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ACCOUNTING THEORY

AN OUTLINE OF ITS STRUCTURE

By

HARRY NORRIS, A.C.A.



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PREFACE

THIS book is addressed in the first place to my fellow-members of the accountancy profession. There are certain others who will, I hope, benefit from it ; but it is primarily my desire to improve the minds of other accountants. This is, of course, a shocking desire to have, but is not some such object the motive of all those who write books on technical subjects ? Perhaps immodesty consists only in admitting the desire. Of one thing I am quite certain ; and that is that in writing about accounting theory I have somewhat reduced the chaos of my own thoughts on the subject ; so that, happily, at least one mind has been improved—and my efforts have therefore been justified.

The others who may benefit from my " Outline " are, firstly, economists, and, secondly, accountancy students. I must warn the latter that I have not aimed to help them to pass examinations in accountancy. To take this book too seriously might even hinder them in this, because at times I have suggested unorthodox solutions to the problems of accounting, and presumably it is not safe to be too unorthodox in answering examination questions. Whether that is so or not, I do think that an examination of the fundamentals on which the practical procedures of accountancy rest ought properly to form an important part of the training of an accountant.

One of the main reasons why I found it necessary to write this book is that accounting methods have been built up in a rather haphazard piecemeal way not suited to the most satisfactory development of such a complex science, art, or craft. I deal in the Introductory chapter with the significance for accountancy of the shortage of an adequate background of what one might regard as a philosophy of accounting ; of the tendency to decide practical problems as they arose without first having reflected on the meaning of the terms used in accounting and on the nature of its fundamental principles. With the best of intentions, this unsatisfactory way of constructing a system would be almost certain to produce some defects in procedure, and, in fact, there do exist some unsatisfactory features in present-day accountancy. This is not to say that the standard of practice as a whole is not good, as indeed it is ; but without a grasp of the theoretical structure of accounting, we shall not quite reach perfection of practice ;

PREFACE

we shall not achieve that single-minded approach to the complex problems of accounting presentation in the affairs of large-scale industry which is necessary if we are to achieve a close approach to Truth, unhampered by considerations of expediency. That is why I join students of accountancy with qualified accountants as the addressees of this "Outline." In my opinion it endangers the proper development of accounting, and, ultimately, impairs the status of the profession, for the subject to be learnt almost entirely in terms of what we do, and not also in terms of why we proceed in a certain manner, and, in a general way, how the things we are measuring (principally business "profits") are connected with that closely-associated field of thought, "economics."

This brings me to the economists, whom I have suggested might find this book useful. As anyone will see who proceeds to the first chapter—and, still more, anyone who chances to reach the penultimate chapter, "The Economist and Accounting"—I have been spurred to activity partly by my feeling that there exists a close but neglected connexion between accounting and economics. The views of an expert in the latter, Professor J. B. Canning, as expressed in my quotation from his book, namely, "The accountants have no complete philosophical system of thought about income . . . , " form the text of this book, and my principal aim is to make good the gaps for the existence of which he gently takes us to task. Economics is very much concerned with "profits," "income," and "capital," all of which it is our business to measure by means of techniques which it is not particularly easy for laymen to understand. If I have been successful in outlining the theory of accounting and in pointing out defects in common usage, economists should be able to find in these pages a good deal that will help them in their own sphere, particularly in relation to the interpretation of business Balance Sheets and Profit and Loss Accounts, which, I suspect, many of them consider to be masterpieces of mystery. By means of these blandishments I hope to inveigle some economists into devoting a certain amount of study to accountancy techniques, so that we might have the benefit of their advice as to whether these techniques conform with the economic significance of profit. I do not think we accountants should claim a complete monopoly in the elucidation of methods of measuring profit.

So much for my beneficiaries (or victims). I am myself the beneficiary of all those of my friends and colleagues who have argued with me about the principles of accounting theory, and if I have

ever tried their patience I now apologize and thank them for a most valuable form of assistance. Most of all, my gratitude is due to my friend, Mr. Kenneth F. Suggett ; if he had not read and forcibly commented on early drafts of this book, my readers would have been victims indeed. Neither he nor anyone but myself is responsible for the more foolish things which I have written in the following pages. There is one other accountant, Mr. A. R. Parker, to whom my thanks are due, for it was he who, as partner in the firm with which I was articled, required of me a careful analytical approach to the problems of accountancy. Though he may now be surprised and not a little alarmed at the suggestion that he has had some part in the line of thought which has led to this book, I do owe him a deep debt for his patience and encouragement at a time when I must have been a somewhat raw would-be accountant.

My thanks are due to the editor of *The Accountant* for permitting the use of a considerable part of an article of mine (published in that journal on 24th June, 1939) on the subject of stock values and oncost, which article forms part of the second chapter of this book. I also thank the editor of *The Economist* for allowing me to quote from an article on "Accountants and Accounts" in the issue of 26th September, 1942.

Finally, I must thank in advance all accountants who are ready to give a fair hearing to my presentation of a case for granting considerable importance to theory in the accounting sphere. To merit my thanks, they will require a good deal of stamina, and a capacity for not being put off by a laborious statement of what might seem to be so obvious as to be not worth saying. Many accounting truths are clearly seen to be indisputable when put into words—and yet, in spite of being axiomatic, they are sometimes contravened in practice. That is why I have taken the risk of setting them down explicitly. I put this work before you, fearful that the reaction might be similar to my response to these words in the opening pages of a book by a prominent philosopher who is attempting to encourage his readers to think philosophically. He writes : " Let us consider as an example the shape of a penny. Common sense supposes the shape to be circular, but from almost any point of view from which the penny is looked at, the penny appears, as we quickly find out when we try to draw it, to be elliptical . . . " This is the sort of thing which is liable to antagonize any readers who are as hard-headed as we accountants are ; and yet, from such near-platitudes is developed a complex structure of philosophical thought and theory. I will

therefore take comfort from this precedent, and hope that the reader will judge me kindly. It is often more difficult to hunt out the obvious, and to make explicit that which is implicitly assumed to be true, than it is to comprehend more complex refinements. It is certainly more important to be sure of the foundations than of the roof. I offer you the foundations, part of the superstructure, and some bits of roof. I hope you will approve of some of this.

H.N.

CHAPTER I

INTRODUCTORY

THIS book is an attempt at an analysis of the fundamentals of accounting on which practical procedure should be based. It is possible to derive "first principles" by a process of reasoning more or less abstractly, and then to compare existing usage in accountancy with a theoretical ideal. By this means we can discover any shortcomings there may be in current practice and point the way towards the appropriate remedy. Departures from ideals cannot and need not always be remedied, of course, since, firstly, practical short cuts are justified by saving of time when the degree of error is unimportant, and, secondly, *some* ideals must remain unattainable.

Present-day practice in accountancy has largely been built up piecemeal by common sense judgment of particular cases. Such body of theory as exists has grown gradually, having been pushed forward in its development by the growing size and complexity of industrial organization and the economic system. In view of the manner of its growth, it is remarkable that we have available a system of accounting which, on the whole, is fairly logical and consistent. Nevertheless, it has some defects, and the exploration of these will be our main concern in this book.

To discover our ideals, we must study primarily the relationships which exist between various classes of cost and resultant revenues. It is the connexion between *variations* in costs and revenues which determines the basis of accounting treatment. In relation to any particular item of business expenditure during a given period, we have to find some test for deciding whether it should be charged against revenue in that period or put into an asset balance, and if the latter, then how it is to be dealt with subsequently. Stock "valuation" is the commonest type of problem involved, and questions arise as to the differing significance of prime costs and overhead costs, and as to the connexion between asset figures and values. It is on these points that I shall venture to criticise orthodox methods of treatment, and to make proposals for changes in technique.

In thinking in terms of ideals, we shall find it possible to get a firmer grasp of the potential weaknesses of accountancy, that is, of

the limitations which arise from the incommensurability of some of the factors involved. There are many things, such as cases involving advertising expenditure, the allocation of oncost, and the like, where accounting results must be treated with reserve. Most accountants are probably fully aware of this need for caution in the interpretation of financial statements, but the necessity for stressing it exists, for elements of incommensurability are sometimes hidden by the use of conventional treatments or definitions. The dangers of conventions are certainly not fully appreciated, and it may often happen that their existence forms a serious obstacle to progress when more advanced methods of technique become available.

The methods used in the preparation of accounts are influenced by many unscientific factors. Chief among these are, firstly, the desire, not uncommon amongst directors, to give very little real information to the shareholders, and secondly, the requirements of taxation regulations. The first of these factors tends to lead to the smoothing of disclosed profits, and to the use of reserve balances in a manner calculated to conceal the truth, though it should be remembered that this may only rarely be directed against the interests of shareholders. The second, tax regulation, involves conventional methods of accountancy, e.g. in stock valuation, designed to reduce the influence of mere opinion, eliminating, to some extent, even informed judgment because it is difficult to exercise it wholly without bias. Methods once adopted are often perpetuated simply because the Revenue authorities will usually prefer a consistent use of a somewhat inaccurate procedure year after year rather than agree to a change in method of calculation or treatment, which, though in itself an improvement, *might* be effected at a moment chosen to be most beneficial to the taxpaying business. This is how one kind of legal convention may become a barrier to scientific progress.

Part of the strength of these non-logical factors derives, in my opinion, from the absence of the construction by accountants of a systematic body of theory underlying their practical procedures. Left to themselves, they would no doubt produce accounts more informative and more accurate than they do at the present time, subject as they are to the pressure of managements and to taxation requirements. Whilst no doubt some of the weakness of their position is a consequence of the inadequate requirements of existing company law in relation to accounts, I have the feeling that the method by which the body of accepted practice in account-keeping has been built up, the method of piecemeal judgment of specific cases, does

not carry with it, in the minds of members of the accountancy profession, such a realization and conviction of the existence of inalienable first principles¹ as is *quite* adequate to withstand the plausible claims of expediency.

As an appropriate text for this introduction, we may take Professor J. B. Canning's comment on this question of theory and practice :

"The accountants have no complete philosophical system of thought about income ; nor is there any evidence that they have ever greatly felt the need for one. Their generalizations about income, to the extent that they go beyond procedure at all, are too inchoate, in comparison with the structure of procedure they have built up, to permit one to suppose that they have ever seriously put their minds to the philosophical task. They have built up their structure of theory only to the extent that they found suitable and convenient statistical material to clothe it in."¹

This book will deal with the "structure of theory" to which Canning refers, even though it cannot always in practice be translated into figures. Approximations and estimates are unavoidable in the preparation of accounts ; the proper sphere of "common-sense," which the accountant must have in abundance if he is to do his job properly, lies in the reduction of the margin of error between the inevitable "guesswork" and the "ideal" method. Without a co-ordinated logical scheme of principles, common-sense is at a disadvantage against plausible arguments. It is only when we are confident about fundamentals that expediency becomes merely a reasonable practical way of approaching the truth in accounting presentation ; to the extent that we are unsure of our groundwork, expediency will often lead in the opposite direction.

The quotation from Canning uses the word "philosophical," and certainly it is important to have the right approach by way of a logical grasp of the whole problem involved in business accounting. So that, for example, the idea of profit ascertained in a "single-entry" way puts a different complexion on things (and its use would almost inevitably produce different figures) than a "double entry" approach using a Profit and Loss Account as well as a statement of assets and liabilities. The difference is in whether we should think in terms of fluctuations in values, taking the position on two particular dates, or whether we should think in terms of the flow of money into and out of the business. Whilst the latter idea has almost completely ousted the former so far as the form of procedure is concerned, it is my contention that it has been slightly less successful in ousting the old philosophy of the significance of values, and that, for instance, the

¹ Prof. J. B. Canning, *The Economics of Accountancy*, p. 160.

treatment of stocks is partly incorrect by reason of the lingering influence of the old method with its underlying idea of value-accretion.

A historical study of the growth of accounting would show how primitive records of cash dealings gradually took on complexities by way of the recording of debts, stocks, partnership relationships, and so on, alongside the growing complexities of commerce and financial dealings. The idea of a statement of profit as being a cash account adjusted by debts receivable and payable, by the value of goods on hand, and by the value of fixed assets acquired, survives to this day. This attitude is largely that of the layman in his view of Balance Sheet figures; accountants have for the most part passed over to an idea of accounting for flows of costs and revenues, but here and there the old conceptions cast a shadow which is not without influence on accounting usage. A thorough-going application of this changed view of the nature of accounting will reveal that there are some deficiencies in accepted bases of inventory pricing. It will be argued that business accounts should exclude oncost from the manufactured stock figure.

It is hard to find amongst accountants any clearly-expressed notions of some of the basic concepts of accounting. Whilst it is easy to see the significance of the profit figure of a business with no stock and no debts, that is, with nothing but cash, it becomes much more involved as soon as these further assets are introduced, to say nothing of the difficulties that arise from modern forms of business ownership and finance. Accepted usage certainly implies ideas of the meaning of "profit," "capital," and other accounting terms, but these implications remain to be expressed more than they have been. Some attempt to do this has been made in America in recent years. There have been several publications there dealing with the general principles underlying accounting statements, and the general accounting literature shows a disposition to attach importance to the theoretical aspect of the subject. This is doubtless because of the academic status enjoyed by accounting in the United States. This has the advantage of leaving a body of expert accountants sufficiently free from the press of everyday commercial business to produce such important contributions to theory as the *Statement of Accounting Principles*, by Sanders, Hatfield and Moore, published in 1938 by the American Institute of Accountants, and Paton and Littleton's *Introduction to Corporate Accounting Standards*, published in 1940 by the American Accounting Association.

There has, perhaps, been a greater distrust in this country of

abstract "theorizing." This was only to be expected in view of the piecemeal "practical" way in which we have built up our accountancy procedures. But it is an attitude which is slowly changing into one of greater regard for a solid framework of theory from which practical procedures may be derived. The need for this reversal of order of development is consequential on the many complicating factors of modern business, and on the urge towards precision in measurement which emerges from government regulations and high rates of taxation. I think we may reasonably say that accounting has attained the status of a science which has as its practical counterpart the art of accountancy. I make this distinction in terms to accord with a penetrating analysis of "Theory and Practice" made by Mr. Christian Oehler, and including the following remarks particularly relevant to my own :

"The theoretical aspect of accounting is that which views it as a science, albeit not an exact science (because of the human element), but the theories of accounting are nothing but principles expressing the result of the scientific analysis of the financial condition or the operating results of a business enterprise and of the methods needed in order that they may be properly expressed and interpreted. The practical aspect of accounting is that which views it as an art, viz., the practical application of the theories of accounting to the solution of the problems of business."

Mr. Oehler uses these words, "... confusing the science of accounting with the practice of accountancy"; that is exactly the confusion we should avoid if we are to improve the "practice." It may be that the reader cannot go the whole distance with me in regarding accounting as a science. But this should be a difference only of words : it is much less important to decide what we call our field of study than it is to appreciate that there exist general principles of profit measurement and of exposition of financial condition which tie up with the associated field of thought termed Economics.³

The fact that general principles can be established by a process of reasoning cannot be too strongly emphasized, for there is a fairly

¹ "Theory and Practice," C. Oehler, in the *Accounting Review*, July, 1942.

² Professor W. T. Baxter has summarized the course of development of accounting science in these words :

"I suppose that most professions pass through three stages. First, they begin on a hit-or-miss basis, and their useful contributions to society are a result of shrewd common sense rather than careful reasoning ; few attempts are made to set out any underlying principles, and such theories as are developed are necessarily rather hazy and confused. Second, critics begin to 'debunk' these theories. Third, principles are developed on scientific lines."

Incidentally he went on to express the opinion that at that time (1938) we were at about the end of the first stage.

widespread belief that accountancy is a matter of conventional treatments which have the merit only that accountants have mutually accepted them, not necessarily for *intrinsically* worth-while reasons, as the rules which shall govern their procedures. As this dangerous belief is under attack in this book we must look at its implications. An American writer, Mr. Stephen Gilman, puts it for us all too clearly :

“ The significance of periodic accounting profit is, therefore, the algebraic sum of the separate significances of the various conventions, doctrines, rules, and practices which at any particular time constitute the common law of accounting.”⁴

The despairing (as it seems to me) conclusion to which this anti-logical view leads is expressed by him in these words :

“ Perhaps the best of all technical assertions as to the significance of accounting profit was Canning’s . . . ‘ what is set out as a measure of net income can never be supposed to be a fact in any sense at all except that it is the figure that results when the accountant has finished applying the procedure which he adopts.’ Any suggestion that such a comment is destructive rather than constructive should be stoutly resisted.”⁵

Conventions do indeed exist in the practice of accountancy, but they are only admissible on grounds of convenience, and, in the last resort, are governed by logical principles. If this idea of accounting as being merely a matter of accepted usage were true, it would mean that accountants might agree on *any* mode of treatment—to take all trading stocks at twenty shillings per ton, for instance—and that what they agreed would be right and proper. This is manifestly absurd. “ What is set out as a measure of net income ” may never be a fact, because we can never attain Absolute Truth. We must approximate and guess here and there, and two accountants starting with the same primary records might arrive at differing figures of profit. But our procedure means nothing if it does not aim at a truth which is determinate. That is to say that “ net income ” *does* mean something quite apart from what we do to measure it : it has objective significance, and our methods of measurement are only valid in so far as they subserve the principles of measurement.

There is room for many differences of opinion in relation to procedure in accountancy, there is much argument as to the proper basis for valuing stock, for example ; but amidst these differences and these arguments, in fact underlying them, is the conviction that there are right and wrong ways of doing things. This can only be so if accounting is a good deal more than a bundle of arbitrary conventions.

⁴ *Accounting Concepts of Profit*, S. Gilman, p. 605.

⁵ *Ibid.* p. 610.

The fact that these principles have not been fully worked out and expressed by accountants has given rise to the view expressed by Mr. Gilman. It has also given rise to some wrong convictions which mar the validity of accountancy statements to some extent.

In studying the measurement of profit we touch on the economist's field of study, and I have recognized this by including a chapter on "The Economist and Accounting." Before we can be sure of our principles we must have the assistance of the economist in elucidating the nature of income. With the present-day inadequacy of the liaison between accountants and economists, I put forward this study only as a tentative attempt at establishing logical principles in our own sphere of interest. Much careful thought needs to be expended on these. In what follows, I hope to stimulate thought amongst accountants on these general lines.

CHAPTER II

THEORY OF PROFITS

THE ascertainment of the amount of profit or loss arising from trade conducted by private enterprise is the most difficult and most interesting problem in accounting. The recording of cash and details of other assets and liabilities could be held to be a primary aim, but such matters of routine book-keeping are here taken for granted. Nor are we concerned, for the moment, with the amount of detailed information which should appear in Balance Sheets and Profit and Loss Accounts. We may concentrate our attention on the mode of ascertainment of the single figure—enterprise profit for the year.

An admirable passage by Mr. Leake will serve to remind the reader of the significance of this process of calculation :

“That important branch of the science of accounting which is concerned with the measurement of the fractional share of industrial production, which we call annual profit and loss, is easily capable of being raised much nearer than it is at present to the status of an exact science.”¹

SERVICES AND CLOSED-VENTURE PROFITS

The essence of business activity is the organization by an entrepreneur of various selected services rendered to him by other people (by way of supply of goods, performance of work, etc.) and the rendering by him in his turn of services (including the supplying of goods) which he is thus enabled to perform for other people (his clients or customers). The services rendered by the entrepreneur are commonly more homogeneous in classification than those which he receives. Thus different kinds of materials and various machines are purchased, working capacities are hired, a factory is rented or bought, a supply is secured, and manufacture organized and managed so as to produce perhaps a single class of article—lawn-mowers, for instance—likely to have value to potential customers.

To secure given quantities of these various services (supply of materials, etc.), the entrepreneur will naturally spend his money only if he expects to obtain a greater sum of money for the quantity of services which he is consequently enabled to render to those who

¹ P. D. Leake, *Balance Sheet Values*, p. vi.

become his customers or clients. His expectations of realizing this surplus out of the process of receiving and rendering services may or may not be fulfilled, but they are nevertheless the mainspring of business activity, and we may define the profit on the rendering of certain services as the excess of the monetary expression of them over that of those specific services which were obtained and combined to enable that particular quantity of services to be rendered. In the case of a "closed venture," profit is simply the excess of cash received over cash paid.²

SERVICES AND PERIODIC PROFIT

The rules for ascertaining profit are usually thought of something like this :

- (a) that profit arises when a sale is made ; and
- (b) that profit is to be computed by apportioning costs to relevant revenues.

These popular ideas seem to me to be quite correct, though perhaps not self-evidently so, for sometimes accountants use methods which run contrary to these rules. Some may be disposed to treat profit as arising only on realization in cash ; others consider that work-in-progress may sometimes be taken as having produced some profit (though no one ever seems to be disposed to say how much, merely that the amount brought into account may be anywhere between nothing and some " safe " figure, well under a " reasonable estimate " of profit earned to date). It could even be argued that profit arises on receipt of an order from a customer, and should be computed on that basis for inclusion in the Profit and Loss Account. The argument for this is quite plausible, and until the nature of profit is more clearly understood and the principles of its measurement widely accepted within the profession, there will always be the danger of specious arguments carrying undue weight because of this absence of a closely-knit body of theory. So long as only unadopted proposals like this one are in question, all is well ; but plausibility is not without some influence in the accounting statements produced at the present day.³

² There are other possible modes of expressing profit, thus, the utilization of a cost-of-living index might be favoured by some so as to attempt to eliminate that part of monetary profit which relates to an all-round increase in prices.

³ Mr. R. S. Edwards is responsible for another theory of profit which he ably supported with very plausible, though, I think, erroneous reasoning. He has suggested that profit for a year is the increase in the discounted value of future cash receipts, less payments (with allowance for payments to or by the proprietors). Such appreciation in the capital value of a business can be very considerable, of course, and the proposal is far more startling than the "profit-on-orders" suggestion. (*The Accountant*, July-September, 1937.)

The most serious defect in existing theory is that it fails to be clear as to whether profit is a surplus of revenue over costs or is accretion in value. It is wrong to assume that these two views amount to the same thing, for we shall reach different figures according as we regard "assets" either as things to be valued as physical units or as cost balances to be carried forward.

We have still not gone beyond consideration of batches of services and their money aspect, i.e. particular "ventures." But the statement in the preceding section leads at once to the idea of *periodic* profit of a continuing enterprise (having always, say, raw materials on hand).

Since it is the rendering of services which gives rise to profit, the profit for a period is the surplus of the money expression of those services rendered over the money expression of the component services received. In ascertaining this component-service money figure, there will be excluded expenditure on services which have been received by the concern, but which are not yet translated into services rendered. Risking a dangerous simplification of the problem, we may say that stocks on hand should be eliminated, at their cost prices, from costs of purchase or manufacture so as to give the cost of goods sold. The delivery of goods to customers is the rendering of service. Stocks on hand, even of finished goods, represent only the capacity to render services, which may or may not be demanded. Those purchases of materials and portions of employees' labour, etc., appertaining to goods *actually sold* are "component services" in the above sense. The foregoing simplification has been made in order to avoid at this stage a discussion of "valuation" at cost *versus* "valuation" at lower of cost or market value. I am not in accord with any of the more familiar arguments on either side of this controversy. For the moment, the reader should provisionally accept the idea of cost as always the correct stock assessment basis. This he may perhaps achieve by thinking only of those cases in which market value comes up to expectations and equals or exceeds cost.

SERVICES AND EXPENSE CLASSIFICATION

In compiling accounts, we have to deal with a great multiplicity of differing relationships between units of services received and of services rendered. The refinements necessary to deal with this variety of relationships constitute a much greater problem—or series of problems—than the simple statement of the broad principle. That broad principle referred to quantities of output of services as though given amounts were directly attachable to ascertainable quantities

of component services. This convenient simplicity does not occur in actual business conditions. Though practice may seem more involved than theory, there is not really a divergence between the two. The view that such divergencies may properly exist is a distressing popular fallacy.⁴ The situation is that theory must be extended to cover these cases. The more involved facts of "practice" may be stated as follows :—

1. Only a part of the cost of carrying on a business is directly and proportionately related to physical articles produced and placed in the consumers' possession or to services (in the narrower sense) actually rendered to customers or to clients. Of such nature are usages of "raw materials" and wages for "direct labour"; these vary almost directly in proportion to the quantity of resultant output. A particularly good example is delivery charges, but they give rise to no serious profit-measurement problem since they are not incurred until profit arises, or is about to arise.

2. Other expenditures—capital expenses—have value in consequential services over a long period after the disbursement of money, and commonly have the capacity to render more or less service (within some limits) according to the intensity with which they are worked.

3. Other costs accrue over periods of time. These have only immediate consequential value which will vary with the intensity of working. Rent and other general overhead expenses exemplify this class, the distinctive feature of which is non-variability with short-term changes in rate of output or of sales.

4. Publicity expenses are related, not to goods which happen to be produced in a given period, but to goods sold from the time of appearance of an advertisement (or of propaganda of any sort) to the time of the last sale effected by the aid of a particular piece of propaganda. This relationship, of course, is not precisely measurable—but this uncertainty is not a special feature of selling costs; it is shared in varying degrees by most classes of expenditure.

PRIME COST AND ONCOST

The most vital distinction between these various classes of expense is that dividing those variable with day-to-day production and those

⁴ See the comments of Mr. C. Oehler on "Theory and Practice" quoted at p. 5.

which are not. It has already been stated that in ascertaining the profit for a period, it is necessary to eliminate from chargeable expenditure the cost of such services received as are not component parts of services rendered in that period. That is to say, expenditures going to the formation of future services to be rendered to customers (represented by stocks of goods on hand to meet future demand, for instance) should be carried forward as unexpired values of some kind. But if some expenditures incurred do not vary with the amount produced during the accounting period, there is no reason to assume that the amounts thereof to be carried forward should be calculated by reference to physical stocks of products which chance to be unsold at the end of such period. Such method of computation is correct only for expenses like "raw materials" and "productive labour" which vary directly with physical production.

It is at this point that we find the most serious defect of existing practice. I hope to show that it is incorrect to include "oncost" in "valuations" of finished goods for Balance Sheet and Profit and Loss Account.

First, the need for abstraction must be mentioned. Possibly there are no expenses which vary precisely in proportion to output. Perhaps, also, there are no expenses which, in the long run, do not have some tendency to vary with output. But if we first assume that there *are* expenses so characterized, we shall be using the only possible method of handling the almost infinite number of variable factors involved. It appears to me that the results we shall achieve by using the convenient (but abstract) division of expenses as between prime cost and oncost and elucidating its significance, will be much nearer the truth than are methods of "valuation" commonly in use. Present methods recognize the existence of such a division, but not its significance.

STOCK VALUES AND ONCOST

I will begin consideration of this question with some figures. Companies A and B are engaged in the manufacture of the same product, and are of equal size, by which I mean that they sell equivalent quantities and values of goods in the year we are investigating. Their expenses differ only because the management of Company B has foreseen a decline in sales, and has restricted production accordingly, whereas Company A accumulates surplus stocks during the year.

The year's results (with oncost included in the stock figures) are as follows :—

	<i>Company A</i>				<i>Company B</i>			
Materials	£	16,000			£	14,000		
Wages		16,000				14,000		
		<u>32,000</u>				<u>28,000</u>		
Stock :								
Add, beginning		12,000				12,000		
		<u>44,000</u>				<u>40,000</u>		
Deduct, end		18,000				12,000		
		<u>26,000</u>				<u>28,000</u>		
Establishment Charges		16,000				16,000		
Selling Expenses		5,000				5,000		
		<u>47,000</u>				<u>49,000</u>		
Total Costs		47,000				49,000		
Sales		54,000				54,000		
Profit		<u>£7,000</u>				<u>£5,000</u>		

The normal output is that corresponding to a yearly expenditure on labour of £16,000. Establishment charges are £16,000 per annum, so that stock values are at prime cost plus 100 per cent. on labour, and since prime cost is half material and half labour, the valuation may conveniently be taken for our purposes at prime cost plus 50 per cent. Company A spends £4,000 more in materials and labour than Company B and as their sales are equal it finishes the year with more stock than B to the extent of a direct cost of £4,000, valuation £6,000. It will be noted that the company which has had the less far-seeing management shows the higher profit. As I have followed ordinary accounting principles in computing the profit, the paradoxical results are an indictment of such principles—one principle only to be exact ; the inclusion of indirect expenses in stock values.

