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What Is a Balance-sheet?

BY WILLIAM H. WHITNEY

LIKE thousands of other accountants, the author of this article has prepared many balance-sheets. In this work, he has attempted to adhere to certain traditional procedures, which he learned from accounting texts and from men who were older and more experienced. Somehow or other, perhaps from study or experience or instinct or contemplation, a sense of right and wrong developed. Traditional doctrines, such as "provide for all losses, anticipate no profits," "value inventory at the lower of cost or market," and "do not substitute appraised values of fixed assets for cost," came to seem safe, and departures from them came to seem dangerous. There were times when departures seemed unavoidable and when forceful criticisms shook his faith in the traditional doctrines.

To evaluate the criticisms, to determine what acts are and are not "permissible," and to decide whether there really is a sound basis for the traditional procedures, he found it necessary to try to integrate them. Are they mere results of custom and habit, or is there a reason for adhering to them? Have they a definable purpose? Do they lead to a describable goal? Can they be integrated? Is there any reason for preferring costs over appraisals? When an accountant is engaged in preparing a balance-sheet, according to the traditional procedures, is he attempting to prepare a statement of assets, liabilities, and net worth? If not, what is he doing? Can his objective be defined in words other than "certified balance-sheet?"

This article is an attempt to answer these questions.

Some centuries ago the common-law courts in England refused to recognize the duty of one, who was entrusted with the property of another, to account to the equitable owner for the use of the property. Appeal was taken to courts of equity, and the equitable doctrines of trust and accounting developed. The accounting principles adopted by courts of equity are exemplified in the accounting statements required from executors, administrators, trustees, receivers, conservators, agents, and other fiduciaries. The accounting procedures taught in accounting texts and adhered to by the overwhelming majority of accounting firms, in spite of vigorous demands for abandonment, agree in principle with these equitable doctrines. Traditional accounting procedures seem to originate from the same sense of fairness, justice, and reasonableness, often called common sense, that has actuated the decisions of courts of equity. Perhaps the accounting procedures of court-controlled fiduciaries have exerted an important influence on modern accounting practice.

Accounting statements rendered to the courts by fiduciaries are composed of the following elements:

First: A statement of value received for the account of the equitable owner.

Second: Lists of subsequent income, and other receipts.

Third: Lists of expenditures.

Fourth: A statement of properties held for the account of the equitable owner, together with liabilities applicable thereto. On this statement, properties, which were originally entrusted to the fiduciary, are listed at the value then determined, less reasonable allowances for depreciation, when it is appropriate. Properties subsequently purchased are required to be recorded at cost, or cost less reasonable allowances for depreciation.

It is not difficult to discover the reason that courts of equity prefer accounts

based on cost. Accounting on other bases is not impossible, but accounts based on cost are easier to understand and check. One does not need special training or study to prepare or comprehend such statements. Millions of fiduciaries who have never seen the inside of an accounting textbook, have prepared statements in which they have satisfactorily accounted to the courts for their use of entrusted property. Even a very young child can make such a statement. For example: Let us assume that a mother sends a child to the grocery store with a dollar, and instructs the child to buy a loaf of bread, a pound of butter, and five pounds of sugar. When the child returns with these articles he brings back a quarter, and with a little help from his mother can submit an account like the following:

Cash received		$1.00
Expenditures		
One loaf of bread	$ .10	
One pound of butter	.35	
Five pounds of sugar	.30	.75
Change returned		$ .25

This simple statement contains the essence of all accounting to rightful or equitable owners for use of their funds. It discloses the funds received for the account of the owner, the use made of them, and the unused balance.

Like this child, and like all of those whom courts of equity formally recognize as fiduciaries, corporation managements have a duty to account to shareholders for the use of their invested funds. This duty is formally recognized in the statutes of some of the states.[1] But neither the statutes nor the courts prescribe the bases to be used in accounting to the shareholders at annual meetings.[2] Consequently, there is a great deal of honest difference of opinion about the comparative merits of accounts based on cost and accounts based on appraisals.

For example, during 1939, Kenneth MacNeal, certified public accountant, devoted the major portion of a 324-page book to a bitter condemnation of cost as a basis for balance-sheet values.[3] He advocates the use of appraised and market values on all published statements. In 1937, Judge Robert E. Healy presented the opposite view. In an address before the American Accounting Association he recounted some of his experiences on the Securities and Exchange Commission with corporations that adjusted asset values to appraisals. He criticized accountants

[1] For example, Ohio G. C. 8623-64 reads as follows: "At the annual meeting, or any other meeting at which directors are to be elected, every corporation, except banks, shall lay before the shareholders a statement of profit and loss and a balance-sheet containing a summary of the assets and liabilities, a summary of profit earned, dividends paid, and other changes in the surplus account of the company, made up to a date not more than four months before such meeting, from the date up to which the last preceding statement, account and balance-sheet were made up, and in the case of the first statement and balance-sheet, from the incorporation of the company.

"A certificate, signed by the president or vice-president and the treasurer or an assistant treasurer, or a public accountant or firm of public accountants, shall be appended to such statement of profit and loss and balance-sheet, stating that they are true and correct and that they exhibit a fair view of the state of the corporation's affairs according to its books.

"The corporation shall, upon written request of any shareholder made after notice of any such meeting, forthwith mail to such requesting shareholder a copy of such statement of profit and loss and balance-sheet."

