause of this evolution. The trend of change seems to be in the direction of various forms of statements to serve varying needs. The trend is to draw up the conventional balance-sheet and operating statement at more frequent intervals because of the accelerated tempo of the times; and to supplement these statements with additional data to serve the growing needs of a more complex society.