Given that it is desired to show stock in the Balance Sheet at a figure which is regarded as the cost (ignoring cases of lower " market values " or inclusion of profit) then it seems to me that the cost of a particular parcel of goods is the amount by which the funds of the concern have been depleted by reason of the acquisition and manufacture of such goods. That is, generally speaking and assuming all liabilities have been discharged, the cost of a parcel of goods is the excess of the cash balance there would have been on hand if the goods had not been purchased and manufactured, over the actual cash balance. This means that cost is direct cost, and that if any addition

is made in the value for oncost, the concern is going to increase its disclosed profits without having done more than manufacture goods. Of course, if the stock is the same at the beginning and close of any accounting period, the profits for that period may not be affected, but an erroneous principle cannot properly be defended on the grounds that it is used consistently, since it is almost certain that the quantitative effect is not consistent.

It is quite common for manufactured stocks to be adjusted in a manufacturing account which has debits for direct expenses or possibly also for "factory expenses," but not for general establishment charges, though these are included in the stock valuations. Thus oncost regarded as part of the stock value is credited against the wrong section of the final accounts. Where stock variations are considerable, the important ratio—gross profit to sales—may be wrongly stated to a serious extent. The correction of this lies not in putting part of the stock value in manufacturing account and part in profit and loss account, but in valuing at direct cost only. The very concept "gross profit" contradicts the inclusion of oncost in valuations. Gross profit is the surplus of sales over the variable cost of producing the goods sold, and the offsetting of such variable surplus against the total of relatively fixed charges gives the net trading profit or loss for the period. To put rent on the same footing as materials and regard it as equally part of the Balance Sheet figure of stock, with differences merely of computation, is to deny the importance of any splitting of the final accounts to show an intermediate surplus figure.

DEVELOPMENT "LOSSES"

Lest I should be understood to consider that the profit balances of all manufacturing concerns are overstated or non-existent, I must at this point mention that most Balance Sheets omit an asset which may in many cases have a cost greater than the amount of overhead expenses included in stock values. Expenditure on the asset to which I refer, does in fact consist of overhead expenses : from which it may be gathered that my objections to including amongst assets a figure of oncost are, so far as net profits are concerned, criticisms of computation only. But the qualification is vital.

A newly established business may well be expected to lose money for the first year or so of its existence. But the loss of money is not a trading loss ; it is part of the cost of establishing a source of income just as much as is the cost of the land on which the factory is built, and as such is capital expenditure. This is sometimes recognized by

concerns such as gold mines (the recognition generally being through force of circumstances) and an asset possibly entitled Development Account is brought into the Balance Sheet at the amount of the deficiency for perhaps the first two years. Such an asset title is not a good description. It may be that the excess expenditure is part of the cost of the physical assets installed ; that is, that the cost of a machine is the amount paid to the maker plus a proportion of rent and other overheads until the date on which development is complete and income is expected. Or, possibly, the deficiency is the cost of acquiring goodwill and might be described as such. I do not propose to investigate this question yet ; the conclusion to which I hold is simply that part of the cost of the fixed assets of a concern is overhead expenses not covered by revenue for the period of initial development.

The fixing of the amount of overhead expenditure to be capitalized is neither an easy nor a precise matter. If the establishment of a business took the form of an initial period of development when no revenue was produced, during which time buildings, plant, staff, etc., were acquired, and organization set up and production commenced, and after a definable date orders began to come in and at a rate sufficient to keep the business in full production, then there would be no difficulty in the computation ; all expenses prior to the date of the first sale should be capitalized. That in practice the problem must always be more difficult than this is, is obvious, but this difficulty is not a valid argument against the treatment which I am suggesting should be substituted for present practice, even though the latter has an established arithmetical procedure which may give it a semblance of virtue. A universal custom of valuing the stocks of all businesses at £5 per ton, whether the product be pig-iron or ladies' gowns, though absolute in its arithmetical precision would be clearly absurd. Valuation at direct cost plus a piece of oncost is, in my opinion, equally absurd, though possibly, by reason of the hypnosis produced by veneration of traditions, good or bad, not so patently.

I will show by means of hypothetical figures how the proposal would affect the trading results of a newly established business. The concern was established at the beginning of year one and that year is estimated to constitute the development period ; at the end of the year sales had reached a " ceiling " which would apparently fix the normal rate for the near future. The second year was one of complete utilization of equipment, that is, of maximum productivity (though less than one year's output was sold), and the oncost addition in stock

values is given by the proportion of "rent, etc.", £9,000, to direct cost, £18,000, in that year, namely 50 per cent.

These are the results of the first two years' operations :

ORTHODOX :					Year 1	Year 2
Materials	..	..	..	..	£5,000	£10,000
Wages	..	..	..	..	4,000	8,000
					9,000	18,000
Stock :						
Beginning	..	..	..	..		+3,000
Ending						
Prime Cost	..	..	..	..	£2,000	£7,000
Oncost	..	..	..	..	1,000	3,500
					6,000	10,500
Sales	..	..	..	..	12,500	28,500
"Gross Profit"	..	..	..	..	6,500	18,000
Rent, etc.	..	..	..	..	9,000	9,000
Profit (+) or Loss (-)	..	..			-£2,500	+£9,000
PROPOSED AMENDMENTS :						
Eliminate Oncost in Stock :						
Beginning	..	..	..	..		+1,000
Ending	..	..	..	..	-1,000	-3,500
Transfer to Development or Goodwill					+3,500	
Profit	..	..	..	..	Nil	+£6,500

It will be seen that present methods of profit ascertainment give the very considerable improvement in results from a loss of £2,500 to a profit of £9,000. My proposals involve regarding year one as being a development period during which it is not true to say that any loss was incurred through trading. £3,500 is permanently capitalized. The first trading results are a profit of £6,500, which figure, whilst equivalent (by coincidence, precisely so) to the net total of orthodox profits, shows a somewhat more sober view of the concern's development than the improvement of £11,500 in the first set of results.

With the most favourable possible position—yearly sales amounting to £36,000, which is at the rate corresponding to maximum productivity—we have a figure of profit of £9,000 and yet the existing accountancy practice gave this profit, though sales amounted to only £28,500.

It is worth while noting that within recent years the assumption that the fixing of selling prices at prime cost, plus oncost, plus a proportion of profit, constitutes a permanent ideal of business management, has been considerably questioned. Price policy is coming to

be considered in the light of studies of consumers' demand at different price levels and the maximization of gross surplus over prime cost yielded at such levels.

As footnote to these remarks on accounting for overhead costs I will quote in support some comments by Paton and Littleton which also serve as an introduction to the next section. The context of these extracts does not, it should be mentioned, proceed to the more specific ideas of treatment as expressed in this book. However, as a statement of general principles, their *Introduction to Corporate Accounting Standards* is closely relevant and seems to me to be the most important contribution to accounting thought in recent years (published in 1940). Here, then, are their admirably-expressed views on the initial cost of organization :

"In a broad sense, all costs of factors which contribute to the grand total of object and conditions making up the economic structure of the enterprise are represented in the physical structure of the enterprise, even though it may not be expedient to assign all of them to specific sections or elements of such physical structure. Accountants have undoubtedly been unduly preoccupied with the view that assets are recognizable only in terms of definite units. Accounting is concerned with economic attributes and measurement, not with the physical layout as such."
(p. 32)

"Many costs incurred are readily assignable to specific elements of tangible property. The possibility of such assignment, however, is not necessary to justify recognition of costs as assets. All costs incurred to secure services necessary to business organization and operation are essentially homogeneous in their significance to the enterprise, and it follows that all service costs incurred, prior to their absorption as charges to revenues, contribute to the total amount of assets of the enterprise."
(p. 32) (A possible criticism here might be that the factors determining the "absorption as charges to revenue" are not mentioned, involving some small obscurity in the paragraph.)

"During the launching period costs are incurred by the enterprise, often on a major scale, but there is at the time no problem of tracing costs in terms of production activity (aside from . . . construction [costs] . . .) or of assignment of costs against revenue." (p. 33)

CHAPTER III

ASSETS AND VALUE

TANGIBLE AND INTANGIBLE ASSETS

The orthodox view of calculation of profit and of Balance Sheet presentation tends towards the idea that revenue is to be charged with the balance of expenses incurred after crediting :

- (i) the value of physical assets acquired in return for such expenditure ; and
- (ii) amounts of expenditure not represented in material form but incurred for the benefit of subsequent accounting periods.

This leads to the " assets " side of business Balance Sheets being a hotch-potch of " tangibles " and " intangibles " as we call them.

The view now put forward is that the flow of expenditure of all kinds (on plant, office salaries, etc.) requires classification according to its various relationships with output and revenue, and that this classification will yield headings of deferred costs to be carried forward, these headings not being descriptions of " tangible " material things, but simply monetary expressions of stored-up benefits accruing to following periods. Some of these benefits happen to be related to, and to be calculated by reference to, physical things (materials and plant, for instance), but these are not universal characteristics of such benefits ; nor, for that matter, is the proper Balance Sheet figure likely to correspond at all closely with any more objective " valuation " of the physical things themselves. The common confusions—found both in and out of the accountancy profession—about the relationship of the cost and the market value of assets, are thus dissolved along with the physical notion of Balance Sheet figures.¹

¹ " Accounting uses money-price only because it is a convenient common denominator by which diverse objects and services are expressed homogeneously and because it is the common mode of expressing bargained exchanges. It is not 'money' that is significant ; it is not 'price' that is significant. 'Service' is the significant element behind the accounts, that is, service-potentialities, which when exchanged, bring still other service-potentialities into the enterprise.

" Behind accounting's array of figures, which laymen may think represent values or money, or, at best, price, lie the tangible and intangible embodiments of services. Accounting is, therefore, strongly rooted in economics even though its objectives are different and its medium of expression, price-aggregates, falls short of being a suitable medium for economic reasoning." (Paton and Littleton, *ibid.*, p. 13.)

This does not wholly correspond with my own theory of the nature of " assets,"

There is a deficiency in terminology here. Money "valuation" (in some sense) of physical things is proper for certain purposes—for example in accounting statements relative to a cessation of business on insolvency. But in Balance Sheets the mixture of abstract and physical headings should be eliminated, and there should be substituted headings of *expenditure* classified by reference to relationship to benefits accruing to the next or later accounting periods. Whether or not the word "asset" may be used to cover both these things, I am uncertain; but "wealth" for the physical, and "asset" for the accounting aspects of these things will serve our purpose.

BALANCE SHEETS—ORTHODOX AND HETERODOX

"Let them continue as is meet
To adequate the balance-sheet.
My spirit shall they never have
Nor make my soul with theirs as one
Till the Mahamanvantara be done :
And though they spurn me from their door
My soul shall spurn them evermore."

(JAMES JOYCE, *The Holy Office.*)

The orthodox classification under criticism may be illustrated as follows :—

A. FIXED ASSETS (cost less depreciation) :				
1.	Land and buildings :			
(a)	Freehold	£100,000		
(b)	Leasehold	150,000		
				250,000
2.	Plant and Machinery (and Vehicles, Furniture, etc.)		500,000	
				£750,000
B. FLOATING ASSETS :				
1.	Stocks of Raw Materials (and Stores)	150,000		
2.	Work in Process	100,000		
3.	Stocks of Finished Goods	200,000		
				450,000
C. INTANGIBLE ASSETS :				
1.	Prepayments (of Insurance premiums, etc.) ..	5,000		
2.	Deferred Advertising	20,000		
3.	Preliminary Expenses (on legal requirements relative to registration and the issue of shares)	2,000		
4.	Discount on Shares	23,000		
				50,000
D. LOSSES on abandonment or destruction of assets (either actually cataclysmic or just more unfortunate than the management considers to be a normal business expense)				200,000
TOTAL (excluding Cash and Debtors)				<u>£1,450,000</u>

but is quoted as indicating the need for a changed viewpoint amongst accountants. Though it is adulterated with a mixture of notions as to what are "assets," the double-account system contains the rudiments of the suggested treatment: it deals with fixed assets in terms of expenditure incurred, and not as value figures. The logic behind this old legally-imposed system is, therefore, not without merit as compared with that which prompted some much later law—the 1929 Companies Act—to require us to state the "basis of valuation" of fixed assets.

The new view put forward involves, in general, prefixing "Expenditure on" to these very assorted headings which, as they stand, constitute an indigestible mixture of material and unsubstantial things. More than mere terminology is at stake in this. On the suggested basis the use of physically descriptive words does not import connexion between accountancy "values" and physical objects. The PROPOSED CLASSIFICATION is as follows :—

		Original Cost of Items in Service	Amortiza- tion to date	
I. CAPITAL EXPENDITURE :				
1. On Land and Buildings ..	£300,000	£50,000	£250,000	
2. On Plant and Machinery, etc.	700,000	300,000	400,000	
3. On Organization	..	..	650,000	
			200,000	850,000
II. PRODUCTION EXPENDITURE :				
1. On Raw Materials (still in store)		175,000		
2. On Work in Process		75,000		
3. On Finished Goods		100,000		
				350,000
III. EXPENDITURE ON ACCRUING RIGHTS :				
Insurance, Rates, etc.	..	..	..	5,000
IV. PUBLICITY EXPENDITURE :				
Initial	..	..	100,000	
Recent (not yet revenue-affecting) ..	..	..	10,000	
				110,000
TOTAL (excluding Cash and Debtors) ..	..	..		<u>£1,315,000</u>

Items C.4 (Share Discount) and D (Capital Losses) have no counterpart in this classification—they would be deducted from equity interest (Capital, Undistributed Profits, etc.). C.3 (Preliminary Expenses) would be included in I.3 (Organization Expenses).

Pro forma figures are given to show the sort of result which might be expected. Allowing for C.4 and D, which even the orthodox view would not hold to be assets, there is an increase of £88,000, which would be reflected in the figure of Undistributed Profits. This would, I think, be the commoner direction of difference, though the incidence of losses on disused plant, often left in Balance Sheet asset figures, is difficult to assess in general terms.

The order of statement is not presented as the last word on the subject. It has *some* regard to stability *versus* possible short-term fluctuation. Mode of arithmetical calculation or estimation is the real determinant of the division, and the resultant figures of expense-benefits—assets, that is—are more conveniently grouped under the heads and sub-heads shown than on some precise grading principle.

I am going to define "initial" publicity expense as something very like organization expense in mode of calculation, and "recent" publicity as being in a sense identifiable with insurance prepayments. The use of "rights" precludes this latter grouping, and it seems more convenient to put both pieces of publicity expense together in spite of their different natures.

DEFERRED EXPLANATIONS

The reader has been cautioned that the expenditure-unexpired conception is more than a matter of words. By this time he will have decided that I am involving myself in some rather complex elucidations of calculation procedures. I fear this is true, but I do not think that the practical working of the scheme is more involved than orthodox methods. These latter lead to enormous proliferation of figure-production, often with unsound premises. Thus, if I am taken as correct in concluding that stock should be valued at prime cost, one is staggered to think of the futility of the great effort actually applied to "apportioning" oncost and adding it into multitudinous job cost accounts. The passion for figures (facilitated by development of mechanical means of producing them in the office) has somewhat outrun the pure reason which should have given the figures a basis of validity.

The observant will have noticed that I have consistently avoided mention of cash and debtors as assets or as anything else. In fact, there are a number of unexplained assumptions and implications which I have been unable to avoid, and which cannot be discussed without some attempt at classifying the discussion itself. What sort of conception of amortization of capital expenditure is involved? How is "Organization Expenditure" computed? Can it be computed? I hope the reader will be able to avoid being prejudiced by strong disagreement on particular points. These may have to go unexplained for many pages, and furthermore, since there is considerable scope for progress in the study of accounting, it is impossible for one person to take it a great way towards the truth. In my application of unfamiliar principles to the multiplicity of expense classifications I am sure to be saying some foolish things. In spite of my conviction of their unreality, I have in practical work to treat the oncost procedures which I meet just as the firmest believer would. And I feel myself to be much more plausible (even to myself) in discussing such absurdities as the proper method of heat expense allocation, than in working out, and trying to express, the incidence of my generalized theory. I

should consider myself fortunate if my readers would let me off detailed application and be satisfied with accepting the generalities ; but I know that only the former can give the latter life enough to have a chance of survival—or perhaps “ birth ” is the word required for description of the conversion of even one other accountant. Pardon my exaggerated dividing line between orthodoxy and truth ! There is always progress in the sciences ; never new truth against old falsity. The fact that accounting has perhaps lagged behind somewhat does not differentiate the extent of progress by more than a matter of degree.

THE PRODUCTIVE ORGANISM AND FINANCE

Reverting to the observant reader's concern for the fate of Cash and Debtors in the Balance Sheet, it may now be stated that a distinction is implied between (a) assets contributing to the rendering of services (supply of goods, etc.) and (b) the legal claims to money, and money itself, to which the rendering of those services gives rise. We may think of a business as having organic unity once it is in running order. Services flow in, are combined, interact, and yield an outflow of services to customers. (Goods delivered are “ outflow ” ; physical output is not—being merely service-benefits in course of translation into services to be rendered.) The diversity of classes of expenditures (as representing services received) leads to a variety of asset heads in the Balance Sheet, but it is incorrect to ascribe any degree of concrete reality to these separate figures. The total organism as a going concern (with stored up benefits to future service-rendering capability) appears to me to be a much more significant and comprehensible conception than is the idea of a collection of separate assets individually “ valued.”

This productive organism is, then, a unity distinguishable from the mere arithmetical summation of the various unexpired expenditure figures. These constitute simply a method of giving the accountant a measure of total activity. If this view is a true one, we are left with finance as a separate conception. The productive organism is considered as being fed with *services*, and as rendering *services*. This is of its very essence. But money is only a convenient invention for facilitating exchange of services, and, though it is present in the situation to give us a common measure of total activity, it is not of the essence of the productive aspect. Hence, we may say that the business, in its financial aspect, buys services for the productive organism to use, with a consequential yield of services to customers

who are then liable to pay money to the business at agreed prices for the services rendered to them.

In short, the business relinquishes money and legal claims to money with a view to production, finally bringing into the business new and (so the business man hopes) increased amounts of money and legal claims to money. Thus it is seen that a proper classification of inclusive business position is in these terms :—

Comprised of :—

PRODUCTIVE ORGANISM : Benefits accruing to future activity—
measured by service expenditures in
suspense.

FINANCIAL POSITION : Money and legal claims thereto, namely,
Cash = Money.
Debtors = Money claimable by the business.
Creditors = Money claimable from the business.

By this is meant that Debts and Plant are not correlative classifications. The former is a claim on money partly representing the proprietor's spendable income. Plant may help in earning income, but any figure attached to Plant expenditure carried forward is significant only in measurement of income, its distinctive feature being that such carry forward is referable to *future* operations and *future* revenue earnings. Finance assets are distinguished from the productive organism as representing :

1. Capital moneys appropriated to use in production but
 - (a) surplus to present requirements therein ; and/or
 - (b) tied up as debts yielding cash only after a period of waiting.
2. Accumulated profits of production.
3. Appropriable to creditors in discharge of their claims.

Liabilities are part of the finance position, and may, of course, exceed existing cash resources—when part of the legal claims to money (debts) are creditors' rather than proprietor's moneys. Liabilities may even exceed all finance assets, involving a claim on the productive organism, the satisfaction of which claim may so injure it as to impair practically all its value. This is a demonstration of the validity of the organism conception, for an organism may be defined as something greater than the non-integrated sum of its parts, liable, as is the human body, to more-than-proportionate injury if a part is removed.

Financial position, then, has only cash, debts and liabilities as constituents and is therefore not the same as the net current, or

floating, asset position, since stocks of goods on hand are omitted.² The productive aspect is important as influencing *future* financial positions ; it is not part of the *present* one. The physical amount of stocks on hand is certainly important in considering future finance, but it is in no sense part of the present financial situation (which is a restricted part of the total situation). The better, and often-employed meaning of "finance" in "the provision of finance for production," for instance—shows that this division is an orthodox one. It chances to have become confused rather than actually abandoned.

We must now devote some attention to the relationship between business profits and individual (proprietors') incomes, following which we shall turn to the application of this view of profits and assets.

² "Viewed as a factor in income measurement inventories are essentially unrecovered costs of materials, labor and other assigned charges ; inventories, in other words, represent that portion of the stream of costs incurred in acquiring and producing goods which can reasonably be applied to revenues of the future. This general interpretation, it is believed, is more significant and more useful for the going concern than that which emphasizes immediate realizable value and current financial position." Paton and Littleton, *ibid*, p. 77.

CHAPTER IV

BUSINESS PROFIT AND PERSONAL INCOME

I AM not going to attempt to deal exhaustively with the problem of measurement of personal income. But since measurement of profit is connected with that of income, the relationship of the two must be discussed. Emphasis must be laid on the fact that there *are* problems arising in the measurement of income, and that their solution does not appear to have been wholly achieved.

Personally, I have no precise knowledge of any proper method of ascertaining the income of an individual with a number of share-holdings or other business interests. The only rules which come to mind are those of the tax office, and these are obviously much affected by taxing policy. For instance, "capital profits" are taxable income in the U.S.A. but not in Great Britain. Further, though British income tax is primarily intended as a tax on individuals, it is collected partly at source on figures referable to business profits, and partly by direct assessment on individuals, normally on *distributions* of profit rather than on apportionments of total profit.

Perhaps the principal problem of income measurement is that indicated in the last sentence—Are dividends or are notional shares of profit to be included in individual income computations? A further question is: Are fluctuations in market values of investments to be considered? If not, then are realized investment profits or "realized losses" to be taken into account?

Taxation procedure is not a good guide to proper income measurement. Income tax is only one of a number of taxes—all borne by the individual in the last resort—and many are not related to his capacity to pay. So long as there is a multiplicity of taxes, there is no special virtue in trying to make income taxation justify its description to the letter. Tobacco duty is paid by smokers roughly in proportion to their expenditure on tobacco, which has no close connexion with income—many people contribute nothing whatsoever to this important item of state revenue—so that there is no compelling reason for desperate striving to make what is conveniently called an "income tax" precisely referable to exact amounts of personal income. Nor, in fact, are precise computations of income made for

this purpose. Under British tax laws at least, rules tend to limit discretion of calculation method rather than to define true income.

INHERITANCE

Bequests of property for successive interests are much more important cases of the need for some sort of income accounting. There has to be some legal regulation of apportionment of money arising, say, out of a residuary estate bequeathed to one person as to income, and, after that life-tenant's death, to another person absolutely. As a matter of fact, the regulation is by no means as stringent as is sometimes supposed. Dividends are normally apportioned on a day-to-day basis by reference to the period for which they are expressed to be declared, if that period includes the date of the testator's death. This is a convenient way of preventing either of the classes of beneficiary concerned from being unduly prejudiced by an odd day or so in date of payment or declaration of dividends. Subsequent dividends are generally regarded as due to the life-tenant.

But these are rules of convenience only, though they may give rise to inequity in respect of investment dealings. (Only in Scotland is there any practice of accruing income on a day-to-day basis on sales and purchases of investments, and then only on dealings in Government stocks.) Other varieties of inequity have often been taken to the courts and more precise rulings obtained. These rulings show that the distinction between capital and income moneys is by no means as clear as might appear at first sight. Even sums realized on sale of property are sometimes partly income (foreclosed property and accrued mortgage interest, for instance).

However, the principal legal regulation affecting life-tenant and remainder-man is that residue should normally be converted into prescribed safe investments at fixed interest, which brings income nearer to the truth since no discrepancy of dividend and earned profits can then arise. Power to retain equity holdings, or other "hazardous" property, generally leaves (legal) income as equal to cash produce in dividends, with some interference by the legal (but indeterminate) rules of equitable apportionment.

FINANCE COMPANIES, INVESTMENT TRUSTS, PERSONAL INVESTMENT HOLDINGS

Accountancy usage and the basis of tax assessment hold to differing principles of profit measurement in relation to investment holding concerns according as they are "finance companies" or "investment

trusts." Now whilst these differences in treatment may be valid if the classification of types of company is itself valid, it is unfortunately the case that this division is not very well marked. Clearly, if the management of either class of company thinks a particular holding is "over-valued" on the Stock Exchange, and that the price will decline, it will sell at once. Buying policy must essentially have regard to future prospects and market valuation, even where the buyer is an investment trust. So that the rigid division is by no means a logical one—though it may have some practical value.

Similar considerations apply to an individual and his investment holdings. If he buys shares in a gold mine during its development stage he may wait many years for a first distribution of profits; he may perhaps sell before receiving a dividend. In this latter case, he will probably make a surplus on sale. Is this profit any less a part of his income than the dividend would have been? A stock maturing at a fixed date may be quoted at more than the repayment price because of a high rate of interest. Here, part of such interest is an offset to the eventual "loss" on repayment, and only the balance is true income.

In short, an investor thinks in terms of both dividends and likely price fluctuations. His dealings are regulated by *all* the future prospects. So that it is difficult to see that profits and losses on investments can be entirely irrelevant in measuring income, whatever the tax rules of computation may happen to be.

A shareholder being a part-proprietor, his calculated share of business profits suggests itself as a possible basis for income measurement. A director-controlled company is not greatly different from a privately-owned concern. There are probably no share quotations and no regular dealings in the shares, and the amounts which happen to be distributed in dividends are fixed by the recipients and may not be closely related to profits. There may be a sleeping interest in unquoted shares, absence of a good market for shares, deliberate restriction even of public-company dividends, and so on. A high yield may be obtained by an investor if he cares to risk some loss of "capital." A sufficient spread of this risk will probably involve some totally worthless purchases and some worth much less than cost. Is income in this case to be taken as the sum of the high-rate dividends without deducting "capital" deficiencies? Such deficiencies were, or should have been, considered as possible outgoings in making the original investment decisions. These deductions are not merely of

companies' trading losses : possibilities of the further losses of breaking up businesses have to be considered by an investor.

RE-INVESTMENT OF PROFITS ("PLOUGHING BACK")

It is interesting to note that whilst dividend payments are a very popular mode of measuring income—and may be the only practicable measure—there is no absolute necessity for all profits to be paid away in dividends. They can be used either to extend the business of a concern or to buy other investments. Commercial and financial undertakings are very important sources of demand for investments, and it would seem that there is a tendency with many of them to accumulate holdings by deliberately restricting dividends. Increase in total earning power thus contributes to a rise in market value as an alternative to dividends at the full rate of profits. The shareholder is able to realize some of his shares if he finds the cash-dividend produce inadequate, and, within limits, he is really cashing-in on the profits which the company has not specifically distributed. Business firms create the demand for investments ; taking business and individuals as classes, members of the former retain profits and then acquire from the latter investment interests in other members of the business classification. If this is followed through, it may be seen that if many businesses were to do this, and if investment trusts were to re-invest their earnings, then the total of dividends received by individuals would be very much less than business profits. Investors could resort to selling some holdings to augment their cash income. In spending the proceeds, they would not (within necessary limits) be drawing on capital ; for their shareholdings, though of smaller nominal amount, would have increased in price. Collectively, they must still own the whole of the businesses through their shareholdings. These rather peculiar matters of finance do not directly affect the aggregate capital of the community, nor its true income. This is rather an important point, since cases of such retention of earnings are very common, particularly when trade is booming.

The management of a company may consider that a good profit return would be obtained by extending activities. If the business is already earning profits, the funds representing these may be used to finance the extension ; if, on the other hand, cash is short, a new issue of shares may well be made—generally largely to existing shareholders. Should the converse situation arise that declining profit margins prompt reduction in activity, then there may be accumulated a surplus of cash representing unused working capital. Here, there

is a good case for returning the surplus funds to the shareholders, though this would not be called a dividend except in the case of winding-up, and then only with a distinctive meaning to the word. British law happens to impose conditions on the return of capital moneys to shareholders, but this is merely a measure for the protection of creditors ; it does not affect our conclusion.

This conclusion is that there is no obvious necessity for profits and cash passing between company and shareholder to be related. If directors can use money to advantage in the business, they will benefit the shareholder by doing so rather than by distributing up to the hilt. And if they have no special use for cash in hand, they might well pass it to the shareholder whether it happens to consist of profits or not. One reason—not an *intrinsically* significant one—for relating distributions to earnings is the existence of, and necessity for, a share market. Unless such a relationship is maintained by some at least of the companies whose shares are the subject of market dealings, it is hard to see how the shareholder's income could be secured to him at all—considerations of ultimate winding-up are too remote. Probably dealings cannot take place and market valuations be established unless some at least of the shares on the market are dividend-paying—whether or not they pay *all* their profits in dividend.