[2] The statutes of some of the states do not permit appraised values to be used for all purposes. For example: Ohio G. C. 8623-38 (b) contains the following instructions regarding the computation of surplus for dividend purposes: "In computing the excess of the assets for the purpose of determining the fund available for a dividend payable otherwise than in shares of a corporation, deduction shall also be made for the unrealized appreciation, if any, appearing on its books unless the amount thereof shall have been transferred to or included in stated capital."

[3] MacNeal, Kenneth; *Truth in Accounting* (Philadelphia: University of Pennsylvania Press), 1939.

for certifying balance-sheets containing appraised values, in these words, "I think the purpose of accounting is to account—not to present opinions of value."[4] Obviously, Mr. MacNeal believes that a balance-sheet should be a statement of assets, liabilities, and net worth, as that expression is generally understood by persons who have not studied or practiced accountancy. To such persons, the phrase means that the statement lists all of the assets at their fair or true or actual *values* on the balance-sheet date, and that the net-worth section discloses the excess of the fair or true or actual *value* of all of the assets over the liabilities.

Mr. MacNeal effectively proves that some balance-sheets which are based on cost are not reasonably accurate statements of *values* existing on the balance-sheet date, by pointing to instances when *costs and depreciated costs* are not fair measures of *value*. Differences between *costs* and *values* frequently are substantial if the fixed assets were purchased several years before a balance-sheet is published. The growth of cities and the character of surrounding developments profoundly affect land values. Building values are affected by the same factors, by changes in price levels, changes in style, and modern improvements in structural design and arrangement.

Even at the time when assets are acquired in arm's length transactions cost is not always a fair measure of value. A buyer who is "hard" and "smart" will buy the same commodity in the same market for less than a buyer who is "an easy mark."[5] The value of the commodity in the hands of the former is likely to be higher than the value of the same commodity in the hands of the latter, although the cost to the former is less than the cost to the latter.

There are many other factors that cause marked differences between cost in arm's-length transactions and fair value. For example, some years ago a corporation in Cleveland, Ohio, paid $371,000 for a foreclosed manufacturing plant of modern design in perfect physical condition. At the time of purchase it was appraised at $875,000. Within five years, the corporation that was created to occupy it, was earning more than $200,000 per year and in the years that have followed its net earnings have aggregated more than $2,000,000. In this instance could cost possibly be considered a fair measure of value either at the time of purchase or subsequently? Clearly the answer is no. The building and machinery sold at a low price because the corporation that had occupied it became bankrupt. The machinery was suitable only for making one line of products and most investors were afraid to take a chance in a location and in a line of endeavor where another had failed. Prejudice made this manufacturing plant sell in an arm's-length transaction for a fraction of its value.

Ratio of supply and demand may determine price, or cost, but it does not determine value. Was the fair value of Chrysler stock $300 per share in 1929 and $6 per share in 1932? It sold at those prices. If costs are values, what is the present value of 100 shares of Chrysler stock purchased in 1929 and 100 shares purchased in 1932?

In the early part of 1920 a certain wholesaler of dry goods in New York City called in its salesmen and one of the officers addressed them somewhat as follows: "The goods that we are buying and selling are not worth the prices that we are giving and getting. They never were and they never will be. Go out and tell that to your customers. Don't try to sell them anything. Tell them not to buy. Tell them to

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[4] Healy, Judge Robert E., "The Next Step in Accounting," *The Accounting Review* (March, 1938), p. 6.

[5] MacNeal, K., *op. cit.* chap. I., "Three Fables."

reduce their inventories to a minimum. We are going to sell our inventory and buy only to fill uncancelable orders from responsible customers." The management of that wholesale dry goods company understood the difference between the meanings of the words "cost" and "value," and used this knowledge to preserve the financial integrity of their company and of many of their customers, in the crash that followed.

Mr. MacNeal believes that balance-sheets should disclose present values. To express his concept of present values he uses market and replacement.[6] This concept of value is the layman's concept. One dictionary defines value as "worth; importance; market price; estimated worth." [7] There is considerably more to the definition. Except for "market price," it does not contain words that can be interpreted with mathematical exactness. But there is nothing in the definition that suggests the accountants' concept of the value of a fixed asset, a prepaid expense having an expiration date that is uncertain. This concept was ably expressed in 1936 in the following definition, which is the product of the joint efforts of a large number of men, well schooled in accounting principles.

"The accountant's valuation of physical assets at any given point of time involves the determination of what part of original cost should be written off to reflect consumed, expired, or lost usefulness, and what part should be carried forward as reasonably applicable to future operations." [8]

The traditional procedures by which accountants arrive at the amounts displayed opposite items of fixed assets on balance-sheets, is described in most accounting texts as a valuation process; but in reality it is something very, very different from valuation, for two important reasons. First: If accountants did what is suggested in the definition immediately above, they would not obtain an amount that any grammarian, untrained in accountancy, would admit is a value. Depreciated cost and value are different concepts. Second: In connection with physical assets, accountants do not claim that they have the ability to determine "what part of original cost should be written off to reflect consumed, expired, or lost usefulness." In order to make determinations of this kind, accountants would have to be thoroughly familiar with the details of their clients' engineering and production problems, the activities of their competitors, and the progress of science and invention. Even if the accountants' definition of value, quoted above, is accepted as valid, the traditional procedures for computing amounts to be set opposite fixed assets do not result in a value. The largest degree of responsibility that an accountant can take in connection with the display of depreciable assets is to state that the allowance for depreciation appears to be adequate. This means something, and it is important, but it is not valuation.[9]

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[6] MacNeal, K., *op. cit.*, pp. 267–270.

