

## COMPANY ACCOUNTING

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1. I suspect that some of you will think it a trifle odd that I should seek to impose upon a learned society a dissertation on company accounting, and perhaps I should clear my conscience by confessing to some doubts when I first came to seriously contemplate its preparation. Now that I have worked through to the end of my thesis I firmly believe that no one should question the importance of the subject matter. Company accounts which disclose clear reports of stewardship have beneficial social implications. Company accounts designed as constitutional portrayals of income generation and wealth accumulation, are sources of vital statistical information about economic activity over a large part of the enterprise sector of a national economy.

2. I understand that just at present the legal sanctions with accounting status touching companies in your country are still very largely to be found in the Companies (Consolidation) Act of 1908. In my part of the world, as you know, we have twice amended this piece of legislation. First, we had the Companies Act of 1929, and now we have the comparatively recent Act of 1948. To those of us who have been brought up under the shadows of the Acts of 1929 and 1948, the accounting standards of the 1908 Act look both meagre and sparse. Section 26 of that Act makes mention of the contents of a balance sheet in the broadest terms. It requires that the summary accompanying the annual list of members must (except where the company is a private company) include a statement "in the form of a balance sheet, audited by the Company's auditors, and containing a summary of its share capital, its liabilities, and its assets, giving such particulars as will disclose the general nature of those liabilities and assets, and how the values of the fixed assets have been arrived at", but it is also made quite plain that the balance sheet need not include a statement of profit and loss. It seems to me that we cannot but regard the absence of some form of periodic profit and loss measure as a blemish, for without it there is little to aid the understanding of those responsible members of society who need to assess a company's operating effectiveness. You will also notice the disclosure exemption conferred upon private companies in the reference I have cited. This tends to veil the financial position of constitutionally secluded companies. These companies may, in fact, engage in very considerable activities, of importance both for the well-being of the nation and those who have had the ability and foresight to start and keep them going. An adequate disclosure of financial information engenders confidence over a wide area, and providing there is no risk to the exercise of reasonable freedom and enterprise, I believe it makes for the vigorous continuance and development of corporate activities.

3. I recognise there has always been a weight of opinion favourable to exemption privileges for private companies. This is readily understandable if we look at the small family business to be found at one end of the scale of private company activities. The goodwill of the

business is a personal one and there is a natural inclination to preserve it within the family. At the other end of the scale is the private company which is nothing more than a subsidiary of a public company, and in some cases it is a wholly owned subsidiary. It is clear that in pliable hands the subsidiary private company device could be used to minimise the disclosure of group information to the public. It could also be used to lay off a highly speculative venture. In between both ends of the scale are a number of private companies conducting quite sizeable enterprises, with or without other non-controlling companies as shareholders.

4. I believe that limited liability is still a privilege. All privileges imply duties, and in this case intelligible accounting disclosure is surely the obligation of the privilege. It cannot be doubted that grantors of trade credit ought to have an adequate means of financial information; both creditors and shareholders have a direct interest in company accounting disclosure. Less directly, but still I think sagaciously, those promoters of the public interest, who are concerned with the continuation and expansion of effective enterprise as a means of securing economic development, should be able to inform their judgments by reference to published accounts. In the long run there is little to be lost but much to be gained by revealing the economic status of those corporate entities which substantially contribute to the wants and add to the wealth of a progressive nation.

5. I think there can be little doubt that one of the serious defects in the 1908 Act was the lack of recognition of the *domestic* entity constituted by a holding company and its subsidiary companies. In that Act the concept of *legal* entity was paramount. If I may, I should like at this point to draw on an address which I recently gave to an accountants' course at Cambridge. I was there examining the nature of accounting principles and during the course of my discussion I said that "we cannot begin to shape accounts until we have conceived either the unit of organised activity, or the transactor whose history and condition we wish to measure and portray in financial terms. Plainly we must look at the transactions which take place under one roof, whatever that roof may be. I therefore regard the entity notion of accounting theory as primary. If you keep to the provisos I am about to mention you can make the entity what you will. It may be a firm, a person, or a company; it may be legal or domestic, a group or an isolationist; it may ascend or descend the hierarchy of economies to be limited at will by political, geographical, industrial or natural boundaries; but whatever province we do choose to account for we know that it must have a real existence, and it must be significant for the purposes which finally resolve the structure of all accounts. I refer to the measurement of periodic income and the measurement of wealth."<sup>1</sup>