This somewhat unco-ordinated commentary is made largely with a view to discrediting dividends as a sole measure of income. On the other hand, I have not wished to state apportioned profits and losses as ideally-correct income elements. Business profits as computed are influenced by amortization of cost balances which may not be in accord with asset values implied in the market price of shares. Depreciation in the value of one of a number of risky high-yielding investments seems to be an essential income deduction. Deduction of the trading losses of the concern is inadequate ; these need not be very considerable to involve the shareholder in the loss of most of his purchase money.

I have emphasized the importance of investment dealings as affecting the determination of income : the separation of capital and income turns out on examination to be of a very doubtful order. If a person with £10,000 cash to invest spreads it equally between the shares of two companies, and one pays a dividend of £250 leaving the market price unchanged, whilst the other pays nothing and falls from £5,000 to £100, it is unlikely that he will be particularly pleased about his dividend of £250 when he has lost £4,900. On the other hand, if an issuing house purchases a block of shares in a prosperous private

company and sells them by public offer at a considerable profit, such profit will go in some form to augment its own shareholders' or proprietors' income. This income is not offset by any loss or expenditure of income elsewhere in the community, nor does the investment profit arise directly from trading profits of the concern for whom the issue is floated, since the issuing house may make a relatively quick sale not affected as to price by changes in the rate of profits.

ENTREPRENEURSHIP INCOME

Although, no doubt, an infinite number of gradations of intermediate situations may be found, it does seem that a useful distinction may be made between :—

- (1) Shareholders with only small holdings, and without direct concern in the management ; and
- (2) Directors of companies, members of partnerships, and sole traders.

The interests of the former class are bound up with capital valuations and the market in shares ; their holdings are not necessarily kept for long, so that their status as part proprietors is of merely fractional significance in both amount and duration of participation. Those in the latter group have a longer-term relationship to their business. They may be unable to withdraw capital to any substantial extent ; there may in fact be no public market for holdings in their undertakings. A public issue of shares is a way of reducing his own capital commitments on the part of the entrepreneur, but this is not a "short-term" step ; it marks a substantial change in constitution and management. Directors of companies having quoted share issues may vary their (possibly substantial) capital interests in the businesses which they manage, but the ethics of this proceeding are very much open to question. There are, of course, many circumstances in which a director may reasonably deal in his company's shares either by way of sale or purchase—there is no reason to assume that he must refrain from selling for the quite personal circumstance of being in need of money because of losses outside the business, for instance. But share dealings effected by directors because of expected future movements in the share quotation (even aside from the use of information not available to the public or other shareholders) are transactions inconsistent with the management function. The law, and capital-market opinion, provide for some sort of "qualifying" interest in capital, and the desire to preserve income by way of fees or salary is a further limitation on a director's share transactions ;

but nevertheless it does seem fairly clear that a director is not acting properly unless he does regard a substantial part of his fortune as an irrevocable commitment in the undertaking in which he shares in management. (It is possible and proper for a person with the title of director to have little or no interest and be really in the position of a salaried manager. The distinction I am making is bound up with the *changing* of amount of interest by reference to stock-market estimates of a company's worth.)

Given this distinction between the casual or "mobile" investor and the entrepreneur, it follows that some difference of income conception may be involved. Business profits must have much more direct relevance for an entrepreneur. Accounting methods in the case of unincorporated concerns treat income as being equivalent to profit—with due apportionment between respective interests. This may be useful, but I am not sure that it is a correct assumption.

It is at least certain that an apportioned share of profits is not an exact guide to spending power. Availability in cash would seem to be an important consideration in taking profits into account in deciding personal expenditures. First, there is the fact that profits may be "locked up in stocks." This, perhaps, may be an extension of the business activity beyond the size commensurate with the amount of capital originally introduced. In this event it may be said that non-availability of profits in cash does not deprive them of their character of income of the entrepreneurs. But profits "locked up" in debtors are partly of a different nature. For with the taking of profit on sale or on rendering of other service, the item "Debtors" includes an element of profit clearly not yet available in cash. If the original capital provided were just sufficient to finance operations until customers paid their debts, then until they do so the profits on the sales outstanding are not available for distribution.

However, the most important source of discrepancy between short-term profits and their "spendability" remains to be mentioned. This arises from the fact that deductions from gross revenues consist of apportionments of costs, and these may well have been incurred earlier than the accounting period in which they fall to be deducted, and the relative contribution to revenue may differ from the amount originally estimated as likely to be earned. Thus a machine may have increased in value in the sense that its replacement cost has arisen. If it is in fact considered that it will be worth while to replace it when it becomes worn out, presumably this will be because it is earning more than the apportionment of the original cost.

Profits will, in effect, be benefiting from a low charge for what is normally termed "depreciation," but there lies in the future the necessity for providing a much larger sum of money for replacement of the machine. This necessity may even be such that there would be serious impairment of the capacity of the business to continue its activities if it were not replaced; the possession of the machine may be essential to the maintenance of the business as a going concern. Now this rise in the price of the machine may mean (*a*) that the concern has been fortunate in having had the old machine at the lower cost whereas competitors may have had to buy their plant more recently; and (*b*) that the additional cost of replacement is a further capital investment. But before they can decide how much money they can withdraw and spend, the proprietors must take into account the approaching replacement which cannot be effected with the funds retained in the business by deduction of "depreciation" at a rate based on the cost of the old machine. This is in no sense a defect of accounting; the position is that accounting for profit is not the same as a possible personal income accounting might be. As I have limited myself to theory of profit, it is outside my present concern to solve this and similar problems of income. Incidentally, I have had to put this limit on the scope of this study of private enterprise accounting principally because I have little idea how these income problems should be solved. But this fact does not invalidate my statement of their existence, nor my conclusion that the relation between profits and incomes is by no means a direct one. They are most closely connected in the case of the management's share of income, but even then there is by no means absolute identity.

The unfamiliarity of such a divorcing of profit and income measurement arises from our having an excessively concrete notion of the difference between capital and income. By this I do not mean that we are wholly sure of the precise way in which this distinction is to be made in practice. Far from it! If we consider the case of a person of some means who derives a fair part of his living expenses from investment holdings, we may ask whether he is to regulate his dealings in them so as to maintain capital or to maintain income at a constant level. And if he chooses to keep capital intact, does this mean in value—so that he must take account of realization losses and of decreases in market valuation—or does it mean that it will be sufficient to see that no part of the proceeds of sale of an investment is spent otherwise than on the purchase of new investments even if a handsome profit resulted within a stock exchange account from the employment

of some accurate market estimation? How individual investors do regard such questions would probably be found on enquiry to be a mixture of these things.

The point is that no one has worked out in detail the importance of these personal considerations: there remains unchallenged the general idea that the distinction between capital and revenue is a definite once-for-all objective and one not particularly difficult to make in practice. That some such division might be easy to make in a non-monetary economy I can well imagine; a self-supporting settler, or even one who satisfies some of his wants by barter, could readily and most usefully distinguish between time spent on obtaining things immediately required, and in provision for the more or less distant future. Time spent fishing, and time spent felling trees in preparation for building a cabin to replace a tent before winter arrives—this is a fairly clear-cut distinction, and a most necessary one; for feeding involves constant attention to the urgencies of hunger; whilst building dwellings involves labour long in advance of enjoyment of its fruits, labour at the instance of thought rather than at that of the immediacy of appetite.

But this division is directly connected with present and future satisfactions as related to present efforts. When we are concerned with a high degree of division of labour, and with complex money methods of distributing the physical fruits of endeavour, the problem is quite different. An owner of capital in present-day society is the recipient of a succession of money yields—share of profits, dividends, repayment, or whatnot—which require to be submitted to a process of sorting and calculation before he knows his true income as distinct from the cash which he happens to receive in any given period. And if what I have said in this chapter finds acceptance in the reader's mind, he will agree that the method of making this particular computation is by no means easy to prescribe.

CONCLUSION

The conclusion is this: that personal income and reported business profits have not an absolute one-to-one connexion. The former is affected by a number of purely individual factors which it is not generally practicable for the business accounts and Balance Sheet to reflect—certainly not in the case of a public company and its innumerable shareholders, many of whom paid enormously different prices for their shares. But industrial profits are the most important item affecting the personal incomes of the proprietors, and it is the accountant's

responsibility to see that they are supplied with the most accurate and detailed figures it is possible to devise concerning business profits, so that they can the more intelligently decide how much to spend and how much to save. (Perhaps the directors may decide that the shareholders cannot stand the truth, or that disclosure might harm the business in some way. I will defer to the last chapter the question of the social relations of accounting. For the time being I leave the reader to decide the merits or otherwise of concealment or distortion.)

CHAPTER V

THE BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

IN this and the following four chapters I will attempt to apply the theoretical treatment of profits and assets, as outlined in Chapters II and III, to the more important specific problems of the business Balance Sheet and Profit and Loss Account. The common types of expenditure must be individually considered in the light of the four-fold classification on page 11. This classification may be summarized as follows :—

1. Costs varying in proportion to physical output or to other measurable services produced.
2. Initial costs—"Capital expense."
3. Expenses accruing at relatively constant rates in time.
4. Publicity expense (distinguished from the foregoing by being incurred to induce sales, not to aid the process of producing goods or rendering services).

AN INSTRUMENT OF ANALYSIS

My main concern in this book is to get away from the idea of profit accounting as concerned with value accretion, and to advocate instead the method of analysis of cost-revenue relationships already employed in connexion with the discussion of prime cost and oncost. The best method of employing this analysis is this : when considering the accounting treatment of any specific business transaction, the accountant should compare (*a*) the state of affairs existing if that transaction had not occurred, with (*b*) the actual state of affairs as including the incidence of the transaction.

To be more practical ; expenses are partly charged against profits and partly represented by unexpired benefits carried forward as assets in the Balance Sheet. To decide on the division to be made—revenue charge or asset—an item of expense should be thought of by reference to what would have been the position if it had not been incurred : so that if it is decided that a particular item of cost refers to subsequent revenue, the profit shown for the period should be unaffected by the item. Thus the relative asset figure carried forward should include the precise amount of that item, to the end that profit

shall be the same with the expense recorded and properly treated as it would if the expense had never been incurred. Some such kind of analysis is equally useful in orthodox profit ascertainment and asset valuation, under which "market value," which may be replacement cost, is sometimes substituted for a cost valuation of an asset if the latter is higher. Here, the question would be in the form of asking whether the profit or loss thought to arise on any individual transaction, is the same as the difference in the total profit of the business according as the transaction is included or excluded (in all aspects) from the books.

Take the simplest case first—a purchase of stores remaining on hand at Balance Sheet date ; if the striking of the purchase out of the purchase journal *and* out of the stock sheets would leave the profit figure unchanged, then it has been properly treated. Thus, if stores are always valued at prices established some year ago, the physical amount on hand will probably be priced at a different rate in the stores valuation from that in the purchase records. So that although there is no reason to suppose that there should be any profit or loss arising on the mere purchase of something still on hand, the particular method of accounting used would result in the profit being affected by the transaction.

Turning our attention to manufactured stock, we may see how this mode of thought fits in with the exclusion of "oncost" from the "valuation" prices of manufactured stocks. Since the question of "taking profit" prior to sale is not supposed to be involved in stock valuation, a true cost figure is presumably required. This can only be prime cost, for if some higher figure is taken, the profit will be affected by the mere manufacture of goods not yet sold. Given a going concern with available capacity, the consequence of a decision to make a particular article is to affect expenses only to the extent of direct costs ; so that if more than these direct costs are included in the asset figure, there will be an equivalent increase in stated profits merely because of the particular mode of recording the results of that decision to produce. This seems to be a clear condemnation of the practice.

This mode of thought may be employed in testing the validity of any accounting technique and in arriving at correct ways of treatment. It is not, of course, necessary to consider each item of expense separately in preparing final accounts. If the particular methods of record and asset-computation are correctly based on the characteristics of the various classes of expense, then the proper treatment of

individual items is automatically secured, given only accuracy in arithmetic and care in the use of the inevitable estimation involved in profit and asset measurement.

EXAMPLE

The place of this statement of analytical method in the general theory of profit is as a basis for assessing the money figures for services received but not yet translated into services rendered. This evaluation of cost of benefits carried forward, either in orthodox accounting or under this proposed scheme, is without doubt the most difficult single problem confronting the accountant and the business man (including, unfortunately, the latter's non-accountancy staff). The better to show its working out, a figured example is given in the following pages. Accounts prepared on orthodox lines are also illustrated, partly so that the difference in the profit figures may be seen, and partly because familiarity with this form of accounts will probably enable the reader to comprehend the position by a glance at these figures. It is naturally my contention that such comprehension may be wrong, but nevertheless accepted methods and modes of arrangement more readily tell their story than do unaccustomed procedures.

Here, then, are the facts and their presentation in the familiar form. We will take as our subject a business commencing operations in January, 1941, as manufacturers of motor lawn-mowers, to be sold largely through wholesale agency at, it is hoped, £100 for each machine. The machines are taken to be identical. This homogeneity of output is one of many assumptions it will be necessary to make expressly or by implication: they serve the purpose of helping us to deal with complexity in stages rather than in one indigestible mass¹.

In these accounts of Motor Mowers, Ltd., the figures given under the various expense classifications are such as to illustrate the characteristics of those classes. But it would be a mistake to assume that "prime costs" are almost exactly variable with physical output, that "overhead expenses" are at rates fixed in time and not affected by production, or that the charge for amortization of plant and machinery should be at a rate fixed solely by time factors. In fact, there are innumerable intermediate cases which do not fit readily into one or the other classification. Thus, electric power is often charged partly at a fixed time rate and partly on a consumption basis. Properly speaking, in such a case, the expense is divisible between prime costs and overheads.

¹(See pp 38 and 39)

MOTOR MOWERS LTD.

BALANCE SHEETS
(drawn up on orthodox lines)

ASSETS	31st December :—		
	1941	1942	1943
	£	£	£
PLANT (Cos. £50,000 less depreciation £5,000 p.a.)	45,000	40,000	35,000
MOTOR VEHICLES (Cost £5,000 less depreciation £1,000 p.a.) ..	4,000	3,000	2,000
	49,000	43,000	37,000
STOCKS : (Prime cost plus oncost) :			
Raw Materials ..	6,000	10,000	3,000
Manufactured ..	28,000	42,000	24,800
DEBTORS	20,000	30,000	25,000
CASH	23,000	33,000	54,000
	77,000	115,000	106,800
PREPAYMENTS	5,000	6,000	5,000
	<u>£131,000</u>	<u>£164,000</u>	<u>£148,800</u>
LIABILITIES	£	£	£
CAPITAL	50,000	50,000	50,000
PROFIT AND LOSS ACCOUNT:			
Brought forward ..	—	- 24,000	+ 4,000
Profit (+) or Loss (-) for year	- 24,000	+ 28,000	- 13,200
	- 24,000	+ 4,000	- 9,200
	26,000	54,000	40,800
LOAN at 8 per cent. ..	100,000	100,000	100,000
TRADE CREDITORS ..	5,000	10,000	8,000
	<u>£131,000</u>	<u>£164,000</u>	<u>£148,800</u>

MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNTS

(Summary presentation of results as computed on orthodox lines)

	1941	1942	1943
SALES	[800] £80,000	[1,800] £180,000	[1,800] £182,000
MATERIALS USED:			
Purchases	30,000	44,000	23,000
Stocks: Beginning	—	+ 6,000	+ 10,000
Ending	-6,000	-10,000	- 3,000
WAGES	24,000	40,000	30,000
	26,000	40,000	32,000
PRIME COST OF OUTPUT	[1,000] 50,000	[2,000] 80,000	[1,600] 62,000
Manufactured Stocks:			
Beginning	—	[400] +28,000	[600] +42,000
Ending	[400] -28,000	[600] -42,000	[400] -24,800
GROSS PROFIT	58,000	114,000	82,800
ESTABLISHMENT CHARGES			
DELIVERY	39,000	49,000	47,000
ADVERTISING	3,000	11,000	11,000
DEPRECIATION: Plant	26,000	12,000	24,000
Motor Vehicles	5,000	5,000	5,000
INTEREST PAYABLE	1,000	1,000	1,000
	8,000	8,000	8,000
	82,000	86,000	96,000
NET PROFIT (+) OR LOSS (-)	£-24,000	£+28,000	£-13,200

(Number of mowers shown in brackets.)

MOTOR MOWERS LTD.

BALANCE SHEETS

(on proposed lines—in summary)

ASSETS	31st December :—		
	1941	1942	1943
	£	£	£
Expenditure on :—			
PLANT	45,000	40,000	35,000
MOTOR VEHICLES ..	4,000	3,000	2,000
ORGANIZATION ..	21,700	21,700	21,700
STOCKS :			
Raw Materials ..	6,000	10,000	4,000
Manufactured ..	16,000	24,000	15,400
ACCRUING RIGHTS (" Prepayments ") ..	5,000	6,000	5,000
ADVERTISING			
Initial	22,000	22,000	22,000
Recent	1,000	1,000	5,000
	<u>120,700</u>	<u>127,700</u>	<u>110,100</u>
DEBTORS	20,000	30,000	25,000
CASH	23,000	33,000	54,000
	<u>43,000</u>	<u>63,000</u>	<u>79,000</u>
	<u>163,700</u>	<u>190,700</u>	<u>189,100</u>
LIABILITIES			
TRADE CREDITORS ..	5,000	10,000	8,000
LOAN at 8 per cent. ..	100,000	100,000	100,000
	<u>105,000</u>	<u>110,000</u>	<u>108,000</u>
NET ASSETS	<u>£58,700</u>	<u>£80,700</u>	<u>£81,100</u>
CAPITAL			
Introduced	50,000		
Brought forward	—	58,700	80,700
Profit (+) or Loss (—) ..	+8,700	+22,000	+ 400
	<u>£58,700</u>	<u>£80,700</u>	<u>£81,100</u>

PROFIT COMPUTATIONS

(proposed basis—summary treatment)
1941 (first year of operations)

	Incurred	Carried forward	Applicable to Production	Carried forward	APPLICABLE TO SALES		
					Year	$\frac{3}{4}$ year Jan.-Sep.	$\frac{1}{4}$ year Oct.-Dec.
PRIME (variable) Costs :	£30,000	6,000	24,000	16,000	34,000	15,000	19,000
Wages ..	26,000		26,000				
OVERHEAD (invariable) CHARGES :	44,000	5,000	39,000	}	44,000	33,000	11,000
Rent, etc. ..							
Plant ..	50,000	45,000	5,000	}			
DISTRIBUTION :	5,000	4,000	1,000		4,000	1,700	2,300
Motor Vehicles ..							
Delivery ..	3,000		3,000		3,000	—	3,000
ADVERTISING ..	26,000		26,000	23,000			
	£ 184,000	60,000	124,000	39,000	85,000	49,700	35,300
SALES ..	..	..	..	[800 × £100]	80,000	34,000	46,000
Trading Profit (+) or Loss (—) ..	..	..	..	..	—5,000	—15,700	+10,700
INTEREST PAYABLE ..	..	..	..	..	8,000	6,000	2,000
				£	—13,000		
PRELIMINARY ORGANIZATION COST ($\frac{3}{4}$ year Jan.-Sept., 1941)	..	..	..	..	..	£—21,700	
NET PROFIT (+) ($\frac{1}{4}$ year Oct.-Dec., 1941)	..	..	..	..	..	..	£+8,700

NOTES

1. Normal Productive Capacity : 1,800 machines p.a.

Prime Costs					Oct. 1941 to Dec. 1942 £20 each £20 "	Total for Normal Annual Output
Materials	..	..	..	..		£36,000
Wages	..	..	..	..		36,000
						<u>£72,000</u>
Establishment Charges and Plant Depreciation }						<u>£54,000</u>

=150 per cent. of Wages.

2. Materials

(1 unit=quantity required for one mower—considered for convenience, as made entirely from a single material.)

	1941		1942		1943	
Purchases ..	1,500 × £20	£30,000	2,200 × £20	£44,000	350 × £20 1,000 × £16	£23,000
Stocks (cost):						
Beginning	—	—	+300	„ + 6,000	+500 × £20	+10,000
End	—300	„ —6,000	—500	„ —10,000	—250 × £16	— 4,000
	<u>1,200</u>	<u>24,000</u>	<u>2,000</u>	<u>40,000</u>	<u>1,600</u>	<u>29,000</u>
Written off stock—fall in replacement cost to £12 per unit					[250] × £4	1,000
		<u>£24,000</u>		<u>£40,000</u>		<u>£30,000</u>

3. Finished Stocks

	1941		1942		1943	
Number on hand ..	400		600		400	
Cost :						
Materials ..	..	at £20 £8,000	at £20 £12,000		250 at £20 150 at £16	£7,400
Wages ..	..	„ 8,000	„ 12,000		at £20	8,000
		<u>16,000</u>	<u>24,000</u>			<u>£15,400</u>
1943—Replacement cost— lower than cost (materials 400 × £12 = £4,800, i.e. a reduction of £2,600)						12,800
Oncost addition, 150 per cent. of Wages		<u>12,000</u>	<u>18,000</u>			<u>12,000</u>
ORTHODOX VALUATION		<u>£28,000</u>	<u>£42,000</u>			<u>£24,800</u>

4. Profits (+) and Losses (—)

	1941	1942	1943	Total
Orthodox	£-24,000	+28,000	-13,200	- 9,200
Proposed	+ 8,700	+22,000	+ 400	+31,100
Difference (orthodox under-statement)				<u>£40,300</u>
viz :—				
Organization Expense			21,700	
Advertising			27,000	
Writing down Prime Cost of Stocks to Replacement Cost :				
Raw Materials		1,000		
Manufactured		2,600		
			<u>3,600</u>	
			52,300	
Deduct : Oncost in Manufactured Stock figure			12,000	
			<u>£40,300</u>	

In this case there is a considerable addition to the profit balance on substitution of the proposed methods for more orthodox accounts. But this should not be thought to be the necessary accompaniment of such substitution. The principle factors—oncost in stocks and time and expense of the development stage—may vary considerably in relative dimensions.

The recording of the purchase of an established business has not yet been considered, nor has the introduction of these proposed methods to businesses which have been operating long enough for the incurring of "Organization Expense" to be a matter of distant history. However, the problem of ascertaining a *YEAR'S* profit is a very similar one in all these cases, and that is the only problem which concerns us at the moment.

It has been assumed that the whole of the cost of Advertising was at once charged to Revenue in the orthodox accounts. This may not have been done. To the extent that any such expenditure were held up in the accounts as a "deferred charge" beyond the end of 1943, the above difference would be reduced.

5. *Stocks*

Cost values only are used in the revised accounts, rather than the sometimes-lower replacement cost. The Finished Stock values may be seen (in conjunction with Note 3) to consist of Materials and Wages only.

6. *Advertising*

$\frac{1}{2}$ year 30th June, 1941 ..	£20,000	
Do. 31st Dec., 1941 ..	6,000	(at £1,000 per month).
1 year 1941 ..	<u>£26,000</u>	Initial build-up of "saleability" taken as Jan.-Aug. (£22,000) assuming one month's lag between advertisement and possibility of sale. £3,000 is charged against the going concern (three months) and £1,000 carried forward as recent expenditure not yet "revenue-affecting."
1 year 1942 ..	<u>£12,000</u>	(at £1,000 per month). Normal rate of expenditure—again leaving £1,000 to carry forward additionally to original £22,000.
$\frac{1}{2}$ year 30th Sept., 1943 ..	£9,000	(at £1,000 per month).
$\frac{1}{2}$ year 31st Dec., 1943 ..	15,000	(at £5,000 " ").
1 year 1943 ..	<u>£24,000</u>	Additional effort to keep up sales. Quantity maintained, but with accompaniment of 10 per cent. cut in money value. Still one month's expense to carry forward—but now £5,000.

7. *Organization Expense* £21,700

The calculation of this appears in the accounts for 1941 split at the point (end-September) at which the business achieves the status of a going-concern. An explanation of the process by which this point is ascertained appears in the next chapter at page 64.

8. *Form of Accounts*

It should be remembered that the statements shown above are intended to bring out the method of arriving at the figures, and may or may not be in the form thought proper for final accounts. As an example of what is desirable in a full Balance Sheet, one may mention that Capital Expenditure is best shown at its full amount for assets in service, with the amortization provision as a deduction. (As a matter of fact, the labelling of the net figure as "Expenditure on," though strictly correct within the sense here used, might well be misleading if this information is not given.)

* * *

But the distinction between variable and invariable costs is often much less clear even than this. Repairs to machinery, for example, may vary by only 5 per cent. on a 10 per cent. variation in output

from the plant, whilst a downward movement in output of a good deal more than 10 per cent. may not result in a saving in repairs of much more than 5 per cent. On the other hand, abnormal usage of machinery may involve very heavy repairs, showing a ratio of increase much greater than that of the output figures. Finally, there is the even more drastic reservation to be made that circumstances in which repairs are required are partly fortuitous and not readily related to output or any other factor, unless pure luck can be described as a factor, which I doubt.

The problems of expenditure analysis present a considerable field for study, but I propose to accept the customary distinctive classifications, and to keep to my main theme relative to the proper incidence of those given divisions. All I need do is to remind the reader again, that accounting, as all other fields of study, is concerned with abstractions. This grouping of expenditure by large classes is an abstraction. It is a very necessary one, for without it the ascertainment of asset figures, and consequently of profits, would be an impossible task. It may be that the handling of figures of recurring expenses with a separate grouping for those more or less intermediate between pure time- and pure output-costs may be a common procedure in the not-far-distant future. In this event some of my remarks in this book would require recasting in the light of this improved technique, but nevertheless I do not think this should involve any change in the general theory itself as already stated.

However, the notion of the nature of productive assets which I am concerned to substitute for the existing excessively-concrete view, can be argued as a valid and usable one only if I explain specifically how figures can be placed on the various assets on bases conformable with the general principles I have outlined. To this elucidation I now turn my attention.

ASSET VALUATION

It will be recalled that the expenditures of a business are all to be regarded as a flow into the productive organism, having, as expected consequences, sales of goods, or of services, to such money amounts as will show profits to the business. Whilst at any time there is a capacity to produce future revenues with no, or only fractional, further expenditures, the evaluation of this capacity (an essential in periodic profit ascertainment) is not the same as a valuation of the physical assets which the business happens to have on hand. It is the confusion of these two kinds of computation which constitutes

the main defect of orthodox accounting procedures. These procedures are not even consistent, as they sometimes involve non-material expenses in being held up, albeit apologetically, as assets in the form of deferred charges of various kinds.

Now this idea of assets as "deferred charges" is much nearer to the one which I am proposing. It is based on a "going-concern" view of costs-already-incurred-thus-relieving-the-business-of-some-future-costs-against-future-revenue, rather than the "winding up" view of realizable values for some material assets and "fixed-capital sunk" view for some other material assets. Perhaps it is that the *usual* intention is really to arrive at cost figures, in which case my hope will be to have established that the wrong assets are being costed, and that some of the bases of calculation used are incorrect.

Asset valuation will be considered by reference to the classification employed in the Balance Sheet illustration, namely :

I. *Capital Expenditure*

1. On Land and Buildings.
2. On Plant and Machinery.
3. On Organization.

II. *Production Expenditure*

1. On Raw Materials on hand.
2. On Work in Process.
3. On Finished Goods.

III. *Expenditure on Accruing Rights*

Insurance, Rates, etc.

IV. *Publicity Expenditure*

Initial.

Recent (not yet revenue-affecting).

CHAPTER VI

CAPITAL EXPENDITURE

THE generally accepted principle that the cost of "fixed assets" should be amortized by charges to revenue over the period of useful life seems to be a perfectly valid one ; it is certainly reinforced rather than challenged by my view of the nature of an "asset." There are, however, several points of considerable importance in capital expenditure accounting. These are :

- (1) the incidence of market value,
- (2) exceptional losses,
- (3) methods of amortization ("straight line," etc.),
- (4) provision for obsolescence, and
- (5) calculation of Organization Expense.

MARKET VALUE

There is undoubtedly some tendency to think that an increase in market value of an asset to something more than book value is an excuse (or even a reason?) for not depreciating it. Perhaps the increased regard for the sanctity of the figure of "profit for year" (in Britain, consequential on the Royal Mail Steam Packet case) has partly counteracted this tendency. But the usual over-concrete view of asset figures has led many to think of a depreciation charge as being an allowance for diminution in market value rather than the amortization of expenditure incurred. I have said that this "amortization" viewpoint is the more general one ; but it is not universally agreed, and is not sufficiently vigorously held.