[7] MacMillan's *Modern Dictionary* (New York: The MacMillan Company), 1938.

[8] "A Tentative Statement of Accounting Principles Affecting Corporate Reports," formulated by the executive committee of the American Accounting Association, published in *The Accounting Review*, June, 1936, p. 188.

[9] The inadequacy of accountants' examinations of depreciation rates, from a valuation viewpoint, is suggested in many publications, two of which are cited below.

Hosmer, W. A.: "The Effect of Direct Charges to Surplus on the Measurement of Income," *The Accounting Review*, March, 1938, p. 36. "In many instances depreciation and obsolescence proved to be greater than the amounts charged to operations in prior years," p. 33. In the year 1936 the U. S. Steel Corporation made a surplus adjustment of $270,000,000 to correct estimates of depreciation and amortization in prior years.

Greer, Howard C.: "Application of Accounting Rules and Standards to Financial Statements," *The Accounting Review*, December, 1938, p. 345. Mr. Greer made a study of extraordinary charges or credits to surplus or profit and loss, disclosed on the published statements of eighteen corporations during a

In practice the amounts shown opposite items of fixed assets on balance-sheets are merely unamortized costs, the consequences of certain decisions by management. There is no serious attempt to determine the amounts that "should be written off" and that "should be carried forward." A serious attempt would be an appraisal. Accountants do not appraise. The usual basis of computations is historical. During the years that have passed since the depreciable assets were acquired, charges have been made to operations or to surplus to build up a credit balance in an account called "Reserve for Depreciation." The balance of that account is determined by many factors, which are neither mentioned nor suggested in the definition quoted above. Frequently the amount is based on maximum rates allowed by the federal income-tax department. In determining depreciation rates, managements ponder such questions as these: "How much depreciation do we want to charge off?" "How much can we charge off?" "How much must we charge off?" They seldom base their charges to depreciation solely on unbiased estimates of probable life and residual value. If managements did that, and if they revised their estimates yearly in the light of their experience and the fullest obtainable knowledge of future probabilities, and if the accountants' warped and stretched concept of value is accepted as valid, then the traditional method of computing the amounts to be shown opposite items of fixed assets on balance-sheets could be accurately described as a valuation process.

Accountants frankly and freely admit that balance-sheets do not portray present values of assets and net worth, when the word values is interpreted in its ordinary nontechnical sense. To corroborate this theme, Mr. MacNeal quotes the following from a letter sent to a committee of the New York Stock Exchange by a committee of the American Institute of Accountants:

"The principal objects which the committee thinks the Exchange should keep constantly in mind and do its best gradually to achieve are:

"1. To bring about a better recognition by the investing public of the fact that the balance-sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

"2. To emphasize the fact that balance-sheets are necessarily to a large extent historical and conventional in character, and to encourage the adoption of revised forms of balance-sheets which will disclose more clearly than at present on what basis assets of various kinds are stated."[10]

Accountants who develop balance-sheets by using traditional accounting procedures do not attempt to include all of the assets. By deliberate choice they omit items that have enormous values that could be immediately realized; such items as valuable franchises acquired without cost, patents developed by research departments whose operating costs are charged to expense, goodwill, or trade marks popularized by the owner (often worth more than all of the other assets combined), long-term leaseholds which have become valuable since acquisition, and enforceable contracts for the purchase of large quantitites of needed materials at prices below present and anticipated market levels. Below the asset caption, accountants list items that are utterly unsalable, utterly devoid of present or

nine-year period. He found nineteen identifiable instances in which charges were made covering "extraordinary depreciation and losses on sale or retirement of capital assets."

[10] MacNeal, K., *op. cit.*, p. 319. Also, see *Audits of Corporate Accounts*, a booklet published by the American Institute of Accountants in 1934, p. 12.

future value, in the lay sense. Examples are discount on stock, premium on bonds owned, discount on bonds payable, prepaid federal capital-stock tax. In determining the amount to be written opposite items of prepaid insurance no consideration is given to cancellation value, or replacement value, which may be substantially higher, if rates have increased since the policy was written. The amount shown is unamortized cost. It is proper to use the same amount in connection with policies which have no cancellation value or are not replaceable. Value, as that word is understood by laymen, does not affect the computation nor the propriety of showing the calculated amount preceded by a dollar sign on the balance-sheet.

The layman's concept of an asset is something of value owned. Accountants deliberately omit from their lists of assets properties that have large immediate values, because they did not cost anything or because the costs cannot easily be traced or allocated to them.[11] By admission of a committee of the American Institute "the balance-sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values." [12] Items that have no present or future realizable value are listed below the asset caption. [13] A balance-sheet is not a statement of assets, liabilities, and net worth, if that phrase is given a nontechnical meaning. A statement which can be fairly described as a statement of assets, liabilities, and net worth, should include all of the assets at present values, as nearly as they can be estimated or computed by competent experts.

Investors and bankers are interested in the cost of assets in a mild sort of manner. They regard it as good information to have available. Their interest in costs does not center in the costs themselves. They are interested because costs sometimes are an index of competence of management and prospects for future profits. Investors and bankers want statements of assets, liabilities, and net worth that include all of the assets at present values as nearly as present values can be estimated or computed by competent experts. They do not want valuable assets excluded, because they did not cost anything or because the costs cannot be allocated or traced. They do not want assets listed at values which bear no relation to present realities, mere historical calculations of unamortized costs, which seldom are serious attempts to determine "what part of original cost should be written off to reflect consumed, expired, or lost usefulness, and what part should be carried forward." [14] A competent appraisal of unconsumed utility in fixed assets would interest investors and creditors more than a mere statement of unamortized cost. But they really would like to have an expression of competent independent opinion on the present value of the property, an opinion which gives proper weight to consumed and unconsumed utility, and which also gives proper weight to replacement or reproduction costs, obsolescence, salability, profit prospects, and all other factors that should be taken into consideration in estimating or calculating the present value of fixed assets.