6. Whilst no one would question the superior necessity for accounts of legal entities, especially where creditor claims are important, the domestic outlook of a holding company and its substratum companies is very similar to that of one company operating a number of branches. The several activities are centrally organised, and policy depends upon

<sup>1</sup> *Accounting Principles*. An address given on 15th September, 1951 at a course for Incorporated Accountants in Caius College, Cambridge.

control. In such circumstances it cannot be denied that group measures of income and wealth are both significant and informative.

7. Where a group of companies is conducted as one economic entity by one management, the members of the legal parent should have some means of judging the financial strength and income-earning ability of the group. Intelligent members of the parent company, and interested spectators of the group's affairs, will require more information on underlying undertakings than is commonly to be found in a balance sheet item described as "investments in subsidiary companies." An adequate view of a group situation requires, at the very least, some assessment of the aggregate make-up of operating assets and monetary claims.

8. The technical details of company accounting consolidations are well known to accountants and do not require precise treatment here. What does need emphasis is the requirement of uniformity. A really meaningful system of aggregates can only be achieved if the underlying details are set up in forms dictated by uniform standards of clarity, sequence, order and method. Both aggregation and consolidation presuppose accounting as a complete, consistent and logical system of record and measure as related to a defined period of time. On the practical plane of accounting mechanics it was Mr. T. B. Robson who remarked that: "The preparation of consolidated accounts is greatly assisted by the adherence of all companies in the group to a uniform classification of accounting items and a standard accounting practice. The issue to all concerned of accounting instructions designed to secure conformity with this practice, not only as between companies but also as between one financial period and another, is of the greatest value. Many groups prepare monthly accounts on a consolidated basis, and the importance of having a clearly prescribed routine in such cases will be readily apparent."<sup>2</sup>

9. At this stage it is pertinent to remind you that one of the criticisms which had some part in prompting the new Companies Act in England was that reliable comment on and interpretation of published accounts was impeded by a lack of uniformity, and there is a sense in which it can now be said that the accounting provisions of the Companies Act, 1948, have established a minimum standard of uniformity in the presentation of company accounts. As we have also seen, there is an impelling constraint which requires us to put together component accounts in like form and content for a like period of time, if resultant consolidated accounts are to have any real significance. Consistency is, therefore, a matter of principle which applies as much to measurement as to form. "If accounting measurements are to be objectively reliable, then accounting methods must be consistently employed. There should be no room for anything that is unnecessarily arbitrary. Consistency safeguards accounting measurements from both the errors of whim and fancy, and from premeditated misrepresentation, but much care and attention must be given to the choice of methods which exemplify this principle if we are to penetrate through to its universal sanction in times of qualitative and quantitative changes.<sup>3</sup> I shall have more to say on this matter when we

<sup>2</sup> Consolidated and Other Group Accounts by T. B. Robson, p. 37 (Gee and Co. (Publishers) Ltd. Second edition, 1950).

<sup>3</sup> Cf. My address on *Accounting Principles* given on 15th September, 1951 at a course for Incorporated Accountants in Caius College, Cambridge.

come to consider the valuation problems implicit in the presentation of accounts.

10. Although I have expressed an unhesitating preference for the presentation of consolidated accounts it must not be thought that there are no reservations. Thus "one company which is strong financially may be used as a cover for another company which is on the verge of insolvency." Again, "it frequently happens that large-scale undertakings are conducting different types of business, in which case any consolidation of accounts should be reasonably analysed to show the position of each type of industrial activity."<sup>4</sup> Moreover, there are cases in which consolidation is impracticable, and although I do not wish to be led into an exhaustive treatment of these reservations, I should like to quote the following two paragraphs from Mr. T. B. Robson's book on *Consolidated and Other Group Accounts*.