The use of a building for one of the twenty years it is expected to last is analogous in some respects to the consumption of one ton of steel out of a purchase of twenty tons. Few accountants would suggest that because the remaining nineteen tons had appreciated in price by 5 per cent. or more there need be no charge against revenue for the one ton used in earning it. (Valuing at market value would

have this effect but it is generally considered wrong to value stocks at more than cost price.) Yet they will sometimes allow themselves to be persuaded that a corresponding increase in the value of a building excuses provision for depreciation. The use of the word "depreciation" is responsible for this. The word *seems* to relate to market value. The market value of a building will sometimes appreciate and sometimes "depreciate." On balance, there will generally be some depreciation in comparison with original cost as the day of collapse (or expiry of lease) draws nearer ; but clearly, in this sense, "depreciation" is not a continuous process. Periodical "depreciation" of a figure of cost is an absurdity ; had the word "amortization" been more generally used by accountants, it might have prevented market value from becoming a factor occasionally invoked in the charging (or rather, not charging) of capital expenditures to revenue.

A proper method of amortization must take into account the expected useful life of the asset and its estimated residual value or disposal cost. So that in the case of land and buildings there would be considered : the type of tenure (freehold or leasehold), the physical condition of the structure, site value, dilapidations provisions, and so on. Perhaps too much has already been written by others on these matters, and it seems inadvisable to add anything to such considerations of detail, important though they may be.

The most significant points of possible controversy are these :—

1. Market value during use is irrelevant except as it may affect any residual scrap value of materials (but the site cost should be segregated initially in the case of land not on short lease—in fixing amortization rates at least).

2. Amortization should relate to physically serviceable life or legal tenure, without allowance for the risk of technical obsolescence. Provision for this last is probably necessary, but it differs in nature from wear-and-tear or lapse-of-time amortization.

More and more are "fixed assets" coming to be regarded as deferred charges to revenue. We may smooth the still-obstructed path of this clearer view of capital expenditure if we take two interesting border-line cases, that of leasehold premises acquired by initial lump-sum payment compared with that of premises held under a long-term lease at an annual rent. When there is no power of termination by the lessee in the latter case, then the annual rent may be considered as a payment by instalments of a lump sum due under the lease ; it is certainly not an annual expense in the sense

of the proprietor having the option each year of spending or of not spending his money on the acquisition of the particular service (accommodation for his business activities). The possibility of cancellation on terms does not influence the incidence of cost ; it compares with the possibility of subletting premises, freehold or leasehold. So that if market value *were* relevant in the "lump-sum" case, it would be equally admissible to capitalize the annual rent so far as it were represented by the value of the excess rental which could be obtained by subletting.

Whether the lease provides for payment periodically (rent) or initially (premium) is merely a financial matter. (That it happens to be a tax matter also is unimportant here ; that is simply one of the anomalies of British tax law.) The lessor will accept a premium smaller than the total rents accruing over the whole period of the lease ; but subject to allowance for this interest factor, there must be a charge to revenue which is, in essence, "Cost of Occupying Premises," and which is likely to be about the same annual figure whether it happens to be rent or amortization.

We may usefully digress for a moment from the main theme into the general aspect of periodic payments. Contracts, or even unenforceable arrangements, involving these always require special care. It is useful to think in terms of the total sum which is to be paid rather than the mere instalments, for these are not necessarily related in time to services received by the paying business. Thus pensions are payments for past services, and it is quite wrong to ignore this fact and treat them as revenue charges in the year of payment. The total liability may be uncertain, and there may even be no legal obligation to pay the pensions, but nevertheless the propositions that some charge for pensions should appear in the accounts during the period of employment of staff, and that nothing more than the inevitable adjustments should appear after the cessation of their service to the business constitute the accountant's guiding principle. The increased use of pension insurance schemes has frequently brought to light this deficiency in liability recording, and quite commonly the insurers' arrangements for instalment provision for past-service pensions have been permitted to determine revenue treatment. This is just another instance of the way in which the mere circumstance of periodic payment is wrongly construed as determining the periodic revenue charge.

Where the annual expenditure in these cases continues to coincide with the receipt of the contemplated annual services, there is perhaps

no reason to bring total liability into account. But should the services themselves cease, or be reduced (actually as distinct from their value aspect, that is), it is wrong to leave the liability to be dealt with by way of annual charge. We need not decide here whether the future liability is or is not a revenue expense, but it should be recognized as a loss affecting the proprietor and his personal spending decisions even if not affecting his business profits.

EXCEPTIONAL LOSSES

This takes us to the often-discussed question of exceptional losses, and their incidence on profit reporting. In the case of buildings, these may take the form of uninsured fire losses or particularly heavy repair or reconstruction expenditure, or non-use owing to obsolescence or to reduced business activity. The desirability of showing the fact of loss in the Balance Sheet is not generally questioned (though less generally actually done); the disputed problem is whether or not the remaining cost balance should be (1) deducted from current profits, or (2) deducted from accumulated past profits, or (3) not deducted from profits but simply indicated as lost capital, or (4) written off to revenue over a term of several years.

In my view, there is no particular difficulty in this, except perhaps a legal one with which we are not concerned. What is done in the accounts may be influenced by the requirements or (equally important) the permission of the law, but this is a matter of convenience or of desirable regulation, and does not alter the fact that there is a scientific problem which can be solved, or at least considered, in a purely logical manner. Implied in an earlier chapter on income was the idea that money income is a convenient abstraction useful in making personal expenditure decisions. Business profit and personal income are alike in that their measurement and expression in money are undertaken to assist the business man or other person in making decisions about the application of his resources. Accountancy does this by reducing the innumerable operations of business or personal finances to reasonably low common denominators so that their total effects may be more readily grasped. And this is *all* it does. When it arrives at an income figure it does not say, "You may spend this sum but no more. If you do, unless your case is one of exceptional hardship, I shall strongly disapprove of you." There is nothing sacred about capital that it should be kept intact—there are various meanings of capital-intactness, in fact. Income figures and profit figures are simply useful in deciding how to spend existing and

future resources to secure maximum advantage or satisfaction.¹

Applying this insubstantial view of figures to the treatment of cataclysmic, or at least exceptional, losses, we may see that it really does not matter what we finally do with them so long as the proprietor knows about them. This means that he should think of them as separate from his current trading; for whilst a small charge for the *possibility* of such losses may be a proper deduction from revenues (which cannot be earned without some risk of incurring them), the actual event is hardly within the normal course of business, and is not something happening purely in the course of earning any one year's profit. Should a building collapse unexpectedly, then the remaining book value should be taken out of the assets section of the Balance Sheet, and should be deducted from the capital figure separately from the profit addition. (The reader should remember that legal requirements are outside our scope. Registered corporations are subject to regulations in their showing of shareholders' capital, and profits are accumulated separately, but this seems merely to be part of the scheme for protection of creditors' interests by preventing payment of excessive amounts to proprietors having limited personal liability for debts of the corporation. There is no intrinsic scientific merit in the separation, and it is often not made in partnership or a sole trader's accounts. In company accounts, therefore, we may be reduced to some such makeshift as showing lost capital as an item of loss on the assets side, provided we are confident that the law does not require the loss to be deducted in arriving at distributable earnings—an unsolved problem which is outside the province of this discussion).

The conclusion is that since the income or profit figure is intended for use in aiding personal consumption-expenditure decisions as it stands, that is, in many cases without having to look back to its detailed make-up, it should not be stated after deduction of a large exceptional loss; the latter is a separate fact to be separately measured

¹ There is an excellent statement of the respective significances of periodic amortization and exceptional losses in Lord Keynes' "*General Theory*" at pages 57-8. Using the term "supplementary cost" as meaning (approximately) lapse-of-time amortization and "windfall loss" as meaning unforeseen or exceptional losses, he says, "... net income is what we suppose the ordinary man to reckon his available income to be when he is deciding how much to spend on current consumption. [Supplementary cost] is not, of course, the only factor of which he takes account when he is deciding how much to spend. It makes a considerable difference, for example, how much windfall gain or loss he is making on capital account. But there is a difference between the supplementary cost and a windfall loss... although the windfall loss (or gain) enters into his decisions, it does not enter into them on the same scale—a given windfall loss does not have the same effect as an equal supplementary cost."

and reported. The resultant figures—profit, or income, and exceptional loss—are for consideration together, so that the beneficiary can make his own decisions but with separate reference as to their significance. An individual may wish to adjust his expenditure to his income, and while he might find it impossible to economize to the extent of covering the exceptional loss, he may nevertheless feel it to be significant to relate his expenses to income before deducting it. We may now recapitulate the general position which it is hoped has been established. Accounting for durable assets should be concerned purely with unexpired costs irrespective of the value of the physical things by reference to which those costs happen to be measured. For the purposes of profit ascertainment, the principal factors are : cost, life, and use or non-use. The Balance Sheet is connected with profit measurement in showing the unamortized cost carried forward in respect of assets in service. Creditors or prospective creditors might be interested in the value of these, and might look at the Balance Sheet figures. But this would be only a makeshift procedure for them, for they would find market value of greater interest. However, Balance Sheets are not primarily drawn up for credit purposes, and any help they may give in this direction is of secondary significance not to be regarded as an objective in the process of assessing asset figures.

THE MATHEMATICS OF AMORTIZATION

Let us tackle this question of method by taking an easy case. If we consider the amortization of Leasehold Land and Buildings first of all, we shall be eliminating a number of uncertainties which are best taken separately so as to avoid confusion—the incidence of wear and tear is one of these awkward factors.

Therefore we will take the case of leasehold premises :

- (i) acquired by initial lump-sum payment ;
- (ii) for a fixed term of years not subject to termination on either side ;
- (iii) without dilapidations liability ; and
- (iv) on a lease short enough for it to be reasonably certain that the buildings will outlast the lease (and we are permitting no cataclysms).

The most popular method of “ depreciating ” a lease of this kind is the “ straight-line ” method. The percentage-of-diminishing balance method, unaccountably popular in most cases, is here set

obviously defective as to be rejected at once, for a lease has no residual value, and the "diminishing-balance" method cannot even seem to handle such a case for it never completely extinguishes the asset balance.

There is also the basis of amortization known, for reasons not particularly clear, as the "annuity" method. Many textbooks on accountancy explain the working of this method, but without doing more by way of expressing its fundamentals than saying that the asset is assumed to be earning interest and is accordingly debited with it. (I cannot imagine what this means.) Lip-service is sometimes paid to the method as being the most "scientific" one, and it is thereupon shelved as unpopular owing to its complexity.

It is worth noting that the "diminishing-balance" and the "annuity" methods produce strongly contrasting results. The annual charge under the former starts high and reduces to a fairly low rate, whilst the latter gives a small net charge ("depreciation" less interest credit) at first, increasing in later years with the diminution in the amount on which the interest figure is calculated. It seems reasonable to say that one of these methods must be wildly wrong, and the likelihood of increasing repair expenditure in later years does not seem to be an adequate defence of the "diminishing-balance" method. Surely it is not a satisfactory alternative to a Repairs Equalization account when no attempt is made at estimating the future liability for repairs, this merely being left to be offset by excess provision for another class of expense without any effort at making a quantitative link between this excess and the possible repairs liability!

The reason for the use of the "annuity" method is that it is a means of separating matters of finance from matters of trading. In the case of leasehold premises, the business man may have the choice between occupying premises either at an annual rent or in consideration for an initial lump sum payment. Other things being equal, such premium would be less than the total rent payments simply because the lessor would receive the money earlier. The lump sum would be the discounted value of the yearly rental value. It would not be worth the while of the lessee to take on premises at a premium unless he thought that their use would yield enough revenue to cover not only such lump sum but also interest on it for the time that he would have to stand out of his money until gradual recovery of it in the revenue from the sale of the goods manufactured or stored in the premises. It follows from this that the manufacturing and trading

section of the revenue schedules should be charged with the rental of which the lump sum is the discounted value. The mere fact of payment being in advance should not be permitted to affect the trading profit, and the interest on the sum invested should appear in a later, financial, section of the schedules. Of course, the separation of the financial from the other aspects of a business in its accounting reports is not itself the reason for this treatment of amortization; it is merely convenient to describe the treatment in these terms. The position is that the charge to operations for the service rendered by an asset should not be affected by the time of payment of its acquisition cost, but should be adjusted to the present value (not to be confused with market value), at the time of the utilization of the asset, of the appropriate proportion of the cost incurred.

We may usefully take a particularly easy case of a two-year lease dating from the first day of a concern's accounting year. If the cost were £1,000 and interest be taken at 5 per cent. then the acquisition of the lease would be worth while only if it were thought that the use of the premises would produce revenue of at least £537 16s. od. per annum as an average for the two years, after allowing for all other expenses associated with the earning of that revenue. This is to say that a rent of that annual amount for two years is the same, so far as trading operations are concerned, as an initial payment of £1,000. The asset account would appear as follows:—

Leasehold Premises				Net Charge to Revenue	
		Dr.	Cr.		
1941—Jan. 1.	Cash—Cost	£1,000			
	Dec. 31. Interest at 5 per cent. ..	50			
	„ „ Amortization		£537·8	}	£487·8
	„ „ Balance c/d		512·2		
		<u>£1,050</u>	<u>£1,050·0</u>		
1941—Dec. 31.	Balance b/d	512·2			
1942—Dec. 31.	Interest at 5 per cent. ..	25·6			
	„ „ Amortization		537·8	}	512·2
		<u>£537·8</u>	<u>£537·8</u>		
					<u>£1,000·0</u>

The higher net charge to revenue in the second year is a reflection of the fact that some of the investment (in leasehold premises) has been realized in the first year. Revenue arising in each year from the business activity facilitated by the use of the premises should have yielded at least £537·8. This is the amount to charge against that

revenue for the service rendered by the buildings, and of this sum, £50 represents expected interest at 5 per cent. which may be withdrawn by the proprietor as part of his income, thus leaving funds amounting to £487·8 in the business (assuming that the revenue earned does in fact cover the charge). If these funds can be used so as to earn 5 per cent. revenue or interest, then in 1942 a sum of £24·4 will be credited to profits from some source, precisely offsetting the increase in the net charge from £487·8 in 1941 to £512·2 in 1942.

Calculations for longer leases naturally show a similar state of affairs, and need no illustration. The disparity in the net annual charge is more marked for these cases. The gradually accumulating money funds (the amortization realized in revenue from sales) should be earning increasing amounts of interest, and unless the net amortization charge be increased each year (as it is under this method of assessment), there will appear to be an increase in total earnings as a consequence merely of the gradual realization in cash of funds invested in a durable production expenditure asset.

The difference in the figures resulting from the use of the "straight line" and the "annuity" methods in the case of, say, a thirty-year lease, is quite considerable. If such a lease cost £30,000, the annual "straight-line" charge would be £1,000; whilst, taking interest at 5 per cent., the annual "annuity" amortization would be £1,952 against which would be interest credits reducing from £1,500 in the first year to £93 in the thirtieth and last year, i.e. the net charge would rise annually from £548 less than the "straight-line" £1,000 to £859 more than that figure, namely from £452 in the first year to £1,859 in the last.

Many books have been written on the subject of "depreciation," and it can scarcely be hoped that in this single chapter anything more than general principles can receive consideration. Unquestionably the amortization deduction in the Profit and Loss Account is one of the main sources of error in the final balance of that account. This deduction is dependent more than any other on estimates of the future; estimates, moreover, which are oftener wrong than right. Since this is so, it may well be asked whether it is worth while to devote time and energy to the working out and application of a "scientific" method of amortization. And it can be at once conceded that a calculation of revenue charge based on the "annuity method" for each separate item of plant and machinery in a works of any size would be a task of impossible magnitude.

It is here that the conception of the value of "standards" is

important. In *An Introduction to Corporate Accounting Standards*, Pearson and Littleton say,

“ . . . a formulated standard may not always conform with generally accepted practice. The latter is like a statistical mean in the midst of surrounding data ; the former may often be a guide to the gradual improvement of corporation accounting practices and a gauge against which to measure variations.” p. 6

This places the status of my analysis of the annuity basis of calculation. That method seems to me to be the ideal towards which the accountant should strive.

A machine is subject to wear and tear by use, and to deterioration by mere lapse of time. That is to say, its life is a function of both these factors ; it will decay even if left unused, and it will generally decay faster by use. Accounting provisions based on output or length of operating time are attempted to take account of the second of these factors. Provision by reference to lapse of time, ignoring usage, is much commoner. A combination of the two may be met with, but is certainly rare.

Now whilst it is largely a matter of arithmetic to derive formulae to deal with both the time factor and the use factor on the one hand, or with the time factor and the interest factor on the other, this is by no means the case in the third permutation—the combination of use factor and interest calculations. Broadly speaking, this is because such a method of amortization would require estimates *not only of plant life, but of usage during each accounting period of a machine's life* : not only is aggregate service life important, but also the distribution in time of the demand for service. Clearly, calculation on these lines is impracticable in the present state of our knowledge of the future. I am not a mathematician, and I do not know whether there is any convenient process of approximation which would yield an amortization figure based on these three factors. I state the position here because it seems to me that there is a considerable field for study yet to be explored. Not only must there be far more work by way of compilation *and use* of “ Plant Mortality Tables,” but method itself is in need of attention by the mathematically-minded.

It is, I think, a salutary thing to realize that we are such a great way from arriving at even reasonably-approximate figures for our amortization charges. Our attempts at the imposition of, and the Revenue's imposition of, at least *some* rules to be kept with a considerable degree of consistency from year to year, are wholly praiseworthy ; but they are very far from ideal, and quite a way from what can in fact be

attained. Provisionally I would suggest for plant amortization, the use of the "straight-line method," a closer study of the actual out-turn of the provisions made by reference to particular plant items and groups of similar items, and the institution of the plant survey as a regular periodic check on the relation of book figures to current circumstances, and also as an inventory check on the existence and utilization of the physical assets corresponding to the Balance Sheet figure of expenditure.

When I first applied myself to the study of accounting I was especially perplexed by the textbook-writer's common habit of listing a number of "Methods of Depreciation" without telling me which was the correct method. Expression of opinion in the student's textbook is often limited to a hint of disapproval at the complexity of calculations involving considerations of interest. I had not, at that time, achieved any understanding of the professional man's traditional caution in expressing an opinion. I am pleased to think that my youthful perplexity still seems justified. Praiseworthy though a degree of caution may be, I think that there are occasions when this attitude is carried too far by accountants. This question of amortization is one such case, for it really is quite extraordinary that there should be no general realization that of such a number of differing bases, some must be wrong. A careful analysis of method may lead to the conclusion that accuracy can only be approached, not gained; but the approach can proceed dynamically, and whatever methods may be adopted must be shown to be at least the best possible approximations. When such studies have been made—and in this outline of the problem scarcely more than a suggestion of mode of investigation can be claimed to have been made—then the textbooks can be rewritten so that future students may have inculcated in them the idea that there is at least something of science in their studies and in their profession, that they are not merely being instructed in the rites of an esoteric sect of figure wizards.

There is some tendency in relation to the less precise elements in accounting—amortization is one—to consider that it is sufficient to follow a "prudent" policy of provision-making. Over-providing may have its merits as compared with under-providing, but it has serious defects, not least that it will generally involve overstating profits in later years. It is the means whereby fluctuations in earnings are ironed out in business accounts. This convention of smoothing profits as stated is not a matter to be viewed with complacency. In the words of Paton and Littleton :

"There are lean years and fat years in business operation and it is a function of accounting to disclose this condition sharply not to cover it up."²

Alongside this purely accounting criticism of so-called prudence, we may profitably consider the social aspect of its widespread practice as brought out by Lord Keynes in *The General Theory of Employment Interest and Money* :

"Thus sinking funds, etc., are apt to withdraw spending power from the consumer long before the demand for expenditure on replacements . . . comes into play ; i.e. they diminish the current effective demand and only increase it in the year in which the replacement is actually made. If the effect of this is aggravated by 'financial prudence,' i.e. by its being thought advisable to 'write off' the initial cost *more* rapidly than the equipment actually wears out, the cumulative result may be very serious indeed.

"In the United States, for example, by 1929 the rapid capital expansion of the previous five years had led cumulatively to the setting up of sinking funds and depreciation allowances, in respect of plant which did not need replacement, on so huge a scale than an enormous volume of entirely new investment was required merely to absorb these financial provisions. . . . This factor alone was probably sufficient to cause a slump. And, furthermore, since 'financial prudence' of this kind continued to be exercised through the slump by those great corporations which were still in a position to afford it, it offered a serious obstacle to early recovery."³

" . . . financial prudence will be liable to diminish aggregate demand and thus impair well-being, as there are many examples to testify."⁴

The accountant is primarily concerned with the affairs of particular businesses and not the general economic and social situation, which is the province of the economist. But if a specific business practice is harmful to the economy as a whole, that is, it is anti-social, it is surely to be condemned however advantageous it may appear to the business adopting it. This forceful condemnation of "financial prudence" by a leading economist must at least curb the enthusiasm with which the accountancy profession is wont to receive a "prudently" drawn set of accounts. Who knows, it may soon be commonly regarded as just as immoral to make a book entry for plant amortization to an excess amount as to conceal a theft of cash by falsified entries.

OBSOLESCENCE

By its very nature, plant obsolescence is an unknown feature of the future. Were it so near as to be foreseen when acquisitions were

² *An Introduction to Corporate Accounting Standards*, p. 77.

³ *The General Theory of Employment Interest and Money*, p. 100.

⁴ *Ibid*, p. 105.

contemplated, it would generally weigh decisively against such expenditures; and consequently circumstances are not normally such that obsolescence can be anticipated by amortization provisions based on predictions as to the life of each individual item of equipment. The contingency of a machine becoming redundant by new invention is so far different from the inescapable wear and tear through usage and lapse of time that it is comparable with the risk factor in the earnings of relatively hazardously-employed capital. Certainly the wholesale obsolescence of practically the whole of a business's equipment should be so regarded. Obsolescence of such a wholesale variety may occur because improved machines would do the same work at lower cost, or because the concern's product is itself obsolete. It is hard to imagine that there is any kind of product for which there is absolutely *no* risk of its being ousted from public demand. If this misfortune occurs, then a considerable part of the manufacturer's equipment, often not physically adaptable to other varieties of output, will be obsolete and worth perhaps only scrap prices. This risk is not the sort of contingency of which any account can be taken in computing profits. It would be quite wrong to make a charge against revenue to meet it, and in fact the accumulation of the necessary reserve might well be impossible if the risk were of an all-or-nothing variety. The position is simply that the hazards involved should be known to the business man, so that he may decide whether the expected profit is sufficiently high in relation to the capital invested.

Turning now to the commoner and less drastic cases of obsolescence of relatively small sections of an undertaking such as a single machine, it seems possible to draw a useful distinction between the more-or-less recurring nature of this type of loss, which it would not be a serious mis-statement to call "normal" obsolescence, and the "exceptional" cases arising from obsolescence of the product or of the whole equipment of a manufacturing process. It is not outside the bounds of possibility that an expert engineer might be able to make a usable estimate of a risk allowance for a plant with which he is familiar, having regard to possible technical developments within the industry.

Without exploring this matter thoroughly, we may take it that some allowance for normal obsolescence can, and perhaps should, be fitted into the accounts of a manufacturing concern. I put it this way because there is a considerable difference between such an allowance and the more objective figures which constitute the usual province

of accounting. This difference necessitates separation of the provision for obsolescence from the ordinary amortization of capital expenditure. Indeed, the accounts should show the profit arising after amortization with obsolescence provision as a final deduction so as to emphasize the considerable element of guesswork in the resultant net figure.

It is absolutely essential too, that the *actual* loss by obsolescence shall be disclosed. When a machine finally passes out of service, its unamortized balance of cost should be shown in the final accounts *somewhere* (in total, of course). This loss balance is not necessarily to be charged to revenue : it will be important to consider the situation in relation to remaining plant, particularly that of a similar kind, for both amortization and obsolescence provisions need only be on the basis of average estimated lives, and early retirement of a particular machine does not represent an inadequate provision where other machines are expected to outlast the average. As has already been stated, exceptional losses need not be considered as deductions in arriving at figures of personal income. The only essential thing about them is that they should be ascertained and reported. If a provision for obsolescence has been established, then normal losses at least should be charged against the reserve. Over a series of years, a comparison of provisions with actual losses crystallizing on retirement of equipment will be a useful guide to the reliability of the estimates on which the provisions are based.

Two common varieties of error may be noted here in relation to balances of book value of plant scrapped. Firstly, there is a tendency to write off the balance in respect of a machine which has been sold—even if only £5 is received for the scrap contained in it—but to overlook it if it falls into disuse without being sold. The need for avoiding this absurd mistake is the principal reason for making a periodic plant survey as suggested above. The second error has already been mentioned. It operates in the reverse direction, leading to a small degree of excess revenue charge, and arises on retirement of a machine before the end of its assumed life when other machines may be expected to offset this by lasting longer than the estimate. Certainly where machines of the same class are involved, it is wrong to regard such balanced variation about a mean as involving correction of the amortization charges.

It is interesting to note the practice of one large concern, Imperial Chemical Industries Limited, who adopt the unusual device of maintaining a "Central Obsolescence and Depreciation Fund" to cover the amortization of fixed assets of wholly-owned subsidiary

companies. The provisions made in recent years for credit to this Fund have been as follows :—

1936	£1,000,000	1940	£2,000,000
1937	1,500,000	1941	2,000,000
1938	1,500,000	1942	2,500,000
1939	2,000,000	1943	2,500,000

These half-million steps indicate a very considerable possible error in the disclosed periodic charge. This is not a criticism of this particular concern's accounts, which are in many ways quite well drawn, and which go a good deal beyond giving the legal minimum of information. For that matter we are not dealing with the problem of how much should be disclosed publicly. But these very round figures do indicate the need for separating "depreciation" and obsolescence in accounts for management. It is hard to imagine that the wear-and-tear portion of these millions cannot be estimated far more closely than the total; considerable risk of obsolescence no doubt arises in many of the branches of the chemical industry, subject as it is to far-reaching technological changes, and this factor is presumably the basis of the "nearest half million" practice. But the two kinds of expense, or loss, are of a very different nature, and their amalgamation is confusing.

The I.C.I. treatment is very unorthodox, for these provisions are made in the accounts of the parent company, though the assets themselves stand in the books of subsidiaries. It appears from the published accounts that lump sums are transferred from the Fund to the credit of these subsidiary companies, and are presumably utilized to write off the cost of retired assets. The amounts thus charged to the Fund for 1940, 1941, 1942 and 1943 were (in thousands) £950, £625, £1,150 and £1,010 respectively, which, though they are again very round figures, one imagines as being related to actual writing-off of assets.

This sweeping cut across the legal division of the group into innumerable separate entities is itself worth close consideration. Its unorthodoxy is reflected in the remarks in each year's Section 126 statement concerning qualifications by auditors of the subsidiaries in relation to the absence of any "depreciation" provisions in the accounts of some of those companies. However, we must not digress too far from our main theme.

The magnitude of the figures quoted is a witness to the magnitude

of the problems involved. No accountant would assume because a particular calculation gives shillings and pence at the end of a "depreciation" provision that the figures are anything but guesses with a wide margin of error. But this does not mean that management should have a free hand at invoking or dismissing the risk of obsolescence as may seem convenient on grounds really inadmissible. In fact, this degree of possible error requires that whatever can be done in the way of estimating and weighing relevant facts, must be done; and that the Balance Sheet and Revenue statement should show the actual out-turn of events and not leave them hidden in the smoothing influence of the periodic provisions.

ORGANIZATION EXPENSE

1. *Development Expenditure.* I must remind the reader that this heading, Organization Expense, does not refer to the preliminary expenses of registration and of raising capital sometimes shown in Balance Sheets under that title. It is intended here as covering the whole cost of bringing a business into running order. It is the cost of developing the organization and activities of the business up to the point at which it may be regarded as a going-concern.

There is nothing very new about this idea. The "capitalization" of development "losses" has long been a common practice in the accounts of mining concerns. If it is a valid procedure in such cases, then it is equally proper in the accounts of any type of undertaking in which there is no expectation of earning a profit right from the first day of business (i.e. the first day on which any expenditure is incurred). It is my contention that it should, in fact, be followed in all cases, and in relation not only to new concerns, but also to any extension of activity, e.g. the building of an additional factory involving the incurring of extra "overhead" expenses in advance of the eventual increase in revenue. The problem is to ascertain, so as to carry forward as an asset, the "lag" expenses not represented in other assets such as plant and stocks of goods.