It can be said truthfully, that accountants engaged in preparing balance-sheets according to traditional procedures, are not attempting to make statements of assets, liabilities, and net worth, if that expression is interpreted in its grammatical, nontechnical sense. Traditional accounting procedures do

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[11] For examples see the preceding paragraph.

[12] See quotation above, referred to in footnote 10.

[13] For examples see the preceding paragraph.

[14] See quotation above, referred to in footnote 8.

not lead to that goal. But they do lead to the preparation of a statement which appears to be a statement of assets, liabilities, and net worth, because it contains a list of items captioned "Assets," another list captioned "Liabilities," and the excess of the former over the latter is shown in another section of the statement, often called the "Net worth" section.

There are exceptions to the rule just stated. The assets of some financial institutions consist almost entirely of cash and items which have cash values that can be accurately determined. In such instances the traditional procedures sometimes result in balance-sheets which are accurate statements of assets, liabilities, and net worth. But the problem is different in the case of corporations that must invest large sums in fixed assets. For a few years following the organization of such corporations, balance-sheets based on cost are reasonably accurate statements of assets, liabilities, and net worth, provided costs are based on wise and prudent expenditures, and provided the corporation is moderately successful. But, even in these rare instances, the divergence between asset values and costs, or depreciated costs, grows wider as the years pass.

The time has arrived when the balance-sheets of most large modern corporations are not reasonably accurate statements of assets, liabilities, and net worth.

For some years the Securities and Exchange Commission has been struggling with the problem of obtaining statements which disclose every material fact and which are not misleading. This has been particularly difficult in connection with promotional enterprises.

The Commission has found an interesting solution. This has been described by the chief accountant of the Commission, William W. Werntz, in the following words:

"In form A-0-1, for corporations organized within two years to engage in the exploitation of mineral deposits, an attempt has been made to overcome the misleading effect of financial statements of enterprises of this type by eliminating the usual requirement of a certified balance-sheet. In its place the registrant is required to submit certified schedules of (1) current assets and liabilities; (2) liabilities, other than current liabilities; (3) amounts due to and from promoters and other insiders; (4) noncurrent assets and capitalized expenses; and (5) capital stock. . . .

"In the schedule of noncurrent assets and capitalized expenses the registrant is required to list and identify each material item showing, however, only the total number of units of each class of securities, the amount of cash and of anything else given therefor by the registrant. The dollar amounts are not permitted to be extended. Thus no representations as to the value of the mining property or claims are made in the registrant's financial statements and the vexing problems of stock discount and capital surplus are avoided." [15]

Amputation at the neck will end a headache. Balance-sheets cannot mislead if they are abolished. Fixed-asset values cannot be misleading if no values are stated. Abolition of balance-sheets may satisfy the Commission, but it is an unsatisfactory solution for investors who want statements of assets, liabilities, and net worth, and for practising accountants who earn their livelihood by certifying balance-sheets. To date, the Commission has applied this extreme remedy only to mining enterprises organized within two years, but there is no promise of immunity to other enterprises. Mr. Werntz followed the comments quoted above with this sentence, "This approach has not been extended to non-mining companies,

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[15] Werntz, William W.: "Financial Statements for Investors," address before the Ohio Society of Certified Public Accountants, Toledo, Ohio, September, 1939. Published by the Securities and Exchange Commission, pp. 3–4.

although that is under consideration at the present time." [16]

Misleading values are not confined to promotional enterprises. When price levels rise, fixed-asset values based on cost less depreciation, are apt to be very misleading to shareholders who are contemplating a sale of stock. Managements owe their first duty to the shareholders in the corporation which they manage. Asset or profit understatement is a violation of primary duty. Therefore, asset or profit understatements can be considered more culpable than overstatements, which violate secondary duties to prospective investors and creditors. Is it not possible that the Commission will ultimately rule that asset values based on cost, or cost less depreciation, are misleading, if they are substantially less than market or sound values on the balance-sheet date?

Values which are correct, by any standard of correctness, are misleading to many readers when they are used to describe fixed assets. Many balance-sheets display an item somewhat as follows:

Land, Buildings, Machinery and
Equipment.... $12,480,292.46

To many readers, such a fabulous sum preceded by a dollar sign means "money, and lots of it." To the same readers, money means cash. When they look at such an item, certified to be correct, they do not see land, buildings, fences, yards, railroad sidings, bricks, concrete, smoke, grime, and so forth. They visualize huge bank deposits or mountains of currency. Perhaps they could understand better if there were no fabulous sums preceded by dollar signs to mislead their imaginations. Perhaps fixed-asset values should be eliminated from all balance-sheets, and perhaps they ultimately will be. What will be the end of this movement toward the abolition of balance-sheets and fixed asset values, which has been started by the Securities and Exchange Commission?