"It seems almost superfluous to say that group accounts need not deal with a subsidiary if the directors of the holding company are of opinion that this is impracticable. If the necessary information is not obtainable because, for example, a state of war or civil strife exists, or because there is no basis upon which the foreign currency assets, liabilities and earnings can be converted into the currency in which the group accounts are presented, clearly the group accounts could not deal with that information, and no legal obligation could alter this inescapable fact."

"It is for the directors of the holding company to decide whether consolidation of any subsidiary's figures is practicable; they have, therefore, a reasonable business discretion in the matter. They should, however, bear in mind that the word 'impracticable,' in the legal sense in which it is necessarily used in the Companies Act, has a meaning closely akin to 'impossible.' The word is not to be interpreted in the sense of 'troublesome' or 'inconvenient' in which it is often used loosely in conversation."<sup>5</sup> Plainly there are some qualifications to the presentation of consolidated accounts when it comes to laying down statutory requirements.

11. Before I pass on to discuss the background of opinion which culminated in the British Act of 1948 I should like to remark, as a matter of history, on the surprising absence in the 1908 Act of any obligation to report in a prospectus on either the past profits or the net assets status of a company which invites the public to subscribe for its shares. I know it was once an old practice to state in a prospectus the average profits of a preceding range of years. Nevertheless, as my present audience especially will know, average figures can be very misleading and open to serious misinterpretation when projected into the realm of probability. Moreover, profits want defining, and I hold the view that any expectation based upon a past trend requires an explicit statement of the elements in the trend. The trend itself must be sufficiently long to be indicative of the immediate future, and consistency of measurement is quite fundamental. I should, therefore, expect to find these matters dealt with as statutory rules in any company legislation bearing upon the statement of profits in a prospectus. The need for a disclosure of net assets is obvious and can hardly require further explanation here.

<sup>4</sup> Design of Accounts. Third edition by F. Sewell Bray and H. Basil Sheasby pp. 8-9 (published for the Incorporated Accountants' Research Committee by Oxford University Press, 1949).

<sup>5</sup> Op. cit., p. 20.

12. The British Act of 1929 tidied up some of the deficiencies in the 1908 Act, but there were still gaps if the law was to be brought into line with the enlightened opinions of society. It was not surprising, therefore, when in June, 1943, a committee was appointed "to consider and report what major amendments are desirable in the Companies Act, 1929. . . ." This committee reported in June, 1945.<sup>6</sup> It was satisfied by the evidence that the great majority of limited companies, both public and private, were honestly and conscientiously managed. It was also made clear that the system of limited liability companies had been and was "beneficial to the trade and industry of the country and essential to the prosperity of the nation as a whole." The committee considered "that the fullest practicable disclosure of information concerning the activities of companies" would lessen opportunities for abuse "and accord with a wakening social consciousness." I regard this emphasis on disclosure as important, and I particularly ask you to mark the reference to a wakening social consciousness.

13. The introductory part of the Cohen Committee report gave a useful summary of those matters to which public attention had been drawn since the Act of 1929 came into force. These were dealt with under the headings of (a) Prospectuses, (b) Private companies, (c) Nominee shareholdings, (d) Accounts, and (e) Control. As company accounting is the subject of my talk, I hope you will bear with me if I quote in full what the committee said about accounts.

"The present legal requirements as to the contents of the accounts to be presented to shareholders are too meagre. The practice of showing a number of diverse items in one lump sum, and thereby obscuring the real position as to the assets and liabilities and as to the results of trading, makes it difficult and often impossible for a shareholder to form a true view of the financial position and earnings of the company in which he is interested. While auditors have tended to press for standards in advance of the requirements of the present law, it has been suggested that their hands would be strengthened if the law were to accord more nearly with what they regard as the best practice."<sup>7</sup> You will especially note that these observations applied to the accounting provisions of the Act of 1929, which were nothing like so slender as those of the Act of 1908.