It will be recalled that we have already considered this problem in criticizing the practice of including oncost in stock figures.⁵ It is indeed correct for overhead expenses to reach the Balance Sheet as assets, but orthodox practice commonly puts them in the wrong place—as part of the manufactured stock figure—whereas the amount for carry-forward has no reference whatever to such quantities of goods as chance to be on hand. It should be calculated on quite a

⁵ See page 14.

different basis, and should then stand alone as a separate asset not normally subject to frequent revision. The common error lies in pinning all costs on to parcels of goods without considering that many of them are variable by reference to wholly dissimilar factors—time, for instance. The accountant should think in terms of the ways in which the amount of each of the expense groups varies—proportionately with output, with sales, with time, with capital employed, and so on.

2. *Calculation of the Asset Figure.* The problems which can arise in the course of the assessment of this particular asset are no doubt many and varied. The general principle which it is proposed should be followed is that there should be taken to Organization Expense Account the deficiency of revenue up to the time when the business first commences to yield a profit. This figure is simply the “loss” shown by an account in the form of a Revenue or Profit and Loss Account from the commencement of business to the date of passing the break-even point. The excess, over sales revenue, of costs not carried forward under other asset heads is the asset “Organization Expense.”

We left the computation of this asset in the case of Motor Mowers, Limited, somewhat inadequately stated, and we may best see how this general principle is to be applied by returning to the figures on page 41. To determine the break-even date, sales may be taken by months. The required factors are : sales, rate of gross profit, rate of fixed (overhead) expense. The sales of the company during the first year are as follows :—

				£
January/March	..	..		Nil
April/June	..	..	..	8,000
July	..	..	..	6,000
August	..	..	..	9,000
September	..	..	..	11,000
October	..	..	..	14,000
November	..	..	..	16,000
December	..	..	..	16,000
				<u>£80,000</u>

Figures are available which show the gross profit on sales to be about 60 per cent. (the last quarter of 1941 shows £27,000 gross margin on £46,000 sales, i.e. 58·7 per cent. ; the year 1942 shows

exactly 60 per cent.). This is subject to Distribution Expenses which are partly at the fixed rate of £1,000 p.a. for the company's own vehicles, and partly variable in so far as transport must be hired. These expenses may be taken as 5 per cent. for our present purpose, leaving a net margin on sales of about 55 per cent.

Overheads may be seen to be nearly £4,000 per month and advertising is another £1,000.

Thus the company must cover expenses at the rate of £5,000 per month out of its 55 per cent. gross margin. Sales must therefore be nearly £10,000 per month for the company's trading to begin to show a profit. It will be seen that this condition is first realized in the month of September in which sales amounted to £11,000. The period of development ended during that month, therefore; and in the accounts drawn up on the basis suggested in this book, the company has been treated as a going-concern as from the 1st October, 1941.

Probably any interest payable on borrowed capital should be ignored in fixing this crucial date; the manner in which the activities of a business are financed is outside the question of the return from its trading operations, and it might well be held to be a going concern though the return were insufficient to cover the charge for interest payable. Nevertheless the interest accruing during the period of development is not a deduction from subsequent revenue, and it is convenient to add it in with the Organization Expense figure. This has been done in the lawn-mower business's accounts.

The effect is that, instead of our company showing a loss of £13,000 (or of £24,000 according to "orthodox" accounts) on the first year's working, there is seen to be a return of £8,700. For the company has been a going-concern only since September, and the earlier deficiency of sales-revenue, £21,700, is simply one of the expenses of establishing the business, as inevitable, and just as much an asset as the purchase of plant at a cost of £50,000 (perhaps worth no more than £10,000 if it were dismantled and sold outside the business).

3. *Expected Costs and Actual Costs.* It is quite possible that the business may reach the status of a profit-earning concern much later than the proprietors expected. This will commonly involve much higher expenditure on "Organization," or greater Development "Losses" than were originally considered likely. In fact, the total funds which the proprietors must sink in the business may be more than they consider the resultant profits to be worth. In other words, had they

correctly estimated in advance the rate of profit and the capital required, they would not have undertaken the launching of the enterprise at all. The question to be decided is whether any deduction should be made from revenue when profits do finally come in, in respect of the moneys lost in the course of bringing the business to that stage.

There seems to me to be no reason whatsoever for making any such deduction. When *some* profits are at last earned, there is no case for reducing them because they are less than had originally been hoped. The position is bad enough as it is ; it should not be *represented* pessimistically as well. It is clear that in such circumstances the Organization Expense asset figure will be higher than any value conception of the asset would make it. But as has repeatedly been emphasized, accounting is not generally concerned with values. Realizable values have some usefulness on occasions as guides in estimating cost carry-forward figures where there have been partial realizations of group assets, such as goods purchased for resale in the ordinary course of business,⁶ but they should never actually enter into the Balance Sheet in their own right, and in the case of Organization Expenditure, are not even of this incidental interest in the preparation of profit statements and Balance Sheets.

Smallness of profits affects the value of the business as a whole and not that of particular assets—the “value” of these as severable portions of the undertaking may be quite small, or even nil, no matter how profitable the business. It is revenue profits on which the accountant reports. Fluctuations in the capitalized value of those profits, and variations as compared with capital invested, are not relevant to this task.

Thus we have the situation that so long as there are revenue “losses,” these are to be capitalized as an asset ; but after this stage is over both profits and the losses which may be incurred later are equally revenue figures, and no further addition should be made to Organization Expense as a consequence of these going-concern losses. Once profit has begun to come in, in circumstances which indicate that, allowing for normal seasonality, there will be a surplus on the ensuing twelve months’ trading, then the going-concern stage has been reached. Whether or not the proprietors may wish to replace a loss of capital before spending their profits is entirely their own concern ; and so long as any asset is contributing to the earning of revenue, i.e., is in service, whether it is plant or something less solid, there is

⁶ This line of thought is an anticipation of the following chapter.

no need, when preparing accounts, to consider the value of this contribution.⁷

CONCLUSION

The accounting treatment of Capital Expenditure as outlined above is very largely determined by the exigencies of profit-measurement. Asset figures (including those of Production Expenditure, discussed in the next chapter) are largely a by-product. These asset figures are of *some* use in considering the financial position, but only in a limited way, for they are cost-balances emerging as a result of profit-measurement, and are not closely related to individual realizable values (we are not at the moment concerned with cash and debts and similar money assets). These cost-balances, when summarized in the form of a Balance Sheet, do at least show the proprietor or the shareholder what has happened to the capital invested in the undertaking ; how much of it has been sunk more or less irrevocably on the one hand ; and at the other extreme, how much of it remains in the more saleable form of trading stocks. The assets side of a Balance Sheet is a record of costs not chargeable against revenue, and of money balances. The existing legal and commercial system, whatever its merits as a whole, is subject to the serious defect that it has led to there being considered as wise finance, the deliberate concealment, by writing-off out of earnings, those significant figures which show the amount of money invested in the business. Amongst these, Organization Expense should stand permanently in the accounts and annual reports so as to enable the relationship between original expectations and actual results to be kept under review. The purpose of a set of accounts is to record the history of a business's finances—how much has been invested in it, how this capital has been expended, and how much has been yielded by this employment of resources. If the careful estimation and statement of these historic truths be accepted as the guiding principle of good accountancy practice, then some reconsideration of Capital Expenditure treatment is called for on the lines stated, somewhat tentatively, in this chapter.

⁷ An abandoned asset should no doubt be shown as such in the accounts, and it *could* happen that a specific part of Organization Expense related to a particular one of a business's establishments which had been closed. If so, then along with the disused Plant, etc., these assets out of service should properly be shown as such so as to give to the proprietors as clear a picture as is possible of the employment of their resources.

CHAPTER VII

PRODUCTION EXPENDITURE

We have seen that the fact that some Capital Expenditure assets have tangible counterparts leads the unwary to think in terms of market values even in relation to profit measurement. This danger is greater still in the case of Production Expenditure assets, i.e. costs carried forward in respect of Raw Materials, Work in Process, and Finished Goods. For here there is not only a physical counterpart to the costs carried forward, but also a closer relationship between fluctuations in physical quantities and those in money figures. Amortization of a machine diminishes its net book value long before its physical disappearance, but materials used in manufacture are charged to revenue as they are actually consumed, and the asset figure is related to those remaining on hand.

The usual form of stock valuation is a series of numbers of physical units multiplied by "prices." Though this form of calculation is arithmetically proper, asset computation is not really a matter of *valuing* those particular assets as specific goods; it is a matter of carrying forward costs relative to future revenues. (Incidentally, there is a point of some difficulty regarding goods marked down to "sale" or bargain prices, which may not even show a surplus over prime cost. This is mentioned here to forestall any reader who may be tempted to raise objections to a strict cost theory of asset statement; the solution is dealt with in the following pages without departure from the principle of this theory.)

The broadest possible statement of the guiding rule for the ascertainment of stock figures is this: that there shall be carried forward as applicable to future revenue, the excess of the costs actually incurred by a business over those which would have been incurred if just sufficient goods had been purchased and manufactured as would, with initial quantities on hand, have covered precisely the sales effected during the period. In other words, the asset figure is the excess cost incurred over that required to produce the bare minimum of goods so as to leave no stocks on hand at the Balance Sheet date. The business is assumed to be a going-concern even in this hypothetical no-stock position; the object of this definition is simply to

express, as precisely as may be, the basic conception underlying the prime-cost-only assessment of carry forward as already discussed under the heading of Stock Values and Oncost (at page 12).

INCIDENCE OF MARKET VALUE

Leaving aside for a moment the special problems associated with the assessment of money figures of stocks of goods which have been worked up, or partly worked up, into a different form, we may concern ourselves exclusively with raw materials or goods purchased for resale without change in their form (as in the case of a retail shop). It will probably be difficult to convince the reader that any reference to market value is permissible within my scheme, in which I have throughout been so insistent that accounting is concerned with costs and their proper allocation against the revenues of different periods. I am compelled to admit that market values are *relevant*. This is often very obviously the case when a parcel of goods has perhaps proved almost unsaleable, and quite clearly can only be sold at greatly reduced prices, much below original cost.

It is my immediate objective to establish that this admission does not invalidate the "cost" theory, but is merely a recognition of the complexity of actual business activity. This is the sort of situation in which it is common to say that theory is not the same as practice. I have repudiated this view. A theory, to be useful, must be as broad a statement as is possible, and in being broad it may omit complete treatment of *all* observed facts. It is necessary only that it should not be inconsistent with observed facts, and should be capable of being extended to explain them in detail when that seems desirable. The circumstance of realizable value being less than cost is such an "observed fact." A common-sense judgment is that Balance Sheet value in such cases should be something less than cost. This judgment seems to me to be correct, and it must therefore be fitted into the general theory and given quantitative expression.

My particular difficulty here is that I have no radical quarrel with what is fairly commonly done in practice, that is, with the "lower of cost or market value" rule. So that the necessary elucidation is rather one of viewpoint and has not the drama of concluding, in this case, that what is generally done is greatly wrong in resulting amount. Conventional accounting has found it difficult enough to reconcile itself to the cost or market rule, and this explanation of its validity does not, therefore, refer exclusively to any special features of my views. Indeed, conventional theorists have, more often than

not, been concerned to express profits and Balance Sheet values as being figures emerging as resultants of correct apportionment of *expenses*, of "matching costs with revenues." Following this principle to its more obvious conclusion, some such individuals have thought that stocks should be valued at cost irrespective of any fall in market values ; the loss is then held to accrue on realization just as any profit would have done. Against this theoretical view, there has been the more common practice of taking account of lower market values. No theory has been expressed which purports to show this to be correct ; there is merely the vague feeling that whilst unrealized profits are not true accounting profits, "unrealized losses" are necessary deductions in arriving at such profits.

This absence of scientific reasons for deducting "unrealized losses" whilst not recognizing proved but unrealized accretions has been a serious barrier to the acceptance of accounting as a rational science rather than a business of conventionalized procedures. It has led such a careful student of our activities as Professor Canning to say :

"Net income has no qualitative attributes" (*The Economics of Accountancy*, p. 126).

And, more explicitly :

"There seems to be no brief expression less general than 'net income is equal to gross income less deductions' that is wholly true, and this expression comes perilously near being meaningless." (*Ibid*, p. 127)

It seems to me that here is a case where illogical method has had more accurate results than theory. This is simply because theories may be dangerous when they are in some respects incorrect, as in the present case, and immediate judgment of a problem on its facts, without the benefit of a guiding theory, is quite often less liable to take one very far astray. But only "less likely." In my view, theory must for ever be pushing forward, taking over, bit by bit, ground which was once the domain of mere pragmatic judgment. In the practical application of accounting, as in many other fields of human activity, man must always be making hasty makeshift decisions and letting theory catch up later. Theories may not always be right, but nor, for that matter, may the makeshift decisions : it is our job to try to get theory nearer the truth ; correct practical decisions will then follow much more easily.

Returning to the specific problem, that of stock evaluation or assessment, we may first observe that there are various methods adopted in practice. Some of these may be mentioned briefly :

lower cost or realizable values (aggregate or individual), "base" stock, average cost, "first-in-first-out," "last-in-first-out," current replacement cost, cost plus some profit (particularly on contract work, crops, or slowly maturing stocks), selling price less percentage, and no doubt many others. That there should be so many methods in use is an indication of the inadequacy of existing theory on the subject. The contradiction between some of these methods shows that some are wrong, and that here is scope—even necessity—for new theory.

The greatest difference I have with conventional accountancy is that it treats its own "raw materials"—classified expenditures—too concretely. In the case of stocks of goods, it is common to think of the year-end evaluation as being a summation of values of individual items of stock. Here is where the error arises. The situation is that though totals carried forward may have to be computed by reference to details of different quantities of different physical things on hand, the totals so derived are only abstract aspects of the business position; they do not attach to the stock itself in detail. It follows from this view that costs of acquisition of goods are, in their accounting aspect, a homogeneous flow of monetary outgo, and that the stock figure to be eliminated in ascertaining the net cost figure for deduction from sales revenue, must be a *cost* figure however much the method of its calculation may seem to indicate that it is something else.

Taking a clear-cut case, we will consider the position of a retailer of ladies' gowns, a trade greatly affected by "fashion." In buying a season's gowns he is well aware that a number of them will probably not realize even his cost price. Accordingly he must be expecting to make fairly high profits on some of his purchases so as to cover the individual losses and leave himself that aggregate of profit which is sufficient to encourage him to carry on being a "costumier." Of course he does not know which gowns are going to show losses or only small surpluses; if he did he would not buy them at all. So that he begins by trying to sell each gown at a price which will show a high profit. As a result he finds that whilst much, perhaps most, of his stock is sold at the prices first fixed (or within the bargaining range which he permits himself and his assistant as a start), some are obviously not really "worth" those prices. The mysterious quality which induces the customers to pay handsomely for their clothes is missing from some of the gowns he has bought. Generally speaking, the fact that these gowns are slow in leaving the shop is the first indication that they are the particular ones on which he will barely cover his costs—or will perhaps incur a loss—those gowns which he

had in mind (or should have had) at the time of purchasing his season's stock, but then only as a likely proportion—*some* gowns, not *those* particular gowns. The trader can expect to earn a profit only on the aggregate of his dealings, and will normally incur deficiencies on some individual items of his stocks. So that from an economic standpoint, the retailer is concerned with his gowns in terms of cost *aggregates* and revenue *aggregates*. This is the standpoint also of the retailer's accountant, and his accounts should reflect the situation by recognizing that costs do not attach to individual items of purchases.

The only basis on which accounting for profits can proceed is to consider part of the cost of the less successful gowns as an addition to the cost of the more successful ones. Where, in the course of manufacture, material is wasted either by reason of spoilage during that process or of defect inherent at the time of purchase, it is common to think of the cost of such waste as additive to that of the goods which are successfully manufactured, the waste itself having only scrap value. Analogously, the impalpable defect in certain gowns, involving deficiency on their sale, is a kind of wastage which enters into the costs of the remaining gowns. That the defect is not a physical one is unimportant: nor does it matter that it does not involve scrapping the goods, which will probably sell for something more than their value as rags (in the stricter sense of that word). It can happen that some items *are* unsaleable. No accountant, not even the strictest cost adherent, is likely to suggest that the purchase price of such items should be included as an asset until disposal.¹

We have been considering a case of fashion goods, but the situation is the same in most classes of undertaking. The business man spends money on a variety of purchases hoping to show a profit on balance after deducting inevitable deficiencies on particular items. If he buys for sale in his shop, a grand piano and a radiogram costing him £60 and £40 respectively, he may begin by pricing them at £90 and

¹ Originality is almost always out of one's grasp! Paton and Littleton in *An Introduction to Corporate Accounting Standards*, which I had not read when this chapter was first drafted, not only express the same view but use the same illustration. Their words are worth quoting as assistance to the reader who may find this reorientation of thought something of a strain, particularly since little change in resulting figures is involved in this connexion:

"In special circumstances a part of the cost of merchandise not sold in a given period is clearly a component of the total cost of the units which have been sold. If, for example, a store selling style goods must carry a large and varied stock in order to be prepared to meet a wide range of customer habits and desires with the inevitable result that a considerable number of units will be unsold at the end of the regular season, it can reasonably be held that a part of the cost of these unsold purchases, which must now be sacrificed at post-season prices, is part of the cost of making the regular sales." (p. 80)

£70 respectively. Yet nevertheless he would not necessarily have required the expectation of £60 profit to induce him to make these two purchases. He knows that not every bargain is a successful one, and he may well be satisfied if it turns out that he can sell the piano for £90 but the radiogram for only £35, the total profit being £25 on his outlay of £100. Now let us suppose that a Balance Sheet and accounts are required, made up to a date subsequent to the sale of the piano for £90, the other purchase still being in stock. If it has become clear that the radiogram will not sell at the price of £70 originally fixed, the question arises what amount should be carried forward as stock on hand? It may be estimated, or even known by the (subsequent) event, that a selling-price of £35 will be obtained, and it seems obvious that a stock figure of £40 cannot be upheld in these circumstances.

I am not able, within the limits of a chapter, to deal with stock evaluation or assessment in detail. I am merely trying to show how some such rule as that expressed roughly as "lower of cost or market value" fits in with, and is indeed an essential of, a cost-allocation notion of profits and assets. In this specific case it appears to me that the radiogram might well be valued at £28. This is selling-price £35, less 20 per cent., the gross profit percentage on the two articles taken together (leaving out of account any other transactions during the period). Thus the period in which sales were £90 will show a profit of £18, and the sale of the second item will show a surplus of £7 over the assessed figure at the Balance Sheet date—an equal rate of profit on sales in each of the periods.

This is as far as we need go in considering the subject of market values and their incidence on stock figures. The conclusion is admittedly rather a peculiar one for so much to be written in reaching it. It is that common practice is probably not seriously wrong so far as resulting figures are concerned; but that the way in which they are conceived is wrong, since saleability of particular items is to be taken into account for the purpose only of deciding how much cost is to be carried forward. The process is not to be thought of as *providing for losses*. There are no real individual losses but only one final resulting balance of profit or loss. Accountancy reports deal with costs in classified groups such as Raw Materials. The assessment of asset figures should be based on this group conception, and the arithmetical method involved—commonly the summation of numerous specific items—should not be allowed to persuade one that the final figures are totals of individual *values*. These figures are simply

portions of costs carried forward as applicable to future revenue. Thus we see that the relationship between stock figures and the physical things on hand is not an absolute one ; in this it differs only in degree from the corresponding relationship in the case of capital expenditure.²

RAW MATERIALS

In a manufacturing, as compared with a purely trading, concern, Raw Materials commonly form a less considerable part of total costs, and whilst the foregoing elucidation of the incidence of market values may be applied to this case, in practice it does not seem that this will be worth while, and almost invariably the cost of specific items may be summed to arrived at the Raw Materials stock figure. The mere fact that prices have declined so that replacement cost is less than actual cost does not appear to involve a loss to which accounting recognition should be extended. It is true that it may have been possible to secure a higher profit in the future if purchase of some kinds of material had been postponed until nearer the Balance Sheet date, but it will not often happen that the gross margin is so small as to be entirely eliminated by a rise in purchase prices during a period of less than a year.

Should materials be a very considerable element of the total business expenditure, market values may become significant. If expensive materials are bought and only a small amount of further processing is necessary to reach the point of saleability, any change in the prices of these materials will probably be closely followed by changes in selling prices of the product—by the effects of competition. These may be such as to involve loss, or little profit, on the realization of goods made from the high-cost materials. If this is so, then market values, in the sense only of product selling-values, do become relevant in the way already outlined.

² It may be inferred from this statement, that market value can have some relevance to Capital Expenditure "carry forwards." Probably this would have to be admitted as being true ideally, but such admission would only emphasize the difficulty of profit measurement—corresponding to the difficulty, amounting perhaps to impossibility, of anything more than approximation, of any kind of measurement in this world. It would not lead to "value" being substituted for cost amortization as a basis for accounting for Capital Expenditures, and, to be somewhat dogmatic, I do not think there could be many cases where any adjustment of the originally-decided amortization rate need be made merely because of some assumed change in market value of plant, buildings, etcetera. The main distinction to be drawn, in their accounting reference, between Capital Expenditure and saleable stock is in the length of time elapsing before recovery of expense in resulting revenue ; this greatly affects the feasibility of establishing connexion between costs and the amount of probable revenue.

Various other situations are imaginable in which it may be necessary to reduce the total of the invoiced prices of particular materials in stock at the year end. Thus whilst replacement cost of some such stock may be equal to original cost, it could happen that some other yet-to-be-incurred item of cost of manufacture of the intended product has so far increased as to involve loss if selling values be compared with specific invoice costs. It will perhaps be worth while to use up existing stocks rather than incur the even greater loss of scrapping, but in any case it is clear that the stock figure taken to credit in the profit statement, should be something less than the specific costs of the materials on hand. To put it a little differently, some part of the cost of stock still unmanufactured should be charged against revenue as being part of the aggregate cost of earning it ; for such revenue may be said to include something in respect of payment for the risk (now a reality) of loss on these purchases of materials. To ignore this factor would be to include in the accounts only a selection of the important business "facts," and, in general, only the more favourable ones. These unfavourable "facts" of declines in estimated profitability must be taken into account. But this "taking into account" is not a matter of substituting values for cost ; it is a matter of estimating the proper amount of Raw Material costs to be carried forward as relevant to future revenue.

Only a very brief word is necessary about the arithmetic of cost assessment. There are various methods of pricing out stocks at cost, varying from "base stock," and the somewhat similar "last-in-first-out," to averaged figures and "first-in-first-out." It will be seen that the only method which fits with the general principle enunciated on page 68 is "first-in-first-out." Any other method will result in the profit figure being affected by the mere fact of purchase of a batch of goods still on hand at the Balance Sheet date. Only on this method will the stock price be precisely the same as that of the recorded purchase figure.

MANUFACTURED GOODS (IN PROCESS AND FINISHED)

Market value, in the restricted sense of expected saleable value, still has relevance when we turn from Raw Materials to the resultant product in the hands of the manufacturer, but it will rarely affect a stock assessment based on summation of individual costs. This happens because Manufactured Goods should be stated at direct cost only in the accounting reports, and there will generally be a fair margin of cover. Selling-prices will have to fall a good deal for the

gross profit to disappear entirely. So that if the reader has been able to concede the impropriety of including "oncost" in stock figures, he will be able to agree that declining market values are rarely likely to necessitate departure from the individual direct-cost basis of assessment. Of course it *may* happen that selling price has unexpectedly fallen so much that a certain product is not worth manufacturing any longer. Nevertheless, the stock of that product, manufactured on the earlier expectation as to selling price, will still be worth while selling ; and if it still shows a gross margin, there is no reason to reduce the Balance Sheet figure for the particular item of stock. The mere fact that something better *could* have been done with the moneys expended on its manufacture is irrelevant. The manufacturer must take these risks, and if what he has manufactured does show some return of gross profit, some contribution has been made to revenue for the period in which sale was effected and there is no need to deduct anything from specific direct cost in preparing accounts for the business.

CONCLUSIONS AS TO " MARKET VALUE "

There are two methods of dealing with " lower market value." One suggestion in relation to the retail dealer is to write stock down to selling price less gross profit at the average rate : the other is to take realizable price (after deduction of selling and delivery costs). It is not necessary to go into their respective merits here, and I do not suggest that the two methods mentioned are peculiarly applicable to any particular circumstances. The business man has two ways of thinking about unsuccessful ventures, rather comparable with the status attached to by-products. He may be disposed to say that next year should be charged with the proper value of the unfortunate purchase—" proper " meaning a figure low enough to enable the earning of the usual margin possible in the course of next year's trading. Alternatively, he may say that the goods are scrap, saleable at a very low price, and to be valued at such price since no question of earning a profit can arise. I have excluded declining replacement cost from the factors having direct influence on stocktaking prices, and have endeavoured to show that it is a decline in estimated realizable value which is the factor influencing, in a downward direction, the costs to be carried forward as an asset.

It is conceivable that the position in which less successful purchases or manufactures are left on hand may be reversed. Stocks on hand may be estimated to have realizable values much higher in relation

to individual cost than had the bulk of the goods actually sold. Logic involves the admission that more than the individual cost of the goods in stock is the proper asset figure. That is, following from the view previously delineated, part of the cost specified in suppliers' invoices, etcetera, as relative to the goods which chance to have been sold, is actually properly to be included in the asset figure carried forward. Clearly, this situation, where less successful goods were disposed of before more successful ones, would be difficult to establish, and probably unlikely to arise. The only practicable course is to limit stock prices to no more than individual costs, and to move them only in a downward direction.

So we see that, "cost or market whichever is less," is not so arbitrary a rule as some have been disposed to suggest. The objection to taking more than expressed cost in the stock figure is not a matter of non-recognition of unrealized appreciation. In some circumstances such a procedure would be within the scope of a *cost* carry-forward conception of assets, but is conveniently prohibited as being particularly subject to uncontrolled abuse, and as being appropriate but rarely. What is wrong with this rule of valuation is that it admits into the Balance Sheet, market values *as such*, when the proper view is that these values have incidence on the amounts of *costs* to be carried forward when costs are considered as classifiable money outflows rather than as embodied, in some sense, in physical things. Also, there is the fact that numerically-inaccurate results are reached, mostly by introduction of current replacement cost as a relevant factor; that is, by thoughts about what would have been the case if purchases had been made at some time other than the actual time (or even by reference to the position if six months' production had been concentrated into the employees' work on the last day of the year!).

MANUFACTURE TO ORDER

What has been said so far on the subject of stock figures has not contained reference to long-term contracts. In relation to the valuation of contract work in progress, present-day procedures are far from adequate. Typical of these procedures, is the view that it is "permissible" to take some profit before completion of the work; that is, to make interim valuations for Balance Sheet purposes at cost plus some profit. Such profit should be computed on a "conservative" basis, it is said, which means that it should be an underestimate. Sometimes, it is to be related to surveyors' interim certificates, or to payments received on account. Whatever the

method of arriving at the allowable profit addition, it is held to give a maximum rather than an exact figure. Certainly, consistent use of valuation either at cost only, or at cost plus some profit as calculated on one of several available bases, is acceptable to many accountants ; some would be disposed to say that valuation at cost only, and valuation at cost plus profit, were both quite proper procedures.

It is my contention that these alternatives cannot all be true. Whatever may be the proper method, despite some attempt at insistence on consistency, the lack of definite guidance leaves to any managers and directors who wish to distort the reported profits, very great scope for doing so. Unfortunately, use is sometimes made of this scope. And the accountant and auditor who are not very clear on what are proper principles of work in progress valuation are an ill match for the business man who wishes to show high profits, or perhaps low profits, and who is commonly in a better position than they to estimate the final outcome of the jobs. Inevitably, the accountant and auditor must place much reliance on the business-man's estimates of various factors. Unless they are quite sure which factors are relevant, and in what manner, the business-man, if he is so disposed, is in a very favourable position for attempting to make the Profit and Loss Account arrive at about the amount which he has already decided, without close reference to the truth, shall be shown as profits.

Long-term construction contracts do not present any problems different from those concerned with goods held in stock pending customers' orders, which may be fulfilled on the same day. Such difficulties as do arise in the former case are those of definition of the economic unit for accounting purposes. In general terms, such a unit is that for which a selling price is fixed, and which is not susceptible to being broken down into smaller units for which prices are fixed or are readily to be deduced. To put this concretely, we may consider a contract for the manufacture of six similar electric transformers for a lump sum, or for six different types at various prices expressed in the one contract. In both these cases the accounting unit is a single transformer—not a group of six—so that profit arises as each is delivered even though the whole contract is not complete. In the case of major works such as bridge-building, the contract will usually be indivisible. This means that until completion of the whole there is no revenue ; there is merely a carry-forward of work in progress cost. No profit arises until the end of the job.