Years before the Securities and Exchange Commission was established, practising accountants were attempting to prepare statements which disclosed every material fact and which were not misleading, because the principal value that attaches to a public accountant's certificate is the confidence of the public in his ability and integrity. The instances where public accountants have failed to live up to public expectations are so rare that they make the headlines when they do occur. In their efforts to make published statements better understood, year after year accountants have been lengthening the explanatory material opposite the various values; they have been abandoning meaningless, stilted phrases, and substituting descriptions that are meaningful, and that are expressed in carefully chosen English. This progress is admirable, but the principal causes of misunderstanding remain uncorrected. The quotation above, taken from a letter sent to a committee of the New York Stock Exchange by a committee of the American Institute of Accountants, proves that accountants, ranking high in the profession, know that balance-sheets are not statements of assets, liabilities, and net worth, as that phrase is understood by laymen, yet accountants continue to foster that misunderstanding by using a form of statement that contributes to it.

In the popular account form of balance-sheet, the caption found over the left-hand side is "Assets." What does it mean? More important, what does it mean to readers? Most readers believe it means that all of the items listed below are assets, that all of the assets are listed below, and that the values are correct asset values on the balance-sheet date. Accountants know that some of the items listed below the

[16] *Ibid.*

caption, "Assets," have no present or future realizable value, they know that some very valuable assets are not listed, they know that the amounts in the value columns are not correct values on the balance-sheet date, and they know how this part of the statement will be misinterpreted by most of the investors who read it. This misunderstanding will not be cleared up by the exertions of a committee of the New York Stock Exchange to attempt to "gradually" convince investors that balance-sheets are not what the form, date, and captions seem to indicate. Some more forceful method is required. Perhaps an explanatory memorandum should be added regarding the assets that are omitted. Perhaps another explanatory memorandum should be added explaining that certain varieties of deferred charges have no value, that they are merely debit balances in certain accounts in the ledger, that they have not been charged to profit and loss or surplus, and that they will be charged against profit and loss or surplus at some future date if the management decides to make the charge. Perhaps there should be another memorandum explaining that the date and the asset caption have no application to the values set opposite the items of fixed assets. Perhaps the caption, "Assets," should be changed or abolished. Perhaps accountants must tell the public what balance-sheets are, instead of merely telling them what balance-sheets are not. Perhaps another title should be substituted for the meaningless, stilted phrase, "balance-sheet."

What does this phrase mean? A sheet on which two or more columns of figures balance, or equal each other. Balancing is a problem of major significance for beginning students of accounting, but probably ranks least in importance among all of the problems that face experienced accountants. Yet it is elevated to the place of chief prominence on the annual statement. Could any other title be chosen that would be more unexpressive?

Fundamentally, the account form of balance-sheet appears to be the product of fifteen minutes of not too strenuous mental exertion on the part of an unimaginative bookkeeper. Once upon a time, by chance, someone picked up a piece of ledger paper and wrote a post-closing trial balance on it. In some such way, the account form of balance-sheet was born. Its principal appeal is its simplicity. This appears to be its crowning virtue. Actually, this simplicity is its most insidious and potent vice. In this world where "necessity is the mother of invention," in this world where human beings do not think unless they must, simplicity is adored. This universal love of simplicity has led accountants to list the post-closing debit balances from accounts in general ledgers, on the debit side of balance-sheets and write "Assets" at the top. This is simpler than the caption, "An incomplete list of assets which includes current assets at present values, fixed assets at cost, or cost less depreciation, and some deferred charges valued at the cost of unused benefits, and others which have no present or future realizable value," and so forth. The caption, "Assets," is more simple, but what it gains in simplicity it loses in accuracy. It makes balance-sheets easy to misunderstand and, at the same time, it gives readers the satisfaction of believing they have comprehended correctly.

The effect of this misleading simplification, in connection with balance-sheet presentation, can be better understood if we imagine similar principles of simplification applied to profit-and-loss statements. If profit-and-loss statements are prepared in a similarly simplified account form, most of the debit balances from the profit-and-loss accounts will be listed on the debit side under the simplified caption, "Expenses." Under this caption we will find such items as beginning inventory,

purchases, manufacturing costs, operating expenses, and financial expenses. On the credit side under the simplified caption, "Incomes," we will find sales, ending inventory, and financial incomes.

When the net profit is added to the sum of the "Expenses" the sum of the items on the debit side will equal the sum of the items on the credit side. If profit-and-loss statements had always been published in that form, how many readers would understand the distinction between purchases, costs, and expenses? How many would have clear concepts of cost of sales, gross profit, manufacturing costs, operating profit, and so forth? Perhaps the fine distinctions in connection with profit and loss, that are so widely comprehended, are due partly to the adopted form of statement, which is less simple, less misleading, more complicated, more informative and, as a result, more understandable, in the true sense of that word, for nothing is understood unless it is understood correctly.

The statement that follows is suggestive, not demonstrative, of what may be accomplished by changing the title and rearranging the facts, customarily displayed on balance-sheets, into a form which crudely resembles profit-and-loss statements. The purpose of the changes is to convey a better understanding of the nature of the facts disclosed, and to help answer the question propounded in the title of this paper, "What is a balance-sheet?" It is not offered as a practical substitute for the account form of balance-sheet. A consideration of its practicality does not come within the scope of the subject.