Some excuse for including profit in the work-in-progress valuation

has often been found in the considerable fluctuation which would appear in the annual profits of a contractor who had a limited number of big jobs running at any one time, and who brought the job profits into his books only on completion. Fluctuation is for some reason thought of as a Bad Thing. A book-keeping or valuation procedure which results in "smoothing" profits is often supported merely because it does just that.³ The true position is that *any* business will show more violent profit fluctuations as the accounting period is shortened, and whilst a year is a useful period for most cases because the effects of some seasonal fluctuations are eliminated, in the case of building contractors it is rather short. Sometimes a contractor's accounts for a year may show a loss or only small profits in spite of considerable activity. This is not to say that such yearly accounts are not worth preparing, or are in some sense wrong. Business profits are related to the conversion of Production Expenditure assets into cash, or at least into debts due by customers. Any procedure which contravenes this principle brings in profits which may arise in the future, but which as yet are certainly not part of the proprietor's income.⁴ On the other hand, as has already been emphasized, the relationship between the figure of profits and the amount the proprietor should spend on his personal consumption is not a precise one. If he derives his income from a business which yields large earnings in one year and nothing for two years, there is no reason to make its accounts fit in with the averaged-out annual figure which he may look upon as spendable. The position is simply that there is no income in some years, and he must plan his spending on the basis of this irregularity. Of course, payments may be received on account of work being executed, and these may include a surplus over what is required to finance the expenditure incurred by the contractor. But such payments are of the nature of loans, ultimately discharged by set-off against the contract-price. By their aid, the construction concern may average-out its profit distributions annually, but that is a proprietorship matter and does not affect the reporting of profits earned.

³ Cf. the remarks of Paton and Littleton quoted earlier (p. 59).

⁴ Thus Hatfield's ironic remark, "The inconveniences of waiting two or three years before reckoning profits in the case of building a ship would be so great that conservatism and consistency are both rejected" (*Accounting*, p. 156).

His footnote to this remark is worth quoting as bringing out the unscientific attitude of some accountants: "The accountant transcends the conservatism of the proverb, 'Do not count your chickens before they are hatched,' saying, 'Here are a lot of chickens already safely hatched, but for the love of Mike use discretion and don't count them all, for perhaps some will die.'"

The important, and perhaps difficult, thing to get down to in accounting for contract work is the real economic nature of the transactions. Quite often this may differ from the expressed, and hence apparent, nature. For example, goods manufactured for and supplied to the British Government on a cost-plus basis are superficially sales. Yet is this really so? Would it not be better to regard the supplier as a renderer of a service in receipt of an assured remuneration? Such contracts (unfortunately) change the economic characteristics of costs incurred and price receivable: surely it cannot be proper to aggregate, in the final accounts, costs which are true expenses (the lower the better) and costs which it is actually beneficial to have running at a high rate (because of the profit automatically receivable on them)! This is something quite apart from the manufacturer's intentions or his morals: it is simply that such contracts are for work to be performed and not for the sale of goods, whatever the precise legal phraseology. As a matter of fact, British Government contracts often contain provisions whereby legal title passes as soon as any work is done on the raw materials, long before delivery or even completion of manufacture. "Free issues" of materials are sometimes incorporated in the goods in manufacture. In such cases the resultant product is perhaps not even legally the subject of "sale," for some of the constituent material may never have passed into the manufacturer's ownership.

In computing a Work-in-Progress figure, the accountant will have to consider whether various items of expense attach to jobs or are part of normal overhead. There would not appear to be any special difficulties in this allocation, which is based on the general principles already discussed. In the case of large-scale site-construction work there will often be expenditure of a nature which bears some similarity to overhead cost, but which is in fact directly chargeable to the job. Supervisory salaries might come under this category of expense; but the size of the accounting unit supplies the key to the problem. The test is: Would that expenditure have been incurred whether or not that particular job had been undertaken?

One final point for consideration is the significance of expected losses on work in hand. The incidence of market values on asset figures has already been discussed, and the arguments relative to figures of goods in stock apply fairly closely to the present case. Some distinction may be made in that we are not here concerned with a diminution in market value: the selling value, in fact, remains fixed throughout, and it is the costs which are the variable factor. The

undertaking to execute specified work constitutes a commitment to incur expenditure. At each Balance Sheet date, the total undischarged commitments, i.e. expenditure to be incurred, must be estimated and compared with the surplus of the contract-price over costs incurred to date. If they are not covered by this surplus, then the accounts must make provision for them to the extent of the deficiency. From an accounting standpoint, the concern's commitments are equivalent to expenditure actually incurred, i.e. amounts paid or owing to suppliers, employees, etcetera, when they are not met by future revenues. Whether this position is dealt with by provision for liability or deduction from the Work-in-Progress balance is not very important, though the former method seems more logical.

CONCLUSION

The main points of practical concern in relation to what I have called Production Expenditure assets are the need for excluding oncost from stock figures, the recognition of "first-in-first-out" as the proper determinant of the cost balance, and the significance of market value and possible losses. Discussion of this last point has been extended beyond the limits justified by what is normally at stake in terms of money figures. "Market values" have always been a favourite bone of contention in the accountancy profession. But the intention of this analysis is to fit in a piece of that "philosophical system" which Canning says is missing from our "structure of procedure," for it seems to me that if we can build up a system of theory, an all-round improvement in procedure may confidently be expected to follow.

CHAPTER VIII

FUTURE RIGHTS AND FUTURE PROBABILITIES

"PREPAYMENTS" AND PUBLICITY

1. EXPENDITURE ON ACCRUING RIGHTS

THE asset thus (provisionally) described is that usually known as "Prepayments" or "Unexpired proportion of payments in advance." Except to say that the item should include expenditure *incurred* in advance and not only that which happens to have been paid, there is nothing to add to the usual procedure of calculation of amounts of rates, insurance, rent, and so on payable before the Balance Sheet date but partly referable to the future. (In spite of the customary mention of payment in the Balance Sheet description, expenses accrued but unpaid are in fact often—correctly—taken to account as liabilities, and, to the extent of the advance portion, as part of the asset figure.)

The amounts of expenses thus carried forward relate to services to which the concern is entitled in the future, and which are necessary or incidental to the earning of revenue. Whilst this is a carrying forward of a *cost*, not of a *value*, the case where future services have been contracted for but are non-existent requires to be distinguished. Leased premises on which a rental continues to accrue, but which have been abandoned, are an example of this special case. Here, it would not only be incorrect to carry forward an unexpired cost, but provision should even be made for the whole future liability, discounted to its current amount. There is a very great difference between contracts giving rise to future obligations alongside services to be received, and those resulting in obligations without concurrent service of use to the business.

I am not particularly concerned about the precise description of this asset so long as the reference to payment is avoided. If one could ignore its ugliness, "Pre-incurred Expenses" might be a good title.

2. PUBLICITY EXPENDITURE

"Shrewd the trader, Lü Pu-wei !
Knowing Time must well repay
Cost and care, he dare devise
Schemes to market merchandise
Rare and strange—beguileful eyes !"

(*The Tale of Meng Chiang—*

Translated by GENEVIEVE WIMSATT.)

(i) *Rigid Rules versus Guesswork.* The outstanding feature of this asset is its difficulty of computation, greater here than in the case even of Organization Expense. Fortunately it is of less general importance, in that many businesses spend only trifling sums on advertising. The commonest treatment of advertising costs is to charge them to revenue as they are incurred, ignoring in the accounts any goodwill value in process of being built up, and also omitting recognition of the significance of the interval which separates the appearance of an advertisement from the invoicing of a consequential sale. Instances in which "Deferred Advertising" appears in the Balance Sheet may probably be traced as having their origin in a switch over to a policy of large-scale advertising involving at first some disproportion between sales and expenses. The accounts covering this period of change in selling policy may well show low profits initially; and the thought may readily occur to the management that this position can be corrected to some extent by bringing to account some part of this asset. The desire to justify the considerable expense incurred is an obvious spur to this attitude, and it is certainly true that revenue will bear a disproportionate charge if the whole of this new advertising expenditure is written off against the sales referable to only a part of the effect of the campaign.

Though the recognition of the asset is correct in principle, considerable difficulty arises in its quantitative assessment, whilst no accepted body of opinion exists as a check on accounting procedure. I have already said that any kind of accounting procedure which leaves a good deal to the discretion of the business man suffers from serious disabilities. This is no reflection on the morals of the average business man. We need not go into this question of ethics in any detail. One need observe only that *some* men are disposed to distort reported results for various reasons, and that *all* men are liable to be biased where their personal interests—money or reputation—are involved, the essence of bias being that it has unconscious influence on opinions—in this case, opinions of the amounts of advertising expenditure to be carried forward. The ideal estimating procedure—for work-in-process, for instance, or for deferred advertising—is for the *management* to decide the *quantities* of various relevant factors, the *accountant* having the task of deciding their *relevance* and of piecing together the bits of information and the management's guesses, so as to produce the ultimate figure himself. The management should try to judge each factor on its merits without reference to the effect on the profit-showing. In fact, it would be an approach to the best possible setting

for true objectivity if no attempt were made at arriving even at a provisional profit figure before all the inevitable guesses had been made, without the option of revision.

The self-imposition of these Trappist regulations on the part of business men is an unlikely event—I have been discoursing on ideals. Legal regulation is at least a partial alternative, but it may not take us the whole way to accuracy. Thus the tax-law approval of stock valuation at lower of (in this country) individual cost or market value does restrict the arbitrariness of stock appraisal. Quite apart from the intrinsic worth of the rule (and it seems to me to be by no means perfect) it has the very real value of imposing some limit on the imagination of the business man, which imagination (unfortunately) is a factor in profit determination.

With the object of facilitating the working of a strictly-controlled war-time economy, the German government laid down very precise rules governing the preparation of accounts.¹ Enactments and orders provided for classification of costs on a carefully prescribed and comprehensive basis. This process of regulation must inevitably restrict very considerably management's scope for departure from fair estimates in stock valuations and other figures. This is the way in which the law can and does, both in and out of Germany, become a factor in profit determination, tending to reduce the incidence of latitude in estimation. The United States S.E.C. regulations are an example of semi-legal guidance and requirements in the presentation of accounts.

Conceivably far more legal regulation could be introduced, so that even Deferred Advertising would not have to be decided by estimate but merely worked out arithmetically in accordance with a compulsory formula. Alternatively, one can see some advantages in prohibition of the setting up of this asset, simply because of the difficulties of accurate computation. How far is such legal regulation desirable? There is no clear-cut answer to this question. Some of its advantages are made clear above: against them, there are certain drawbacks to this type of control. The largest of these disadvantages is the tendency to reduce the number of persons who need to think. If it is merely necessary to look at, and apply, written all-embracing instructions in order to produce accounts, imaginative speculation on the fundamentals of accounting is going to be much reduced. This speculation would almost certainly frequently indicate the superiority of techniques

¹ (i) *The Accountant*, 18th October, 1941; *Standardized Cost Accounting*, by Camillo Holzel; (ii) *Standardized Accountancy in Germany*, by H. W. Singer.

differing from those provided in law, and unfortunately not many people will spend much time in the consideration of the exact form in which illegal practices should be carried out.² Even if they were to arrive at any useful conclusions, the reluctance of the law to relax its dominion over newly-won territory is sufficiently serious to interfere with the free development of scientific method. Germany, for instance, has now saddled itself with an extremely tortuous system of allocation and articulated grouping of expenses. This seems to me to be the worst possible expression of those ideas of the attachment of costs to material things which I have all along been trying to dispel from the mind of any reader who may chance to hold them. It will indeed require a very revolutionary spirit amongst post-war German accountants for their figure-methods to break free from the shackles of law and to achieve that scientific development to which I think our subject-matter is open.

(ii) *Unavoidable Expediency.* I have digressed somewhat from advertising expenditure. The incidence of law in accounting is relevant to this special topic, but is itself of great importance and interest and no doubt worthy of more spacious treatment. To return to this original topic, I should say at once that research has not yet proceeded sufficiently far to enable any accurate computation of this asset to be made. There are two courses open to advocacy by an accountant faced with the problem of accounting for considerable publicity expenditures. Firstly, some approach to truth might be achieved by the adoption of a practice of carrying forward a fraction, or the whole, of such expenses during a given period ending at the Balance Sheet date, provided the fraction, period, and other factors, were adhered to every year unless exceptional circumstances merited their revision (such circumstances *not* including a desire to conceal high profits or their reverse). Secondly, the whole amount of advertising costs might be charged to revenue each year *and disclosed in the published accounts.*

The first course of action is illustrated in the treatment I accorded to advertising costs in the accounts of Motor Mowers, Limited (page 41). This company spent £20,000 in the first six months of 1941, and £1,000 per month from July of that year to the end of 1942. During the company's development stage (January to September, 1941), there was therefore an initial expenditure on publicity of £23,000. The assumption is made that the effect of any particular

(²) Though I have spent a little time on such a theme at p. 28 in relation to certain features of British company law.

item of propaganda is reflected in the company's sales journal one month, on the average, after its appearance or broadcast. The sum of £1,000 expended in September may therefore be regarded as approximately relative to October sales, so that initial Publicity Expenditure should therefore be taken to run to the end of August, this asset thus becoming £22,000. To this must be added the expenditure for the last month of the accounting period, for this cost of £1,000 is assumed to be reflected in January revenues.

This process of "carrying forward" the last month's expenditure is something which is intended for adoption for the future (keeping all the drawbacks of "conventional" procedures fully in mind) so that a similar amount is carried forward in the 1942 accounts, but in 1943 expenditure rose to £5,000 per month in the last quarter, and the asset is taken at an additional amount of £4,000. Common sense tells us that this sudden increase in publicity effort cannot be expected to be effective without some lag in reaching a peak. It is a measure of the recognition which the accounts on page 42 give to this lag that they show a profit for 1943 amounting to £400 whilst the charging of each year's expenses as they were incurred would have resulted in an apparent loss of £3,600.

The possibilities of some inaccuracy in this procedure are too obvious to need emphasizing. I leave it as an open question whether, pending some research revealing means of correlating advertising with resultant revenues, this adjustment is worth making. One may make the modest claim in its favour that its non-use leaves the disclosed trading results wrong, whilst its use brings them nearer to the truth.

The second possible course of action in accounting for advertising expense—to charge revenue at once, and to disclose the charge—is a simple expedient. It rests on this principle: whenever there is any factor affecting the measurement of profit to a materially-unascertainable degree, then the accounts must show the amounts involved and the treatment which has been followed. This means that whilst it is generally sufficient to leave (say) rent payable, in an aggregate figure of expenses because its accurate ascertainment as a revenue charge is usually a simple matter, a doubtful factor such as obsolescence must be shown separately so that the person reading the accounts may form his own idea of the degree of possible error which attaches to the final balance. If advertising costs are considerable, and if no treatment on the first-mentioned lines seems reasonable in the circumstances, the error which is involved in charging revenue at once will be sufficient to render the accounts incomplete if the amount of the

charge is not disclosed. Of course, further information on advertising policy and on varying rates of expense during the year might facilitate a still clearer view of the income position ; the disclosure of the total only, without further information, is put forward as a minimum requirement for a Profit and Loss Account to merit the description at all.

(iii) *First (and Second) Principles.* It is hard for me to preach this doctrine of expediency. In general, I am arguing for a scientific status for accounting, but on the question now before us, I have no adequate technique to propose other than the foregoing alternatives. Disclosure in the absence of the possibility of apportionment is itself a principle and not merely a matter of convenience ; but it is a second-class principle. Some day it should be possible to replace it with the first-class principle by which the costs are allocated against the correct revenues.³ It is fortunate that in only a minority of cases is this problem of sufficient magnitude to affect the profit figure by a material amount.

In conclusion, it may be as well to say once more that we are not concerned with putting a *value* on this or any other asset. It really does not matter, from the Profit and Loss Account standpoint, if initial advertising expenditure has little or no resultant value. Along with other development costs, it is part of the capital investment in a business. Indeed, if it is not to be segregated in the accounts, it will form part of the capitalized organization cost under the proposed method of treatment. (The significance, or insignificance, of the relation between value and cost of this asset, or of goodwill, are considered at page 108.) If goodwill has a saleable value, it may well be that advertising has contributed to its growth. But the cost of this could not properly be said to be an *element* of the capital value of earnings, which value may greatly exceed costs incurred. In any event, the influence of publicity is so bound up with other forces, such as price policy, that its separate *valuation* is quite inconceivable. To put costs into the right accounting periods is the maximum that may be asked of an accountant in most things ; in the case of Publicity Expenditure it is probably all that the most omniscient could achieve, and then not until he is armed with some yet-to-be invented statistical technique.

³ This subject is receiving the attention of those more directly concerned in advertising problems than ourselves. There is, for instance, a recent publication in the United States which deals with research into (*inter alia*) the effect of advertising on sales. (*The Economic Effects of Advertising*, Neil H. Borden.) The results of this study are not conclusive on the aspect with which we are concerned, but this is not to say that statistical analysis will not eventually yield fruitful information.

CHAPTER IX

THE TRANSITION

So far we have discussed these changes in methods of ascertaining profits and assets without having referred to the inevitable problems of transition. Whenever any change in practice is put forward in relation to a particular business, there is always the reactionary argument available that the results of the year of change will be grossly distorted. This is frequently a source of contention apart from these proposed amendments in method. For example, I recently heard of an obvious case of incorrect stock valuation. A company which imports its principal raw material sometimes on f.o.b. and sometimes on c.i.f. price terms, was in the habit of charging freight and handling charges against revenue without adding them in the stock valuation of its f.o.b. purchases. This meant that similar materials were variously valued merely because they were bought on differing purchase terms, though there may have been no marked difference in the total layout per ton. Clearly this was absurd, and representations were made to the effect that stock should be valued at the total costs incurred in getting the goods to the factory. The inevitable argument against this was, of course, produced ; and since Excess Profits Tax was likely to swallow up cash to the extent of any advance in the stock figure, one could view more sympathetically the contention that each year's error was offset by the following year's. However, the proportion of f.o.b. purchases had shown some tendency to increase in recent years, and it seemed desirable that something should be done to regularize this intrinsically-indefensible position. The arrangement finally made was admittedly a compromise : it did not reach the rapidity of approach to truth which is the aim of the methods proposed in this book. But at least the situation will be corrected within the space of a few years by easy stages which do not involve any one year in radical " distortion."

In view of existing weaknesses in the co-ordination of logic and accountancy as practised, this sort of compromise is often the most that can be done in putting business accounts on, or nearer to, the right lines. It is often more than can be done, in fact, for many

curious and logically indefensible practices may be found in the accountancy methods of industry, strongly entrenched against even a moderately progressive spirit in accounting. To make the changes necessary to bring a set of books into line with the methods now proposed would, I think, involve making alterations as from the first day of an accounting period. That is to say that the results of no one year will be computed by a mixture of old and new methods. The alteration involved in putting the stock figure on a prime cost basis, by way of example, will be so considerable that the fresh period's Trading Account should be debited with stock at prime cost leaving the oncost balance, which is included in the old-basis valuation, to be dealt with by way of separate adjustment.

The most severe restriction on changes is, without doubt, the rigidity of methods of computation for taxation assessment. It is certain that a sudden change in the basis of stock valuation would not, and should not, be permitted to operate to diminish the taxable profits to the full extent of the stock reduction. The most acceptable basis to the Revenue and to the taxpayer would seem to be that which I have in mind in the above tentative suggestion. So far as the taxpayer is concerned, it would not be entirely true that he had suffered by previous over-valuation of stock which was not going to the offset of later adjustments. No doubt he will have had charged against his taxed profits a considerable amount of expenditure on development, "Organization Expense," which was really a capital expense on the view here advanced. Some further consideration of this taxation aspect would seem desirable: the cause of right accounting (and hence of fair taxation) merits special treatment in revenue legislation if some degree of "transitional relief" is necessary to the equitable working of the scheme.

An established business desiring to amend its accounting practices would almost certainly not have all the information necessary to produce a Balance Sheet precisely similar to that which would have been forthcoming if the new system had been in operation from the beginning. It will probably be unable, for instance, to compute its Organization Expense figure, for the relevant facts are not all contained in the books, and may well be lost in the mists of time. Fortunately this is less important than might at first sight appear. Current results can be computed accurately despite some defect in the Balance Sheet. It will, of course, be the case that the Profit and Loss balance—Undivided Profits—will not be what it might have been, but if the reader has been able to agree with the remarks in the chapter on

"Business Profit and Personal Income" at page 29, he will realize that this figure is comparatively unimportant. I argued there that the legal restrictions on distribution to shareholders are simply for the protection of creditors, and that the rules are otherwise quite arbitrary, there being no intrinsic connexion between earnings and payments to proprietors. The amount of contributed capital will obviously be known (though often obscured by "bonus issues" and the like), but the amounts of retained profits, and of total capital invested, will not be ascertainable. Nevertheless the law will probably work not unreasonably as it stands if the transition from one system to another is not permitted to affect the Profit and Loss balance brought forward. (I do not suggest that the limitation of distributions may not be a very convenient arrangement for some purposes.)

British law does not *directly* regulate profit measurement; such force as it has operates through the status which is accorded to "settled practice," more particularly to the doctrine of "consistency." Our primary problem is that of measurement of current earnings; earlier undistributed profits are of secondary importance, and the difficulties of transition should not be exaggerated. A change in practice as "settled" is all that is necessary; the support of law is thereby assured. Practice will change if there is widespread re-examination of the fundamentals of accountancy. This reconsideration is vitally necessary.¹

The accounts of the period of change should commence without the encumbrance of secret reserves, and with stocks computed at prime cost. I feel that the change is of such magnitude that it would not be useful to credit a Trading Account with such a stock figure when the opening stock valuation included a substantial amount of overhead expenditure. The Advertising asset will also require computation—to the extent that this is possible in accordance with the principles enunciated in Chapter VIII. It does not very much matter what is done with the other side of these adjustments in the Balance Sheet (let us hope that does not sound too heretical). The figure of oncost in stock, less secret reserves, etc., might well be carried to an Organization Expense account, provided the arbitrary nature of the resultant figure is clearly indicated in the asset-narration in the Balance Sheet, thus :—

"Organization Expense—Oncost in stock, less reserves,
end—1940 £56,000."

¹ This subject is pursued further in Chapter XII (pp. 122-124).

It should be remembered that I am refraining from passing judgment on the question of secret reserves in published accounts. But other amendments of procedure, in particular the assessment of stocks at true cost, *must* be carried through to shareholders' accounts as well as to the accounts for management, for the way in which the old practices distort the disclosed results cannot be tolerated on any grounds.

It is quite likely that many company directors would feel disposed to "write off" any suspense asset balance created by the transfer of oncost in stock at the date of amendment of the system. There is a natural tendency to retain earnings for "ploughing back" into the business to the extent that the shareholders' desire—or agitation—for cash permits such a withholding from distribution. Various devices are available to make this retention less apparent. A notable method is the writing down of assets by charges against, or allocations from, profits. For instance, goodwill is commonly regarded as being somehow an unhealthy asset to appear in a Balance Sheet and its purchase cost is often reduced by lump sum profit allocations. The propriety of amortizing goodwill is perhaps an open question. I am inclined to think it is usually unnecessary, and even incorrect. Whatever the logic of the matter, the writing off is normally effected in lump sums without any calculation of an approximate amortization rate, and this even though there are considerable profits suggesting that goodwill retains an undiminished value. The stock market has some influence in this matter, for the appearance of goodwill in a Balance Sheet probably reduces share values owing to market operators' experiences of companies with "watered" capitalizations. Promoters or vendors of companies may often have been overpaid in respect of a "Goodwill" of doubtful value, but the scepticism thus created in the minds of stock operators is not an intrinsic reason for writing off this assets' purchase cost. It may, of course, be a good practical reason, but its unfortunate consequence must be recognized, that is, that it enables directors to keep back shareholders' profits without reference to the use which can be made of them.

I have touched briefly in this chapter on the external obstacles, legal and psychological, to the suggested change in mode of computing trading results. These obstacles are, I think, of small importance, and far from insuperable. More formidable is the inertia of thought in business, and perhaps in the profession of accountancy. There is an unfortunate tendency to cling to the older forms even when newer methods are of proved validity. How far this conservatism will be a

hindrance to the adequate development of accounting in the future, I cannot say.

Undoubtedly, greater attempts at progress in accounting thought and method are called for on the part of the professional accountant if he is to improve his status in the economic structure.

CHAPTER X

GOODWILL AND THE ACQUISITION OF ESTABLISHED BUSINESSES

WE have not so far given much consideration to the accounting aspect of a change in the ownership of a business. Chapter IV dealt with some of the problems of income-measurement as affected by such changes, but there remain for discussion the method of recording the purchase of a going-concern, and the relation between initial "valuations," "Goodwill," and the computation of profits earned by the new proprietor.

GOING-CONCERN "VALUATION"

Accountants are often asked to "value" a business, or, what is usually much the same thing, shares in an incorporated business. That they are asked to do this seems to me to be evidence of a popular superstition that things objectively *have* values. They *have* no such thing. It will, however, be true to say that there is a price for the whole business at or above which the proprietor will be prepared to sell out, and, furthermore, that there will be a price at or below which a prospective purchaser will be prepared to buy. If the limiting selling-price is not more than the limiting buying-price, and if these two people come together, then a sale will probably result. There seems no particular harm in saying that at the time of the transaction the business had a value of £100,000 (if that were the dealing-price).

Of course, it may be considered that in valuing a business an accountant is merely estimating what the sale of it might be expected to fetch in the market. If this is his function, then he will operate by applying his judgment to a compound of facts about stock-exchange quotations for securities in similar concerns, about current interest rates, and about the special circumstances of the particular business. No doubt the accountant is performing a useful service in many cases by passing opinion on values in this manner. (Whether, in doing this, he is acting qua accountant, or merely as a reasonably-unbiased informed observer, is another question.) But the impression one receives is that there exists a belief, which I would hold to be fallacious, that behind the welter of circumstance, there may be found a figure which is the right and proper value; a figure perhaps *influenced* by

market opinion of yields and prices, but, fundamentally, significant in its own right.

In reality, the parties' limiting prices are affected by many considerations. The seller's is influenced by his intentions or hopes as to his retirement from business, by his capacity to fulfil the existing financial commitments of his business (which may have grown to proportions excessive for him, even though the concern is a very profitable one), and perhaps by the knowledge that his business is sought for purchase by a competitor who may be prepared to pay more for it than a newcomer to the trade. The buyer may think he can make more of the concern than did the seller, in which case he may be ready to pay more than is justified by the profits which the existing owner has been able to earn. Or the business may have succeeded in holding out against successive amalgamations amongst its rivals until it forms a lone obstacle to a monopoly grip on the market by its large competitors. If this is the case, the price paid may be out of all proportion to the profits directly attributable, in the past or in the future, to the activities of that concern.

So that the dealing price of an undertaking depends, not only on the figures disclosed in its accounts, but on innumerable factors personal to the buyer and seller. It depends on the condition of each party's liver on the morning of their meeting, on whether the process of bargaining happens to reach a price near the high limit (the buyer's) or near the low one (the seller's) in the early stages of the proceedings, and on many other factors not assimilable to those capable of expression in an accountant's report.

There are, of course, possibilities of actual error in the opinions on which the protagonists *base* their limits. In this event it is possible to conclude that the business was "worth" more than the price at which the seller let it go, or that the buyer paid more than it was "worth." But in each case, the expression cannot mean more than "worth to him," and there remains very great room for difference between respective "worths" by reason of factors which affect one person but not the other. In result, it may be said that whilst there are objective measures of various aspects of a business—its earnings, its liquidity, and so on—these are only factors to be taken into account by buyer or seller in fixing *his* price limit. It may not happen that the parties actually put figures to their "valuations," but one of them must make a quantitative offer as a start in the negotiations, and this offer must be within the limit to which he would go if the other were to press a "hard" bargain. Similar considerations apply to the other

party, who has to decide whether he will accept it or make a counter-offer. Though neither may be quite clear in his own mind just how far he is prepared to go, nevertheless, if he is pressed further and further towards a less advantageous price, there will be a gradual stiffening of his attitude until a point is reached at which he refuses to deal.

We now reach the conclusion that not only is there no such thing as a true and correct value divorced from the attitudes of buyer and seller, but even those attitudes may not be clear; they may become clear in the process of bargaining itself, when the parties may be under the impression that they are relying on their intuitions. Intuition is a very insecure basis for deciding whether or not to part with a large sum of money, or to dispose of a profitable undertaking. If the weighing-machine had not been invented, the grocer would have to sell sugar largely by resort to his "intuition," and his customers would have to use theirs in making their purchases. Apart from the variations in the amounts they would get for their money at successive transactions, it would be most difficult for them to decide how to allocate their weekly housekeeping moneys, and accurate comparison of rates of charge by different grocers would be impossible.

Where the weigh-scale comes in, there also does the accountant. But whilst the grocer and his customer would be involved in some difficulties if they had no scales to help them, the problems of the buyer and seller of a business undertaking would be incomparably more difficult in the absence of the accountant. His periodic reports on the condition and results of the concern during the recent past must inevitably be used by the bargainers. The use of the accountant at the time of negotiations is that he can supply the parties with relevant *objective* information about the business, and perhaps about external financial and commercial conditions, to help them form their *subjective* valuations.

Generally, each party should have his own accountant. It is not essential that the latter should be limited in relation to the facts on which he is to report. The essential thing to be emphasized is that however far his report goes, it does not arrive at an objective value of the business. The task of the accountant is always to reduce the "unknowns" of economic activity, so that the persons to whom he reports, or for whom he keeps books and accounts, are the better enabled to make sense of the multitudinous factors which they must take into account in making any decisions.

The usual form of the expression of an accountant's opinion on the "fair value" of a business goes some way towards recognizing the

true nature of his position. He is generally most reluctant to put a value on a business or a price on shares without detailing the factors and assumptions on which he bases his final figure. He normally refers to the figures of past profits from which he deduces his "value," for he is hardly likely to commit himself to the view that future earnings are to be taken unhesitatingly as equal to past figures. He will often state first the value on an "assets basis" (about which enormity there will be more later) as well as that on a "profits basis." He will perhaps mention prices at which the latest dealings took place in any shares there may be in issue. In fact, he will do anything, and quite rightly so, to avoid the onerous and impossible task of *valuing* the concern.

We may extend our sympathy to the poor accountant on whom the duty is unequivocally laid—perhaps in Articles of Association or in an agreement of option of sale or purchase—of stating a "fair value" at which a transfer of a business *is to be* carried through. His price is not to be merely by way of help to either of the parties, it is to be binding on them by virtue of the confidence in him which they have previously embodied in contractual arrangements. If the document which provides for this mode of price-ascertainment specified precisely how the accountant should perform a more or less arithmetical procedure, all would be well, but generally it does not do this, and the accountant is left to his own devices in deciding what rate of capitalization to employ, and whether to take any account of future earnings or to rely solely on past results, making the assumption that they will continue unchanged in rate even though he may know this to be unlikely. As compared with a freely-negotiated price, the accountant's binding value has the defect that it is not closely bound up with the seller's idea of whether the business, with all its future possibilities and potentialities, is worth, to him, no more than the price for which he is selling. Nor are the buyer's personal uses for the business, nor his guess as to what he will be able to make of it, taken into account. So that, unless, as is unusual, his valuation procedure is closely laid down, the accountant may arrive at a figure at which one of the parties would not deal had he not previously contracted to accept the accountant's ruling.

ESTATE DUTY VALUATIONS AND THE INCIDENCE OF TAX LEGISLATION

The imposition of death duties involves an assessment of "values" often not connected with any sale transaction. Realizable values of

the property comprised in an estate are largely easy to ascertain, since the commoner business interests—stocks and shares—have a fairly ready market, and there are available particulars of the prices at which stock-jobbers are prepared to take at least some quantities of the securities. If the estate should include property of uncertain value, such as a share in a partnership, there is the problem of estimating what the business might fetch if it were sold in the open market. From what has been said, it will be seen that I do not consider this can be done effectively in the absence of a real transaction. But to say that it is impossible to arrive at values in the abstract, is not to say that the estate duty procedure is wholly invalid. The guesses which must be made at the amounts which might be realized probably reach something not very remote from what would be the result of the sale. I am not concerned to deal with the question of duty assessment as such; I wish to point out merely that even these “valuations” are not measures of an intrinsic characteristic of a business. The characteristics which are intrinsic are recent earnings, amounts of cash, debtors, etc., the trend of sales, and so on. *From* these a guess may be made as to what *would* happen *if* something else happened; but this estimate of what price would be realized if the business were offered for sale is nothing more than hypothesis. Objectivity cannot be granted to anything beyond the intrinsic characteristics.

VALUES AND CONTROL

The subjective element in so-called valuation may be seen in relation to interests in concerns with quoted security issues. For the sum of stock-exchange valuations of the shares, etc., of a company is not necessarily equivalent to the estimate which might be made of the realizable value of the whole undertaking. The relationship of the rights of the various classes of shares (and debentures, if these are considered as part of the capital) itself affects the market's assessment of their worth, without there being any inevitability about the cancellation of these influences in the aggregate. It has been remarked by Lord Keynes that the mere recurrence of a (peace-time !) bank-holiday involves an increase in the market's valuation of the railway systems of Great Britain to the extent of several million pounds.

Furthermore, the dividends which are paid by a company have far greater influence on the quoted prices of its issues than have actual earnings. The view that a company is a body of persons—shareholders—carrying on business in common with directors appointed (as their

agents) for convenience of management, is quite inappropriate for the purposes of "valuation." A company is usually far from being a complete democracy, and the value of the interests of individual shareholders is commonly dependent rather on the profits which the directors feel disposed, or can be urged, to distribute, than on the profits themselves. The true incidence of earnings is the extent to which increases therein are likely to lead to some increases of dividend, or to which decreases may prevent maintenance of the recent rate of payments. It is not too much to say that *some* directors (I am not estimating these as necessarily a majority but at least they form a substantial number) look on even equity shareholders as creditors for the supply of funds on which the least possible rate of "interest" (expressed as a dividend and therefore not pre-determined) shall be paid. I am not suggesting that this undue possessiveness on the part of management necessarily means that they, the directors and officials, get the benefit of the earnings not distributed. It is the case, however, that their own jobs are made more secure if they are able to build up reserves of undistributed profits for a rainy day—not the day when the shareholders should be glad of this "prudence," but the day when the management is able to use these funds to carry on business and so pay themselves salaries when the more profitable course (for the shareholders) would be to cease trading, or at least to restrict operations for a time—but this would involve cessation of or economies in management remuneration!

VALUES AND SPECIFIC ASSETS

We are now in a position to draw a conclusion about the relationship between the purchase-price of a business, or a partial interest in a business, and the status of figures of "value" both for the whole undertaking and for particular assets taken over. Whilst objective characteristics of the business are fundamental factors on which buyers' and sellers' appraisals are based, these appraisals and the emergent price are largely subjective. They are dependent on the parties' personal circumstances. One buyer may be prepared to pay more for a business or an interest in it than another. He may be a competitor in a position to gain a partial monopoly by the deal, and if the seller knows this, he may be able to get some of the benefit of this higher appraisal. The shares of a public company have a ready market at prices which may be influenced merely by the disposition of the Board to distribute a greater or a smaller part of the profit—

irrespective of their efficiency in their management function of maximizing those profits.

And so we see that the purchase-price is, as regards the business, a subjective measure of the advantage of standing in the position known as "proprietor," "partner," or "shareholder," with whatever benefits attach to that title (*a*) by way of future earnings of the business, increase in earnings of the buyer's already existing business, congenial employment, and so on, or alternatively, (*b*) by way of the directors' future disposition to pay dividends, access to general meetings with the consequent opportunity to make sufficient fuss to provoke the directors to issue an invitation to join the Board, and so on. A "business" is not a mere collection of legal rights and material assets. It is an organism. It has employees who are familiar with its affairs, and, with advantage to its earning capacity, will probably continue to work for the concern after the change of ownership and irrespective of any legal claim on their services. It has customers who will probably continue to buy there rather than elsewhere, unless other concerns can supply their needs to their satisfaction at exceptionally lower prices. It has connexions with other firms ensuring prompt attention to particular needs for goods or services. The contrast between a going concern and a mere collection of plant, buildings, typewriters, salesmen and so on, not yet fixed and turned into a *business*, is of the same order as the difference between a live animal and a parcel of the chemicals of which its body may be said, in a very limited sense, to be composed.

In essence, the view put forward is that the purchase of a business, or of an interest in one, is not merely an acquisition of legal rights or titles. The price paid is largely governed by probabilities of future events (revenues and expenditures) expected to arise from the exercise of the legal rights taken over and of business relations with such (normally most) of the customers, suppliers and employees to whom the deal operates as an effective introduction.

The immediate factors to be taken into account by each party to the sale of a business are :—

- (i) the probable future profits; and
- (ii) the break-up value on piecemeal realization of the assets.

This statement differs from the more widely-held view principally in leaving out of account the book values, or replacement cost or other "going-concern valuations" of the specific assets used in the business. The only incidence any such "valuations" should have, is on the amortization to be deducted in estimating future profits.

With conceivable exceptions, this charge should be based on replacement cost, adjusted by reference to the ages of individual machines, buildings, etc.

Given a rate of profit, the problem is to think of its capitalization, taking into account current interest rates and the degree of risk attached to the earning-power of the particular business. Now this risk is minimized by the safety of moneys recoverable on the sale of assets piecemeal, if that proves necessary. The greater the realizable value of the assets on winding up, the less is the risk. Either the business will prove worth-while as a going-concern, in which event revenue earnings will be the produce of the capital invested in the purchase, or alternatively it will be found necessary to wind up the business, when the break-up value (proceeds of piecemeal sales) will offset this investment of capital. In neither case—success or failure—is replacement cost of particular assets a determinant of the worth of the business.

As has already been seen, the establishment of a business requires the expenditure of capital, not only on durable goods, trading stocks and other material things, but also on organization and development to the point of profitability. If the business earned the expected rate of profits on this total expenditure, it could be said that the business was worth the amount expended on it. But this "worth" derives only from the profits; they are the major determinant of the purchase price of the business. If profits of £10,000 per annum be expected, it matters little whether the plant and other assets cost, or would now cost, £20,000 or £100,000 (provided amortization is properly assessed); the income on an investment of £100,000 would be 10 per cent. per annum in either case. So that, though "value" may be a much misused word, the expression "value on an assets basis" has still less validity. It generally does not even cover that usually very important item of capital expenditure provisionally termed "Organization Expense." The sole value of the totalling of replacement cost of the material assets would seem to be to enable the purchaser to decide whether or not, by setting up a new business and spending that total of money piecemeal, he could bring it to the point of earning more than the business he contemplates purchasing. But this somewhat remote consideration is quite distinct from the question of the incidence of amounts of particular assets on the purchase price. In fact, only break-up realization values of these have any incidence on the price, and this by virtue of the restriction of probable loss of capital in the event of the disappearance of profits.

Given profits of £10,000 per annum, then, with a net break-up value (after discharge of liabilities) of nil, a price of £100,000 would show a return of 10 per cent. to cover the risk of loss of the whole capital invested. With a net break-up figure of £40,000, the same annual profit could be considered as £2,000 on the gilt-edged portion (5 per cent. of £40,000) and £8,000 at a 10 per cent. risk. A price of £120,000 would then be a 5 per cent. investment to the extent of the safe gilt-edged amount of £40,000, and a 10 per cent. investment of £80,000 in a commercial risk.

It is not suggested that this is the way in which buyers and sellers normally do their bargaining. It is, however, put forward as being the way in which their accountants should present the more objective facts of the case to their clients or employers. The sooner accountants stop bandying about this word "value" the better; in particular, they should re-examine just what they mean by saying that a business has one value "on a profits basis" and another "on an assets basis."

THE PURCHASER'S BOOKS—RECORDING THE ACQUISITION.

Now that these almost metaphysical speculations have cast so much doubt on the importance of "values" of individual material assets, it may be wondered how they are to be recorded in the purchaser's accounts—or if they are to be recorded separately at all. It is, of course, the detailed recording of assets (and liabilities) which constitutes the very first purpose of accountancy—the tracing of the movement of all the funds and assets of an undertaking, person, or other entity, with a view to "accounting" for their disposal, i.e. with a view to keeping track of the "accountee's" moneys and showing him that they have not disappeared (at least, not otherwise than in some manner revealed by the books).

The desirability of putting *some* figure in the books to help the process of accounting for funds and assets is clear in the case of windfall gains such as a bequest of an investment to an institution or charity. It is not particularly important what figure is entered as the book value, and if there is no market quotation for the issue, then some arbitrary figure had better be attached to the holding. Similar reasoning prompts the retention of a book value of £1 for an asset—perhaps a very doubtful debt or an almost certainly valueless investment—which it is desired to write off out of profits. Without the retention of some book value, the asset may be forgotten notwithstanding that it may prove worth someone's while to misappropriate it.

These considerations lead us to the conclusion that on the purchase of a business, if only to satisfy the primary aims of accounting, we must not be content with a single asset account for the new business, even though it be agreed that the price paid for that business is not properly referable to any measure of the individual assets acquired.

The relevance of replacement cost to estimates of future earnings has already been mentioned. It seems fairly clear that, as a general rule, material "fixed assets" should be set up in the books of the purchaser at their current replacement cost, less amortization for the expired portion of their lives. In this way, the amortization calculated and provided on such "revaluations" will be equivalent to that taken into account in estimating the rate of profits which would justify the purchase price paid for the business. So that if the actual revenues and working expenses turn out to be just as estimated, the charging of amortization on these book figures of fixed assets will leave, as net profit, that amount which the buyer expected as a return on his investment.

UNECONOMIC ASSETS

As an extension to the general rule mentioned above, it is necessary to add that only those assets which it is *intended* to replace later by similar ones shall be so valued in the books. It is possible for the seller to have in his factory a machine which is too large for the business. Possibly the original purchase was a mistake; whether it was or not is immaterial to the present situation, namely (i) that it cannot add to revenue an amount commensurate with its replacement cost, and will therefore be displaced at the end of its useful life in favour of a much smaller and cheaper machine capable of the quantity of service required; or (ii) that equivalent services will be obtained in other ways, such as by having the work done by an outside firm; or (iii) that the function served by the machine will cease, and gross revenue be accordingly depleted.

Similar considerations apply to the case of trading stocks, which should also be taken at a book value equal to replacement cost, or, if they are thought unlikely to show a profit on that figure, at a reduced amount. The basis of assessing year-end stocks has already been considered in Chapter VII, and similar principles apply to the commencing figures for an acquired concern, with the substitution of cost-of-replacement for original-cost. Cost to the seller is of no importance to the buyer. The degree of efficiency or of good fortune in the former's manufacture or purchase of his stocks affects *his* profits,

not the buyer's. In relation to assets not worth replacing (we may call them "uneconomic assets") it may be necessary for the accountant to invite the purchaser to state the highest price at which he *would* replace them, or what outlay would be required for the acquisition of other means, capable, in the circumstances of that particular business, of rendering the desired amount of service in spite of costing less.

This matter of the book valuation of uneconomic assets bears on the nature of valuation itself, and on the commonly-expressed view that assets have "going-concern values" assessable by reference to their contribution to the revenue of the concern. In fact, however, this situation arises only where the asset is worth so little as not to be worth replacing, or where it is unique and cannot be replaced in anything resembling its existing form. Where an asset can be, and probably will be, replaced, it should not be taken at any figure higher than amortized replacement cost—any more than stocks of goods should be written-up prior to sale merely because the proprietor thinks he has made a good bargain and will be able to sell at a considerable margin.

INCIDENCE OF OWNERSHIP ON BUSINESS ACCOUNTS

It is interesting to note that changes in the ownership of a business sometimes do, and sometimes do not, affect the accounting records of assets and profits. Normally, a business is regarded as an entity apart from the proprietor himself, and it has been emphasized that whilst the object of the accountant's profit measurement may be to assist the proprietor to determine the amount of his income, the two things, profit and income, are not identical conceptions. Thus capital value assessment, irrelevant in profit computation, may be relevant for the proprietor's personal spending decisions—particularly if he has more than one business or business interest. But in the case of a complete change of ownership and transfer of legal title in the business and its assets, we have treated the assets, and consequently the future earnings, as being subject to fresh determination. Indeed, it may be that the purchaser does not know the book values of the assets he acquires, or does not know those of individual items therein.

In the case of dealings in the shares of a company, there are at least *partial* changes in ownership, possibly occurring with great frequency. Whilst historical facts (cost of fixed assets, etc.) may be just as irrelevant to the purchaser of shares in a company as to a person buying a business outright, it is clear that no scheme of accounting

can, or should, provide for constant amendment of the books of a business merely by reason of a succession of partial changes in ownership. When there is a complete change in control, the situation rather resembles the case of the purchase of the undertaking itself. If control is by virtue of the holding of all the share capital in issue, then the most convenient course would be to amend the books of the company so as to bring book values into line with the implications of the price of the shares. However, legal regulations applicable to incorporated concerns set limits to such a procedure, as would, in any case, the existence of minority interests in the company.

These considerations bring out the importance in the interpretation of accounts, of the shareholder's or proprietor's personal situation in relation to the business. Whilst accounting reports are objective as regards the business, adjustments may be necessary before a beneficiary in the earnings can decide what is *his* income from the concern. Accountancy textbooks and examination papers have already made us familiar with such adjustments in relation to the accounts of a parent company. The desirability of apportioning profit distributions by reference to the earnings before and after the date of acquisition of control has been brought out, and the possibility of using revised asset valuations as a basis for adjusting the dividends received to arrive at truer figures of earnings has been contemplated by writers on the subject. One of the largest British holding companies, Imperial Chemical Industries Limited, maintains a "Central Obsolescence and Depreciation Fund," allocations to which are made in respect of subsidiary companies' assets.¹ This is a most reasonable short-circuiting of the narrow restrictive legal conception of the separate status of parent and subsidiary.

As is well known, the profits disclosed by the several accounts of companies which are part of a group, often partake somewhat of the nature of a legal fiction. Subsidiaries and parent company really form only one economic entity in many cases, more particularly where trading transactions take place between them. If there are no established trade prices for the goods or services so dealt in, the absence of arms-length status for these inter-company dealings greatly affects the objective validity of the prices, the amount of the transactions, and hence the disclosed earnings of the "separate" concerns. Where there are minority interests, this position is most difficult. Apart from any possibilities of defrauding the minority (and the means are so easy that the temptation must be a strong one), it

¹ See page 61.

simply is not possible to arrive at separate figures of true profits in some of these cases. Separate figures are, of course, given. The law, having permitted the *appearance* of division, completes the illusion by requiring separation of accounts, and, in Great Britain, nothing more, as yet. A holding company which does not publish consolidated accounts or the accounts of its subsidiaries and other group-companies, can show practically what profit it pleases—a sad commentary on the standing of accounting, and on the commercial and legislative appraisal of the desirability of giving the shareholder true accounts. For, by the standards of measurement which have been put forward in this book, the “profits” reported by most British holding companies are quite untrue. That the shareholders may know this does not alter the fact.

Then, too, there are often deliberate adjustments of the accounts of group companies—by varying charges for administration expenses or for goods supplied—designed to reduce income taxation. Perhaps one company would show losses if there were no such adjustment, whilst another would be paying tax on its profits. There is no need to pass any moral judgment on this. Apart from occasional dealings in ownership of incorporated concerns purely for the sake of their accumulated loss allowances for taxation, no obloquy should attach to the adjustment of inter-company accounts to the effect that the tax payable is about the amount which would be applicable to one “legal person” having profits equal to the net total for the group. The point is that the law maintains a fiction of separation of entities which is not in accordance with the economic facts of the case, and that the world of business tends to cut through this fiction for some purposes, and for others to take advantage of the weaknesses of these legal structures.

Consideration of the incidence of partial changes in ownership, such as are almost daily occurrences where there are large blocks of shares in public issue, and of the entity notion introduced by the law, leads us to, and emphasizes, that view of the relation between business profits and proprietors’ incomes already discussed in this book. This is, that income is a personal conception, and that profit as reported is merely one datum in many required for the estimating of proprietor’s income. Adjustments will have to be made by reference to the personal circumstances of the proprietor; and if the latter gains full possession of ownership he may find it convenient to amend the accounting records of a business by reference to the circumstances of his acquisition of control. This “amendment” should be considered

by comparison with the case of an outright purchase of an undertaking where perhaps records only of debtors and liabilities would be handed over by the seller, leaving the buyer to open a fresh set of books with asset figures determined without reference to original cost to the business.

WORKING CAPITAL ON ACQUISITION

There is one other factor involved in the determination of purchase price and not so far discussed. I refer to the surplus or deficiency of working capital at the time of sale of an undertaking.

Since a business is to be viewed as an income-source when acceptable prices for it as a going-concern are being considered, it follows that any funds on hand in excess of reserve capital required to maintain the expected flow of profits, are surplus to the capitalized figure of future earnings. That is to say that the price paid covers both an income-source and rights to a sum of money available now or in the very near future. Conversely, if working capital is insufficient, the income-source conception should be retained on the basis that the concern will be able to have finance for the desired scale of operations, and then, from the price which would be paid or asked for that source, the shortage of working capital should be deducted.

A business which has accumulated investment holdings (otherwise than in associated concerns) is an example of this state of affairs. We may take the case of a company the control of which is under negotiation for sale, and which is in this position :—

BALANCE SHEET			
Capital and Reserves ..	£140,000	Capital Expenditure ..	£50,000
Creditors	10,000	Production Expenditure ..	30,000
		Debtors	20,000
		Government Securities ..	40,000
		Cash	10,000
	<u>£150,000</u>		<u>£150,000</u>
Capital and Production Expenditures :			
Of these figures £20,000 is for Organization Expense. The remaining assets are material ones and have :			
		Amortized Replacement Cost, equal to the book value ..	£60,000
		Break-up Realizable Value	£30,000
		Government securities—market value	£50,000
		Estimated Annual Profits from trading operations (after amortization of replacement cost of assets)	£14,000

Further calculations relative to the purchase price of the whole undertaking may be made on the assumption of a return of 10 per cent. on capital invested in an enterprise of this particular nature.

It must be repeated that no accounting procedure can *value* the business. The accountant can only advise the buyer or seller that a price of x pounds would show a return of 10 per cent. on capital invested in the business (that invested in Government securities will be distinguished). It may be convenient to call this a "valuation," or the capitalized value of earnings, but it is not really an expression of value in any objective sense. The accountant can, or should, say only that IF future trading profits be taken at £14,000 per annum, and IF a return of 10 per cent. be taken as expected, and IF certain other assumptions are made, then a purchase price of £226,000 will fit these circumstances. (Possibly he can be useful to his clients or employers in advising them on what might be considered a reasonable return on an industrial investment, or on the state of the organization and management of the business which is the subject of the propositions. His wide experience in commercial and financial affairs may place him in a position to give valuable advice on these things. But this is outside the limits of accountancy—and in any case, the fullest possible investigation of affairs will not disclose any attribute of measurable "value.")

Now, to return to the price mentioned above, we may set out the details briefly in the following calculation :—

Operations—Annual Profit	£14,000	
Deduct: Safe return attributable to net break-up value, £40,000 (see below) at $3\frac{1}{2}$ per cent.	1,400	
	<u>£12,600</u>	
Capitalized equivalent at 10 per cent.		£126,000
Break-up Realizable Value :		
Capital and Production Expenditure	£30,000	
Debtors	20,000	
	<u>50,000</u>	
Deduct : Creditors	10,000	
		<u>40,000</u>
Surplus Finance :		
Terms to customers are 7 days, whilst suppliers commonly allow one month. High figure of debts outstanding arises from circumstance of large sales item in last week of accounting period. Budget discloses that the liquid position is such (Creditors including substantial tax provisions not yet due) that the whole of the year-end cash balance may be considered free. That is to say, it could be withdrawn without prejudice to the <i>existing</i> scale of activities. There are available therefore :		
Cash	£10,000	
Securities (at market value)	50,000	
	<u>60,000</u>	
TOTAL PURCHASE PRICE on assumptions made		<u>£226,000</u>

We may now proceed to final considerations on the question of business purchase. The main problem remaining is that of the nature of the difference in amount between the purchase price paid for a business, or for shares in a business, and the total, or proportion thereof, of the book values of the various "tangible" assets. This is exemplified in the above instance by the £76,000 excess of the total price over the net assets in the Balance Sheet (excluding the surplus of the Government securities). This excess becomes £96,000 if there be excluded from assets the £20,000 expended on "Organization."

GOODWILL, ORGANIZATION EXPENSE AND PURCHASE PRICE

Like the other Capital and Production Expenditures included in the Balance Sheet, the amount of Organization Expense is an historical fact not directly incident on the present "value" of the concern. Unlike Machinery and Trading Stocks, however, Organization Expense is not a physical thing, no amortization is necessary, and "replacement cost" is quite irrelevant even if, as is very doubtful, it has any meaning at all in relation to this asset. This is not to say that the business might not possibly "fall to pieces" or decay in some way, but this is scarcely comparable with the more or less predictable and certainly inevitable approach of the end of a machine's useful life. Organization costs have been defined as the expenditure arising from bringing a business through the stage of development and establishing it as a going-concern. It has been maintained that the amount so expended is a capital investment and that whether or not the business man has obtained "value for money" (on his own assessment of the position) is not a question which affects the statement of the figure of profits, or indeed, of that asset itself. It would appear to follow from this that fluctuations in the extent of the business's "going," equally have no incidence on the amount of the asset, whatever the reasons for a decline in activities, and hence no amortization is required.

The purchaser of a successful business would normally expect to pay more for it than the sum of the replacement costs and realizable values respectively, of the physical assets and money claims included in the business. The development of the business would have involved expenditure other than on these specific assets, and if the developer's hopes were realized, some extra value would be attributable on the occasion of sale. But this does not mean that some figure can be placed by the buyer on Organization. On the sale of a going-

concern, what is usually called "Goodwill" is so mixed up with the "value" represented by Organization Expense that it is not possible to distinguish anything separately-measurable.

It is suggested, in fact, that the idea of "apportioning" the purchase consideration is a false one. This idea is that the price paid is a sum of separate asset values. It is usual to enter the assets acquired at figures described as "cost," with any remaining difference between the total "tangible assets" and total consideration taken to Goodwill Account. But, for one thing, it is not the case that the purchase price is a reliable objective valuation of the business. The purchaser may think he has done a good bargain, in which case such a procedure as has been outlined would give a low figure to goodwill, though it may have been that the purchaser's criticisms of the condition of the plant had been partly effective in influencing the seller to take a lower price. It could happen that the price was such a good bargain for the new owner as to be less than the sum of the figures attributed to the various "tangible assets." Here, orthodox accounting practice would bring in suggestions of a Capital Reserve, or of writing-down plant, perhaps.

The resolution of this problem is implicit in the statement that the replacement cost of assets is not a factor in purchase price ascertainment (except indirectly in relation to amortization and estimated profits). Whilst book values must be placed on all the tangible assets, these book values are not *parts* of the price paid.

Since it is impossible, and in any case unnecessary, to put a value on "Goodwill" and on Organization Expense in the purchaser's books, the only remaining course is to show in the Balance Sheet both the total purchase consideration and the total of the values set up for other assets. These may well appear as deductions, the one from the other. Thus, a Balance Sheet may show (at the head of the assets side, it is suggested) the following figures:—

PURCHASE OF BUSINESS

Purchase price	£100,000
Deduct : Book values attributed to tangible assets acquired, less Liabilities assumed ..	72,000
	<u>£28,000</u>

Alternatively, a similar, but reversed, entry will be required on the Liabilities side where the attributed values exceed the net purchase

consideration. The entry should appear in the Balance Sheet so long as the business continues to operate ; should it cease to do so, then the balance of the item should be treated as a capital gain or loss.

CONCLUSION

It is not without regret that I say "farewell" to that old friend "goodwill," on which so much accounting argument has taken place and so many examination questions have been posed. That a concern has the benefit of goodwill with its customers is but one of a hundred reasons why the purchase consideration paid for the business should exceed the total replacement cost of the individual tangible assets. Apportionment in its various forms—of business purchase price and of overheads, for instance—does not always make sense. In the former case, it is certainly meaningless ; and in dealing with business acquisition in this way, we have perhaps added to lay (and possibly professional) confusion of Balance Sheet figures with "values."

We should rid ourselves of the idea of there being a doubtful ("intangible") asset called goodwill which ought to be written off out of profits—as happens so often. This writing-off is only a mode of providing more working capital out of profits, whether or not it is intended as such. Allocations to reserves are the right way of saving funds for expansion.

If X is a live pedigree dog, and Y a dead one, then perhaps $X - Y = Z$. But Z means nothing in itself. The label "goodwill" in business accounts closely resembles Z : its use is as sensible as trying to find what makes the dog tick by dissecting it.