THE XYZ CORPORATION

CLASSIFIED SUMMARY OF FUNDS INVESTED BY SHAREHOLDERS, EXPENDITURES NOT CHARGED TO PROFIT AND LOSS OR SURPLUS, RETAINED PROFITS, AND UNEXPENDED FUNDS ON HAND

As of the close of business, December 31, 1939

CAPITAL STRUCTURE, AND FUNDS INVESTED BY SHAREHOLDERS		
Preferred stock, 10,000 shares authorized, $100 par value per share, 5% cumulative.		
Outstanding, 6,000 shares.		
1,000 shares exchanged for present factory site in 1924	$ 100,000	
Sold for cash at $95 per share, 5,000 shares, having an aggregate par value of	500,000	
Aggregate par value of 6,000 shares of preferred stock outstanding	$ 600,000	
Less discount, $5 per share on 5,000 shares	25,000	$ 575,000
Common stock, without par value. Declared value $40 per share.		
Authorized and outstanding, 20,000 shares sold for cash at $40 or more per share. Aggregate declared value	$ 800,000	
Plus premium of $10 per share on 5,000 shares sold for $50 per share	50,000	850,000
Capital surplus from purchases and sales of treasury stock		48,500
Total funds invested by shareholders		$1,473,500

EXPENDITURES NOT CHARGED TO PROFIT AND LOSS, OR SURPLUS		
Cost of land, buildings, machinery, and equipment (Schedule 1).*	$1,020,336	
Less mortgage bonds outstanding, including unamortized premium of $5,000	255,000	
Net expenditure for land and buildings from shareholders' funds	$ 765,336	
Less deductions from past earnings to provide for depreciation	289,114	
Unamortized cost of equity in land, buildings, machinery, etc..	$ 476,222	
Stocks in uncontrolled affiliates at cost	217,864	
(These stocks are not listed on any exchange.)		
Goodwill at cost. Purchased from the AB Company in 1926..	90,000	
Prepaid expenses	27,539	
Organization expense	24,865	
Unamortized balances of expenditures not charged to profit and loss, or surplus	$ 836,490	
Unexpended remainder of shareholders' funds, now invested in working capital	$ 637,010	
RETAINED PROFITS		
Unappropriated balance	$ 116,393	
Appropriated for the protection of bondholders, in accordance with provisions in the bond indenture	$ 130,000	
Total retained profits	$ 246,393	
Less deposits with the sinking fund trustee, represented by cash and securities in the sinking fund	130,000	
Unexpended remainder of retained profits now invested in working capital		$ 116,393
WORKING CAPITAL (Schedule 2) *		
Current assets	$1,386,460	
Current liabilities	633,057	$ 753,403

* Schedules of land, buildings, machinery, and equipment, and of working capital are omitted, because their inclusion would add nothing of value bearing on the subject. If they were included, there would be nothing unusual about them, or different from similar schedules that accountants customarily make. Inventory can be valued on any basis that is considered good accounting practice without affecting the conclusions that will be drawn in this paper.

"The purpose of accounting is to account—not to present opinions of value." [17] These words of Judge Healy are the key to the essential differences between the accompanying form of presentation and the customary account form. The account form appears to be a statement of values. Essentially, a corporation balance-sheet is an accounting of management to shareholders for expenditures made in acquiring properties owned and for unconsumed benefits properly chargeable to future operations. The title of the accompanying statement informs the reader that it is an accounting for expenditures

[17] Healy, R. E., *op. cit.*

not charged to profit and loss or surplus. Except in the working-capital section, there is nothing in the title or the captions to suggest that it is a statement of values.

The words of Judge Healy also make clear the reason why traditional procedures favor costs over appraisals. "The purpose of accounting is to account—not to present opinions of value." [17]

It is not impossible for managements to account to investors for use of funds if costs are periodically replaced by appraised values. However, if such substitutions are made, an accounting is more difficult to make, and more difficult to understand. This is one of the reasons that accountants advocate the retention of costs in the fixed-asset accounts. All of the invectives directed against the listing of fixed assets at values based on cost lose their effectiveness when the rightful nature of balance-sheets is understood, when it is recognized that balance-sheets are not statements of assets, liabilities, and net worth, and that they are an essential part of the accounting that managements are legally and morally obligated to render to shareholders for the use and care of invested funds.

Fiduciaries, who account to courts of equity for funds entrusted to their care, are required to segregate their transactions into classifications, and submit separate statements for the various classes of transactions, because the accounting can be better understood when segregations are made. The same principle applies to corporate accounting. Income and expenses are accounted for on profit-and-loss statements. Changes in surplus are accounted for on surplus statements. Unexpended funds, expenditures for properties owned and unused benefits, invested capital, and retained profits are accounted for on balance-sheets. If valuable properties or assets have been acquired without expenditures that can be allocated to them, they do not belong on balance-sheets, which are primarily accounts of expenditures not charged to profit and loss or surplus. But they have a rightful place on a balance-sheet which is a statement of assets, liabilities, and present net worth.

The accompanying form avoids the misleading features of the ordinary account form of balance-sheet. The caption, "Assets," is omitted. There is nothing in this statement to suggest that it includes all of the assets at present values. Except in the working-capital section there is no suggestion that the amounts are values. They are described as expenditures, which is what the amounts really are on any balance-sheet that does not substitute appraised values for cost.

This point deserves special emphasis, because one of the most deep-seated misunderstandings in connection with modern balance-sheets is the idea that the amounts set opposite the various items of fixed assets are values. Accountants have encouraged this misunderstanding by allusions to "book value of buildings," "book value of machinery," and so forth. These so-called book values are not values, because accountants are not appraisers. When computing the amounts shown opposite items of fixed assets, accountants purposely ignore well known factors that affect values, because they are not competent to estimate or measure them. The fact that the traditional procedures do result in fair values, when these well known factors are absent, does not justify the characterization of the traditional procedures as a valuation process.

The accompanying statement describes the deduction for depreciation as "deductions from past earnings to provide for depreciation." It is not described as an "allowance" or "reserve." This is a simple statement of historical facts. Here, there is no implied representation that the accountant has

determined "what part of original cost should be written off—and what part should be carried forward."[18] The net investment in fixed assets is described as "unamortized cost," which is exactly what it is.

Accountants differ on the propriety of including organization expense on balance-sheets. This difference of opinion has its roots in the erroneous concept of balance-sheets as statements of assets, liabilities, and net worth. When the balance-sheet is accepted as a record of expenditures that are not proper charges to profit and loss or surplus, there can be no difference of opinion regarding prudent outlays for legal services in drawing up a charter, incorporation fees, and commissions on the sale of stock. These expenditures are essential to corporate existence. The benefit continues as long as the operations of a corporation are profitable. There is no reason why such charges to organization expense should be deducted in computing earned surplus.

The descriptive caption, "Retained profits" has been used in the accompanying statement instead of "Earned surplus," because the latter is inconsistent with the true nature of balance-sheets. The latter title suggests an attempt to measure the excess of assets over liabilities and stated capital. In fact, customary balance-sheet procedure does not attempt such a measurement. The credit balance in an earned-surplus account is a measure of the result of certain historical events. It is the excess of profits that have been realized over costs and expenses incurred or estimated, dividends declared, and other deductions.

The sources of funds retained in the form of working capital are clearly disclosed on the accompanying statement. It answers the question propounded by so many beginning students of finance, "What has become of the profits that were not paid out in dividends?"

When a balance-sheet is recognized as an accounting for certain kinds of expenditures and unexpended funds, it becomes easy to harmonize cost procedures and balance-sheet practice in connection with inventories. Because the amount shown opposite the inventory is not represented to be its value, the inventory can be shown at the amount that is most appropriate for cost computation.

This statement is not offered as an example of the optimum arrangement of items. It is not an attempt to demonstrate how all of the complicated and involved problems of modern balance-sheets can be most easily solved. It is not submitted with the idea that it will be adopted by anyone. It is an attempt to expose the misunderstandings that are inherent in the account form of balance-sheet. It is an attempt to reveal the true nature of balance-sheets prepared according to traditional procedures.

The accompanying statement has four main sections:

1. An accounting for funds received from the shareholders.
2. An accounting for expenditures from those funds for properties owned and benefits unconsumed on the balance-sheet date.
3. An accounting for retained profits.
4. An accounting for unexpended funds.

Perhaps a better title can be found. Perhaps working capital should not be described as an investment of unexpended funds. Perhaps current liabilities should be added to fixed liabilities somewhere. Perhaps section three should be combined with section one. Possibly separate sections should be provided for fixed assets, intangibles, and deferred charges. The merits or demerits of such suggestions have nothing to do with the theme of this

[18] See footnote 8 and the above discussion of the quotation.

article, which is an inquiry into the essential nature of balance-sheets, and which is not the development of a substitute and superior form of statement. If the accompanying form of statement is adopted by any practising accountant, then he must consider these and other alternatives as they apply to his clients.

Thus far in this article the balance-sheet has been treated as a statement prepared solely for the benefit of shareholders. What about creditors? Are they not entitled to some consideration in determining the nature of the information that is to appear on balance-sheets? The answer is no. If managements are to render to shareholders a complete accounting for the use and care of their funds, the amounts displayed on balance-sheets should be based on cost, with deductions for depreciation and probable losses. The balance-sheet is prepared for shareholders. Creditors have only a minor interest in the facts disclosed.

This does not mean that creditors are not entitled to receive the kind of statements that they want prepared. If they want statements of assets, liabilities, and present net worth, such statements can and should be prepared. Undoubtedly, shareholders will join with creditors in demanding statements of assets, liabilities, and present net worth, if the majority of them ever find out that they are not receiving such statements. They would like to know the present net asset value of their shares. Such a statement should include all of the assets, whether they are recorded or unrecorded on the books of account, whether they were bought or acquired by other means, and whether or not there is an accurate record of their cost. Accountants can prepare such statements with the help of other independent experts who are competent to express opinions that accountants are not competent to express. The problem of assembling pertinent facts and opinions into properly qualified and understandable statements is comparatively simple for any practising accountant. Most of them have already done this in connection with incorporations of going-business enterprises, reincorporations, reorganizations, mergers, and consolidations.

If the accounting difficulties are so slight, why are accountants not preparing statements of assets, liabilities, and net worth to accompany their balance-sheets and make the nature of both statements and the condition of the corporation clear to investors and creditors? One reason is that investors and creditors are not demanding them. Managements will expend funds only for statements that are demanded by investors and creditors.

Accountants want to make the fullest disclosure that is consistent with the true interests of the shareholders. Managements frequently object to disclosures in the first draft of a report and compromises must be found that will disclose enough to satisfy the standards of good public accounting practice without making the statements so objectionable that managements will refuse to publish them. Many investors and creditors do not realize that managements can publish what they please, and that no public accounting firm can compel a management to publish a statement as submitted and qualified.

Probably the time will never come when full disclosures of all of the facts discovered in the course of an audit will be advantageous to the shareholders. Disclosures to shareholders in published statements are available to competitors. Many facts, uncovered in the course of an audit or examination, are confidential. Disclosure would give competitors advantages that would ultimately injure the shareholders for whom the disclosures were originally intended.