CHAPTER XI

THE ECONOMIST AND ACCOUNTING

ACCOUNTING is concerned with the nature of certain concepts used by economists, and the means whereby such concepts may be given quantitative expression. Whatever the precise relationship between economics and accounting, it is clear that there is at least some common ground, and that economists and accountants should each have some knowledge of the other's work. I cannot hope to improve on Professor Canning's analysis of the connexion between the professions, and the reader is referred to the first chapter ("The Academic Status of Accounting") of his book, *The Economics of Accountancy*, for an unbiased statement of an economist's view of the position.

The importance of this matter to economists is unquestionably considerable. In the words of Professor Canning :

"Economists are making a larger and larger use of the accountant's reports in their investigations. Economics, to be sure, has fostered accountancy from its academic advent, but the foster parent has been more influenced by the new relation than has the adopted child [specifically, he means in the American universities]. The parent is far from understanding the child, and the latter is often bewildered by the interpretation placed upon its doings" (p. 4).

A study of Canning's book and that of Professor Irving Fisher (*The Nature of Capital and Income*) reveals that even those economists who have gone out of their way to study the doings of the accountancy profession have failed to perceive what are the latter's ideas of income and assets. Possibly the accountants are to blame for not saying what they are trying to do. Whatever the reason, the fact is that the figures produced by them are probably improperly understood by economists and by laymen.

We may see this in Fisher's example of the computation of a person's income on p. 135 *op cit.* His statement of a lawyer's income for a month may be summarized as follows :

			\$	\$
Investments :	Interest	2,000		
	—New Purchase ..	<u>500</u>		
				1,500
Furniture :	Use	50		
	—Repairs	<u>30</u>		
				20
Self-Practice :	Fees received ..	2,000		
	Expenditure ..	<u>500</u>		
				1,500
Outgo to Cash :	Received	4,000		
	—Paid	<u>3,780</u>		
				—220
				<u>\$2,800</u>
	TOTAL NET INCOME			<u>\$2,800</u>

These figures imply amounts of receipts and payments as follows :—

Receipts.	\$	Payments.	\$
Investment Interest ..	2,000	Purchase of Investment ..	500
		Practice Expense ..	500
Gross Fees	2,000	Furniture Repairs ..	<u>30</u>
			1,030
		Personal Expenses (balance)	<u>2,750</u>
			<u>\$3,780</u>
TOTALS AS ABOVE ..	<u>\$4,000</u>		

It is at once clear that what Fisher labels "Total Net Income" is simply the man's living *expenditure* for the month, this being the sum of \$2,750 cash payments and \$50 "use" of furniture, or "depreciation," as many accountants would call it. His method of setting out the calculation is not particularly important. It purports to show income from individual sources, and Fisher remarks that it is not the only or the usual method of accounting. Nevertheless, whilst his studies lie largely in the field of tracing income to sources—to items of wealth—he has in this case committed himself to a particular view of personal income. It seems to me that this view is quite different from the accountant's, and furthermore from the layman's, idea of income.

I feel sure that the lawyer would consider himself as having an income for the month of \$3,500, made up of \$1,500 from his practice and \$2,000 of investment income. The accountant might speculate on whether a month was a sufficiently long accounting period for income reporting; perhaps, if \$2,000 were not a representative month's investment revenue, he would prefer to compute some average amount. However, the accounting refinements need not be investigated; the abyss between Fisher and the accountant is clear. The former continues from the figures relating to the lawyer's affairs with these remarks :

"In practice the minor sources of income are neglected. The income and outgo of one's 'cash' almost balance in the long run . . ." (p. 135).
 "Practically, therefore, the lawyer's income is obtained by taking . . . only the two principal items, the income from investments and the income from his professional work. Each of these is \$1,500 . . ." giving a total of \$3,000. (p. 136)

Now the idea of deducting from income the cost of an investment purchased (for that is how he arrives at \$1,500 income from investments) will seem quite grotesque to an accountant. The latter's view would be, in brief, that the lawyer's income was \$3,500 of which \$2,780 had gone in living expenses and the balance, \$720, had been saved (\$500 being invested and \$220 going to increase the cash balance). Fisher has apparently been unable to accept any view of income other than services yielded. Thus he says :

"The income of a community is the total flow of services from all its instruments. The income of an individual is the total flow of services yielded to him from his property." (p. 101)

Risking the commission of some academic solecism, one might say that this is the same as "consumption." Certainly personal expenditure is the money measure of income on Fisher's view.

His disagreement with ordinary accounting practice apparently arises from the idea that this is based on maintenance of capital intact. He would consider only receipts and payments in computing the income yielded by a factory ; thus the cost of machinery purchased is taken to be an item of outgo (deduction from income) in the year of disbursement. He distinguishes between the mere reckoning of depreciation and the actual setting aside of funds by purchase of investments :

"To reckon what one ought to save in order to maintain capital is not to save it, and a definition of income which depends upon an ideal reckoning instead of a real payment is to that extent inadequate." (pp. 111-2)

His view of the accountant's methods of income reporting are clear from the following quotations :

"Realized income is the value of the actual services secured from the capital ; earned income is found by adding to realized income the increase of capital value, or deducting from it the decrease. We may designate them simply as income and earnings." (p. 234)

"It is to earnings that accountants instinctively give their main attention. But they err grievously when they attempt to spirit away realized income and put earned income in its place . . . earnings cannot be calculated except by the aid of depreciation, depreciation cannot be calculated except from capital-value, and capital-value cannot be calculated except from expected realized income." (p. 235)

"But so persistent is the accountant's instinct to put aside realized income in favour of earnings, that we need to point out in detail the confusions which arise unless income and earnings are carefully distinguished" (p. 236)

"... the general principle connecting realized and earned income is that they differ by the appreciation or depreciation of capital . . . the fallacy consists in reckoning depreciation of capital as part of outgo, or appreciation of capital as a part of income. This usage is difficult to combat, for with many it has become habitual." (p. 238).

Now all this is rather staggering to an accountant. For far from such "usage" having become "habitual," it is not at all the state of affairs. Accountants do *not* attempt to guess the capital value of a business in reporting on income; no addition is made to current earnings for any increased worth arising from improved prospects for the future profitability of the business; nor is any account taken in the revenue account (rarely even by way of Balance Sheet and capital reserve adjustments, which are unimportant in any event) of any increase in the value of a machine.

Professor Fisher's misconceptions on this matter are not without some justification by way of defects in orthodox-accountancy-professional views on the nature of Balance Sheet figures and the incidence of market values of assets. I have already gone into this matter (on pp. 48-51, for instance) and should any economist read this book he may well more readily approve this amended orientation than would many accountants. Nevertheless, what accountants do in practice is more nearly expressed as the allocation of expenditures against revenue than as the adjustment of realized income by reference to fluctuations in capital values. The whole of Fisher's criticisms of the accountant's procedures fall to the ground simply because his basis is an assumption (partly excusable) that these procedures are something which quite definitely, and in spite of undoubted defects, they are not.

The importance of all this is twofold:

Firstly: accountants are too ready to assume that the nature of the figures which they produce is a matter of common sense, and that, apart from a good deal of complexity in the process of producing these figures, the actual meanings to be attached to the resulting figures, of profits, for instance, are readily, and in fact generally, understood.

If Fisher's views are examined, it may be seen that this is not so. It therefore behoves the accountant to make quite certain that no

fault lies on his side, and that he himself has a fairly clear idea of what he means by saying that a business has made a profit of £5,000.

Secondly : it would appear that Fisher's views on income, have influenced contemporary economists, and since, as Canning has pointed out, they are "making a larger and larger use of the accountant's reports in their investigations," it is of the utmost importance that there should be an adequate comprehension by them of the nature of the principles followed and the factors measured by the accountant.

One might imagine that "income" was so thoroughly an economic concept that economists would be able to tell the accountancy profession just what it meant, and, subject only to the limitations set by normal practical difficulties, how it should be measured. For some reason they have not advanced so far, notwithstanding that, according to both Fisher and Canning, "income" is the most important subject for consideration in the sphere of economic science. My conviction of the unsatisfactoriness of the position as expressed by Canning is the main reason I have for making this essay into the theory of accounting. I quote his remarks again :

"The accountants have no complete philosophical system of thought about income ; nor is there any evidence that they have ever greatly felt the need for one. Their generalizations about income, to the extent that they go beyond procedure at all, are too inchoate, in comparison with the structure of procedure they have built up, to permit one to suppose that they have ever seriously put their minds to the philosophical task. They have built up their structure of theory only to the extent that they found suitable and convenient statistical material to clothe it in. Their advances in theory seem unlikely to precede development of practice ; and practice will develop only when interested persons become willing to pay for pushing statistical inquiry further than it has hitherto been pushed." (p. 160, *ibid*)

Canning has devoted himself to the study of accountancy practice rather more than has Fisher and he at least goes so far as to say :

"There is no reasonable ground for doubt, however, that earnings (earned income), to the extent that they can be economically measured, constitute a superior and more immediately convenient measure of income."

But he disappoints one by accepting earnings as being realized income adjusted by fluctuations in capital values, and proceeds :

"The proprietor and those beneficially interested in proprietorship wish chiefly to know what *net changes in power to command future final income have occurred within a year by reason of the enterprise activities.*" (pp. 169-170)

This scarcely seems to be the sort of information which accounts are designed to provide. However, Canning's work must be one

of the best attempts made at an exposition of the significance of accepted accounting procedures ; and since no comparable attempt appears to have been made by any member of our profession, we accountants must acknowledge his book as a praiseworthy effort from which we may derive much benefit in the process of setting our house in order.

It will be useful to give a last quotation from his book so as to show, in a few words, the sort of view of income which is apparently held outside our profession—by some people at least :

“The *statistical* ‘ideal’ or ‘standard’ income towards which we *can* approach would make net income consist of the algebraic sum of six terms, viz :

1. Receipts that are favourable to the proprietor.
2. Disbursements that are unfavourable to the proprietor.
3. Appreciations in true capital value (where ascertainable).
4. Depreciations in true capital value (where ascertainable).
5. Increases in ‘book value’ of those assets that cannot have true capital value.
6. Decreases in ‘book value’ of those assets that cannot have true capital value.” (p. 135)

This scheme is not put forward by Canning as something which is wholly achieved, or even achievable, in practice ; he conceives of it, however, as an “ideal” which should be approached as nearly as possible. Now the accountant would not agree to this as an ideal. In fact, it is questionable whether he would understand what items (5) and (6) meant at all. It is unnecessary to examine the six terms in detail. There is no doubt that they cannot form a basis for agreement between economists and accountants. It is the duty of the latter to make some essay at explaining their procedures for the benefit both of others and of themselves. I hope that my own attempts in this direction may be of some assistance to economists in aiding their understanding of what we do, and their judgment of what we ought to do ; for, critical as I am of portions of the orthodox accountancy viewpoint, it seems to me to reach something very much nearer true income than are the views of the economists who have worked in this field.

It should be mentioned that some items appearing in accounting reports may mislead any economist, or anyone who may chance to see them, into thinking that some particular unscientific treatment is accepted as a proper thing by the accountancy profession. The sort of thing I have in mind is, for instance, the setting up of a fund for some specific purpose such as provision for staff pensions. Possibly

an investment might be earmarked against such liability, and the income therefrom set off against the periodical pension payments.

Everyone is familiar with the commendable substitute for book-keeping in use by many housewives, the tin-can method. Now I have nothing against this method; it is an admirably convenient one, with merely the inconvenience of involving a certain amount of mental book-keeping to keep track of the amounts borrowed from the rent-tin to pay the milkman. The economist may be at a loss to understand why the records of the finances of commerce and industry should make use of the tin-can method, too—for that is all that the fund is in most cases. The economist would suggest that the management should employ the funds at their command wherever they will earn most revenue, and should acquire outside investments only if the money cannot be utilized with advantage within the concern's own range of business activity. It will seem strange to him that this money should be placed in a tin can apparently without reference to the condition of the business and notwithstanding that it is not the pensioners' tin can, and if the concern is unsuccessful the contents of the can go into the general pool against which all the creditors claim and, incredibly enough, the pensioners themselves would have no claim at all in the majority of cases for any future pension after the date of the failure of the business.

There are other happenings which may well puzzle or deceive an economist. Thus there is the appropriation of some profits to a reserve account against the contingency of a particular loss or expense, or sometimes losses in general, being incurred. It is not very unusual for the balance of such reserve remaining after the eventual charging thereto of the loss or expense—or even the whole reserve if the contingency does not materialize—to be left on the books as a reserve and not transferred back to accumulated profits. It must be quite impossible for a layman—our economist—to decide just what the accountant regards as the profit of such a concern, whether or not the provision of a sum for a broad class of contingencies is a deduction in *arriving at* profits, and what on earth is the significance of leaving as a reserve the amount definitely known not to be required. The position is often hidden by the inclusion of such reserves in the general figure of liabilities; it is well for the accountant that this is the case, for the economist's opinion of this state of affairs is scarcely liable to be flattering, and what he would think of the charging of a particular loss or expense to a reserve originally intended but not required for something else, I hesitate to think. In fairness let it be said that the

accountant does not necessarily instigate, or even approve, such practices ; it is rather that his indecision and the inadequacy of the quantity of reasoned consideration of these problems leaves him in a weak position in his relationship with directors who are thus able to influence the account-keeping. This influence can often be a bad one for reasons already explored ; generally through an unconscious bias towards the presentation of a favourable position ; on occasions through a desire to mislead.

The differences in the meanings attached to the word "profit" by accountants and economists respectively (once more—in so far as *either* of these groups is clear on the matter) are probably recognized sufficiently clearly to prevent confusion. I refer to the status of "proprietor's salary," "interest on capital," and perhaps "allowance for risk," as deductions in computing (economist's) profit, or as parts of (accountant's) profit. Except in the special case of partnerships, these factors are not often dealt with in accounting records. Generally, and I think rightly so, the ascertainment of a lump sum residuum of revenue is the goal of a profit-and-loss statement. Economists have to use the notion of "pure profit." Though useful to them in the construction of economic theory, this is not a measurable objective business fact. Presumably, however, no confusion should arise on these legitimate differences in outlook.

I have tried in this book to express the significance of the accounting representation of the results of private-enterprise activity. In Chapters II and III, for example, I have made a tentative synthesis of each of accountancy's annual exhibits, namely the Balance Sheet and the Profit and Loss Account. The fascination which I find in generalization in the science and practice of accounting is to me a sufficient reason for attempting it. But let it not seem a remote and unpractical exercise to any of my fellow accountants. Accountancy has not the high standing which is its due ; it lacks this standing by reason of the existence of room for the standards of accepted practice to be raised somewhat nearer the ever-unattainable Absolute Truth. Reasoning, on the lines I have indicated (inadequately, I feel), is the sole means of attaining this essential practical result.

Economists can help us in this. Possibly I have strayed into their field of thought in my study of the nature of the economic attributes of business assets and profits—I am not alone in thinking that "Accounting is concerned with economic attributes and measurements. . . ." ¹ Certain it is that some co-operation between the two

¹ Paton and Littleton, *op. cit.*, p. 32.

groups would yield benefits to both. May my hopes that I have done something to stimulate this mutual aid prove to be justified.

Postscript :

From James Agate's "Theatre" column in the *Sunday Times* of 11th December, 1943 :

"I remember some twenty years ago at the London School of Economics delivering a lecture to County Council school teachers, the subject being the lovers in Shakespeare's plays. Leaving the hall I heard one young woman say to another : 'Yes, it was all right, but I would rather have heard the other lecture.' I discovered afterwards that my rival's subject had been 'Alternative Systems of Accountancy on Chinese Railways.' Why, I reflected the other evening, must we in the theatre never hear anything about anything except love? Why not entertain us with alternative systems of accountancy on funicular railways? After all, did not Ibsen write a moving play about the purity of municipal bath-water?"

CHAPTER XII

THE ACCOUNTANT AND SOCIETY

"She may detain, but still not keep, her treasure ;
Her audit, though delay'd, answer'd must be."
(WILLIAM SHAKESPEARE, *Sonnet 126*.)

THROUGHOUT this essay on the theory of accounting I have been concerned to further the aim of supplying to the management of industry accurate money measurement of the results of their activities. My theoretical treatment has dealt with the means of attaining truth in Balance Sheet and Profit and Loss Account, truth in a concise form perhaps, but nevertheless an approach to the whole truth. I have reminded you occasionally that this aim may differ from what is considered appropriate for the world outside any particular business concern, including in this outside world the real proprietors of a great many of the largest undertakings we have at the present day.

DISCLOSURE AND TRUTH

Though my general treatment of the subject has quite properly been divorced from this question of public disclosure, it is fitting that some consideration be given to this aspect of accounting, for it is this which is by way of being a " burning question " of the (financial) day. In spite of my apparent indifference to the shareholders' needs and their rights to information, I do not find myself ready to accept the more cynical view of the amount of difference which might be allowed to exist between accounts for directors and those for shareholders. My personal feeling for the wholesomeness of scientific truth and impartial investigation is such that I find it impossible to accept any differences in relation to the reporting of fact, except such as arise from peculiarities in point of view. It is clear that management is concerned with many matters of detail which are of no importance to the shareholder : many details should receive accounting recognition in figures for directors, whereas a more summary treatment is permissible for shareholders' accounts, and is even desirable if clarity is to be achieved.

Now it has to be admitted that this ideal is far from being the guiding principle of directorial policy in Great Britain. Far too often do accounts go as far as they can in the way of concealment of things which the shareholders would certainly be very interested to know. It may not unreasonably be said that the showing of an accurate-as-may-be profit figure—the prime object of the accountant's work—is not only neglected but is deliberately avoided in a surprisingly large number of cases. The paraphernalia of non-science—concealment of management remuneration, alleged conservatism in stock valuation, inscrutable treatment of taxation liabilities, contingency provisions, and the like—are sufficiently well known to merit their being taken as read in this chapter. I hope that in this book I have stifled some of the siren voices of convention which have lured many a good accountant from the path of true science to the mist-enshrouded marshes of Giant Expediency. But the existence of distortion as an important influence in moulding the form and figures of published accounts is, I suggest, generally admitted, despite much disagreement on what constitutes a lapse from Truth, and on what, if anything, justifies such lapse.

There has long been a strong undercurrent of feeling about the unsatisfactory state of many published accounts. This has in recent years come into the open in the form of criticism of the professional accountant. Thus a writer in *The Economist* for 26th September, 1942, under the heading "Accountants and Accounts," has made a rather useful survey of defects in present-day practice, coupled with a rather less useful commentary on the relationship between the professional accountant and industrial accounting. Correspondence which this article aroused showed a marked degree of dissatisfaction, both in and out of the profession, with the existing state of affairs. The most important point as it concerns us here is that some accountants consider that the auditor and the accountant can exercise far more influence in the presentation of accounts than they do at present—and the original article would seem to express this view. On the other hand, many, and perhaps most, view legislation as the only means of effecting improvements. There seems to be general agreement on the need for change, and for the legal enforcement of change. How far is the accountant justified in putting the onus of securing progress on Parliament? The answer to this question raises consideration of certain limitations on the usefulness of statute as against common law.

THE LEGAL STATUS OF ACCOUNTANCY USAGE

Warning :—

“ . . . Here lie abashed
The great negotiators of the earth,
And celebrated masters of the balance,
Deep read in stratagems and wiles of courts.
Now vain their . . . skill . . . ”

(ROBERT BLAIR, *The Grave*.)

British control on accounting practice in the presentation of accounts is chiefly marked by its paucity. Apart from enactments which relate merely to certain specific classes of undertakings, there are only the cautious provisions of the Companies Act, 1929. These provisions include no rules affecting the ascertainment of profits, and require a degree of disclosure in relation to subsidiary companies and directors' fees which is worse than inadequate. This is not intended as an exaggeration. My contention is that in the absence of such provisions as have been made in respect of these two matters, it is quite conceivable that professional opinion on the desirable degree of disclosure might well have carried more weight. As it is, the relevant sections of the Companies Act may be used by a director of the secretive type in opposition to the views of any accountant or auditor who feels that the published accounts should include more than the statutory minimum of information.

Thus, Section 128 specifically excuses a company from including the remuneration of its managing director in the disclosed figure of directors' emoluments—in fact it prohibits it from so doing—whilst the dispensation to exclude salaries derived from appointments renders the whole section almost useless. In a sense it is worse than useless, for as I have indicated, auditors' opinion on this matter might well have had sufficient force to produce disclosure had there not been this legal justification for concealment. The situation in relation to subsidiaries is precisely similar. The carefully worded—and whittled down—provisions for a crumb of disclosure set the stage of accountancy usage so that directors may conceal the loaf—or the absence of half the loaf. Of course many directors do take a proper view of their responsibilities and go further than the minimum, but the fact remains that legal excuse for concealment exists, and the issuance of a consolidated Balance Sheet appears almost in the light of an act of charity : its absence does not even arouse the comment of auditors, influenced as they must be by the expressed opinion of the legislature.

The paradox is, now clear : statutory provision for disclosure may, if it is itself inadequate, produce less disclosure than there would have been without it. The truth is that professional accountancy opinion itself has legal force as part of the common law affecting companies and other bodies. The variety found in " expert opinion " when accountants are called in as witnesses in actions turning on accountancy reports, is no bar to the validity of this truth. This variety is but natural in relation to the controversial issues which are involved in legal proceedings. It is, furthermore, relatively easy to find two experts in any subject who disagree. The slow but progressive development of accountancy usage is quite different from what may be imagined from these clashes of opinion, and it carries such weight that it does regulate the form and content of published accounts to a very large degree. There is a legal " right " and " wrong " in accountancy quite apart from statute, which is indeed so small a part of the basis of company practice that accepted usage is responsible for whatever coherence there is in methods of ascertaining and reporting on profits and financial position.

If this attribute of legal force is agreed to appertain to accountancy practice as generally accepted, it follows that we may look to professional opinion for progress towards the attainment of that amount of disclosure and that high standard of accuracy which are undoubtedly lacking in some of the accounts which are to-day produced by industry to its proprietors. The accountant must not hide behind the skirts of feeble legislation, for it may not be particularly important to have more forceful written law ; far more useful would be an authoritative lead from the profession in the direction of better and more informative accounts. This does not mean that the individual auditor must resign on every occasion on which his clients offend against his ideas of what is right and proper. This kind of protest will be ineffective if general opinion is not available to support his position. The individual progressive auditor will always find himself ahead of the general level of development. His own views should help the average views on the way towards the ideal. Industry should not be permitted to lag far behind the average of opinion, and it is towards the narrowing of this gap, at present a formidable one, that the individual auditor must, if he is to fulfil his function properly, direct more of his energies than hitherto. If accountancy were based on clearer notions of the underlying principles of what I have argued to be a science, its practitioners would speak with an authority which could not be denied its rightful place in the pattern of our present economic system.

That this is not yet the case is because progress in accounting as a logical scheme of thought has been grossly inadequate, and because some form of central directive is required.¹

THE ACCOUNTANT'S SOCIAL DUTY

It does not contradict the democratic principle of Freedom to say that each member of society has a circle of responsibility and duty in the course of his activities with a perimeter approximating to the limits of that society. So that the old individualist view that the building of a factory was the business of the manufacturer, the builder, and the landowner, and of no other people, has gone by the board. It is more and more accepted that what each man does in life affects not only his immediate circle but society in general, so that to-day it is impossible to build a glue factory either in Regent Street or on the banks of Grasmere, and to-morrow it will be permissible to build such a noxious structure only in areas which a planning authority allocates for such purposes after consideration, on at least a national scale, of industrial needs, housing and amenities.

Not less does the responsibility of the accountant extend beyond the limits of his legal duty to the persons by whom he is appointed or to whom he reports. This is not as yet widely appreciated, and the ultimate standard of practice which it envisages is an ideal to be approached rather than adopted before society is ripe for it. Let us glance at such recognition as has already been paid to this extra-clientorial conception of our place in the scheme of things. Firstly, we have some ideas on the importance of accounts in our economic system ;² secondly, we have the conscience-bidden duty towards those people—for example the tax collectors—who trust us though they have not paid our fee.

The Economist, in the article already mentioned, and in the course of delivering judgments with which I am not wholly in agreement, refers to this social aspect of accounting in words which put the point admirably. They are as follows :

“For private enterprise to continue to ‘deliver the goods,’ capital must flow into those industries where the return is high and be withdrawn from those where it is low. Even as late as the early days of limited liability, the money needed was put up by a comparatively small class of people who lived in intimate contact with the development of

¹ We have perhaps some promise of this latter requisite in the formation of a Taxation and Financial Relations Committee of the Institute of Chartered Accountants.

² For example, Lord Keynes' comments on “financial prudence” quoted on p. 59.

industry and commerce. They knew, or could know, where their money could give the best return. For a quarter of a century at least, this state of affairs has ceased to be typical. Now, whatever method of putting up the money is adopted, the savings invested must be those of a mass of small men who need advice. The publication of frank, full and proper accounts is needed in order to disclose the position so that anyone with a modicum of grounding in accounts can grasp the facts. With all the figures available, it would no longer be possible for directorates to plough back earnings once the rate of return had fallen well below the average; and the reaping of fantastic profits, for anything but quite short periods, would also be eliminated by the rapid entry of savings into industries still under-equipped with capital. It is beyond question that such knowledge would lead to the use of savings in a manner more beneficial to the community than either the pre-war practice or the suggested alternative of a board of specialists, who, however wise and experienced, would be powerless to find their way about the ramifications of modern industry without the assistance of facts which ought to be available to all. This is the answer to those who believe that company directorates owe no duty to anyone beyond those who put up the money, or perhaps to them and their work-people."

And since, in accountancy matters, the duties of the director, the accountant, and the auditor run together, we may include these latter two as having the social duty so convincingly argued. It will be all too easy for the professional reader to bring to mind cases of the inertia of capital to which the writer of the article refers. There are innumerable concerns which continue in being, otherwise than for the purpose for which they were originally intended—after the operating plant, for example, has been sold—or at least on a scale much smaller than is appropriate to the amount of funds in their hands. Such companies gradually turn into miniature investment trusts in many cases, so that management remuneration may not cease altogether, and perhaps, too, so that the directors' financial power is enhanced by the prestige or other value of being in control of funds for investment. Not all such small investment companies are to be condemned, for some of them exercise specialized functions in a specialized industry or share market. The cases which call for censure are those in which directors decide for themselves that they will invest the shareholders' surplus funds on a considerable scale in general securities or in a type of business not contemplated by the original subscribers of capital and as an alternative to returning the capital not required in the company's business, leaving the shareholders to deal with their money as they think fit. These cases are examples of the inertia of capital; that is, the ineffectiveness of a decline in profitability in moving resources out of declining industries into those in need of expansion. Full and accurate accounts would act

as a pointer to this state of affairs, and would therefore facilitate mobility of capital and increase the aggregate of human welfare.

The second aspect of what I called extra-clientorial responsibility is that auditors' reports are read and relied on by other people besides those to whom they are addressed or who pay the fees of investigation and report. There is no doubt that this creates a position of trust which is respected by auditors generally, and which, it should be noted, possesses a nice degree of balance. The reputation of money as an influence on men's allegiance being what it is, the confidence which is placed in the auditing profession by the Inland Revenue, by many war-purpose Government officers, by industry (in pooling schemes requiring certified returns of wages, etc.), by prospective investors, and by many others, is ample testimony to the integrity of the profession as a whole. I am proud of this. I do not wish to lose this status of independent trusteeship by transferring the functions of the auditor to a Government department, for then we could not be regarded as other than the emissaries of the taxation authorities or of Government controls.

An impetus has been given to the writing of this book by my feeling that the status of auditors, and of accountants generally, is less satisfactory than is desirable. We have, I think, important functions to fulfil in the scheme of society in general. This status in society needs constant attention if it is to achieve full fruition, for it is a position of curious delicacy. To foster the proper functioning of the accounting process in industry, it is necessary that accountants shall first of all be experts in their own art and science, and shall secondly have a proper appreciation of the relation of accounting and the professional functions of the auditor to society as a whole, and in particular to the efficient working of industry and the investment market. Lastly, they must possess a sense of responsibility to various groups, including directors, shareholders, the general public, and the Government. To satisfy this responsibility, they must be capable of achieving, as between various conflicting interests and the desires of the groups concerned, that progressive compromise which constitutes the principal instrument of the less spectacular (but perhaps the more durable) kind of progress.

“ ‘ Well, I have looked into my accounts.
I find this wrong and this wrong. But,
with God's grace, I will rectify this and
this. I will set right my accounts.’ ”

(JAMES JOYCE, *Dubliners*.)

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