In an honest attempt to answer the question, What is a balance-sheet? it is

not possible to ignore the fact that balance-sheets in the customary account form have been a convenient means of suppressing vital facts about enterprises. The title is meaningless. The caption, "Assets," is misleading. Some assets are omitted. Some items that have no value are included on the asset side. Some items are valued at cost, some at market, some at appraised values which did or did not represent an honest attempt to make the balance-sheet more truthful several years ago. Managements who want to make balance-sheets more difficult to understand have power conferred by statute to engross values on the records in violation of sound accounting principles and give them a legal existence that accountants cannot ignore.[19]

What more convenient means of suppression could there be, than a popular form of statement, which most readers think they understand, and which few, or none, actually do understand? The popularity of this form of statement makes it easy for managements to go through the pretense of disclosure, without actually disclosing much. In view of the active opposition that most managements display towards proposals to make additional disclosures, is it unreasonable to conclude that the form of balance-sheets is misleading because managements want it that way, not because the accounting profession is unwilling to prepare or incapable of developing forms which will be correctly understood?

[19] For example, Ohio G. C. 8623–38 (f) contains the following: "Whenever the board of directors of a corporation shall be of the opinion that its assets, including patents or goodwill, have a fair value to the corporation in excess of the amount at which they are carried on its books, and shall determine the amount of such fair value, it may order all or a part of the fair value so determined to be entered on its books and thereby create an excess of assets, which the board of directors may apply to a dividend in shares of the corporation and transfer to stated capital or apply to an increase of stated capital represented by shares without par value."

Until the Securities and Exchange Commission was established, there was no means of enforcing any accounting standards on corporations not subject to regulation by public-utility commissions. Accountants had to rely wholly on moral suasion. Even now, accountants must rely on others to enforce the accounting standards which they are trying to uphold. Accountants who uncover unsound accounting practices have no direct means of enforcing sound practices. The most severe penalty any public accounting firm can impose is refusal to allow its name to be used in connection with a published statement.

Moreover, accountants have been under pressure from shareholders and creditors to depart from sound accounting standards and publish statements that conform more closely to their misconceptions of the information that should be contained in balance-sheets. This pressure has been particularly difficult to resist, because the value of accountants' certificates is proportional to the reliance that creditors and investors are willing to place upon them.

The accounting profession is doing everything within its power to promote more adequate disclosures, and to serve the interests of investors and creditors, whose confidence in their work attaches value to their certificates. But, the accounting profession will not be able to persuade managements to permit the publication of more informative statements until investors and creditors, by their insistence on more disclosure, have evidenced a demand that will not be denied. Thus published balance-sheets are and probably will continue to be compromises, which are partly based on adherence to sound accounting principles and partly based on legalized departures from them, and which imperfectly satisfy the conflicting desires of managements, shareholders, creditors, and the accountants who prepare them.

Summary

Many misunderstand balance-sheets and believe they are statements of assets, liabilities, and present net worth. Balance-sheets prepared according to traditional standards constitute part of the accounting corporation managements should render to shareholders for use and care of shareholders' funds. Although the courts have not classed corporate managements as fiduciaries, their responsibilities and duties to shareholders are actually fiduciary in character. The amounts shown opposite items of fixed assets on balance-sheets should be based on cost because they are accounts of expenditures. Traditional accounting procedures are sound, because accounts based on cost are easier to understand than accounts based on appraisals, and because they comply with the equitable doctrines governing reports of fiduciaries.

In addition to the accounting now rendered to shareholders on profit-and-loss statements, surplus statements, and balance-sheets based on traditional accounting principles, shareholders and creditors are entitled to statements expressing independent expert opinion on the value of all of the corporate assets, liabilities, and net worth. The need for this additional statement is growing because the differences between asset values and the account balances based on cost and reasonable allowances for depreciation grow larger and more numerous as the years pass. Statements of assets, liabilities, and net worth, which include all of the assets at present values, frequently have been prepared by accountants, in collaboration with other experts who are competent to express opinions that accountants are not competent to express. Occasions for the preparàtion of such statements have been incorporation of going businesses, reincorporations, reorganizations, consolidations, and mergers. Such statements are not offered as the sole opinion of the public accounting firm preparing the statement but as an expression of the combined opinions of management and of all of the independent experts. When such statements are prepared and submitted with balance-sheets in the majority of published reports, the true nature of balance-sheets will be evident by contrast. Preparation of such statements involves additional expense which managements will not incur until demanded by shareholders and investors.

Managements have authority, conferred by statute, to engross on the books of account values that violate sound accounting principles, and to give them a legal reality that accountants cannot ignore. Some shareholders and creditors who discover that balance-sheets are not statements of assets, liabilities, and net worth, bring pressure to bear on accountants to depart from sound accounting principles, and prepare balance-sheets that conform more closely to their erroneous concepts. Accountants try to adhere to sound principles. Governmental agencies lay down numerous rules and regulations that must be complied with. The only solution to the dilemma created by such a conflict of forces is compromise. Thus published balance-sheets are, and probably will continue to be, compromises, which are partly based on adherence to sound accounting principles and partly based on legalized departures from them, and which imperfectly satisfy the conflicting desires of managements, shareholders, creditors, and the accountants who prepare them. While these conflicting forces are resolving themselves into a result that no one can foresee, accountants may discover that their best chance of preserving the traditional accounting principles is by advocating publication of an additional statement including all assets at present values as nearly as present values can be estimated by independent experts collaborating with managements.