14. I know that you have been mercifully free from major financial scandals, and I suspect that questions of accounting disclosure to prevent abuse do not weigh heavily with you. Nevertheless, it is still my view that there is everything to be gained by producing accounts which give a clear and orderly picture of the activities of enterprise. Accurately designed and informative accounts make for greater effectiveness; they help those co-operating in economic activity to understand their own contributions to income generation; they assist economists and others to overcome those difficult social and economic problems which always press hard upon the heels of enterprise, and in a country which is developing manufacturing enterprise they should attract much-needed capital to efficiently-run concerns. In the last resort increasing standards of living only result from increasing real product, and increasing real wealth accumulations made possible by

<sup>6</sup> Report of the Committee on Company Law Amendment. London. H. M. Stationery Office, June 1945, Cmd. 6659.

<sup>7</sup> Op. cit., paragraph 7 (d), p. 8.

saving part of that product. National aggregates of this order are but the sum totals of individual entity contributions, and whether that entity be a small farm or a major public company, those responsible for its management can only intelligently increase its level of productivity if they know with some accuracy what has so far been achieved. Expectations should be founded on clear and open accounts of the past. I agree that accounting cannot take the place of fertility in resource and imagination, but I do think that it can and does point out salient economic elements of strength and weakness. In this way it helps entrepreneurs to realise a "capacity for imposing their authority on their organisation and of persuading others to entrust them with the resources necessary for new ventures."<sup>8</sup>

15. The Cohen Committee was interested in the financial implications of company accounts. The primary purpose of published company accounts is to convey adequate financial information in a form that can be assimilated by shareholders and creditors, and apart from a few inevitable tangles of accounting mechanics the British Act of 1948 has secured this end. Nevertheless, I feel that other purposes are slowly but inevitably coming into view. For example, the Cohen Committee considered suggestions framed with the object of relating accounts to general economic policy. Although I must confess to some disappointment at the line taken, I think it is instructive to look at what the committee said on this most forward-looking topic. I quote from the report: "We have also considered suggestions that, to assist those responsible for framing general economic policy, companies should be required to disclose in their accounts details of sales, expenses of production, selling and distribution, administration and management and other like details. In our view, however, such information could not be given in sufficient detail to achieve the object in view without loading the published accounts, of which the primary purpose is to convey financial information in a form that can be assimilated by shareholders and creditors, with so much detail as to fail in that purpose. We consider that information required for general economic purposes would be more appropriately and conveniently obtained through some such machinery as the Census of Production Act, under which information could be required in greater detail than would be practicable in published accounts."<sup>9</sup>

I do not myself feel that it is impossible to give information without overloading published company accounts. It is my view that a simple form of presentation can be devised which could be readily assimilated by shareholders and creditors, and set in a style which would also assist those responsible for framing general economic policy. As I said in my book on *The Measurement of Profit*: "In the circumstances of the times it may well be that the machinery of the Census of Production Act is the better instrument to the fulfilment of national economic enquiries, but even such an instrument is not free from the immediate requirement of adaptation to the growing technique of Social Accounting."<sup>10</sup>

16. I would now like to deal with the accounting material which seems to me to be appropriate to the requirements of an ideal Com-

<sup>8</sup> C.f. Professor G. C. Allen's address to the British Association (*Economic Journal*—September, 1950).

<sup>9</sup> Report of the Committee on Company Law Amendment, paragraph 97 (H. M. Stationery Office, June 1945).

<sup>10</sup> Oxford University Press, 1949, p. 46.

panies Act. I seek to outline a simple form of accounts which will meet all financial disclosure needs and at the same time make available useful and meaningful economic information. It is my own point of view that the two general economic concepts of periodic income and of wealth are central and quite fundamental to the practice of accounting. Income, as most of us know, is devoted to consumption expenditure and saving, while at bottom wealth implies a store of real assets.

17. In a paper which I gave to the Australian Congress on Accounting at Sydney in November, 1949, I dealt with the influence of economic ideas on the formal statement of accounts and the principles of accounting measurement. I drew attention to the fact that a substantial part of the subject matter of economics is now brought under discussion and explained by reference to national aggregates of income and expenditure and their interrelation. I tried to explain in that paper that the problems which confronted economists in the applied field of income and expenditure studies necessitated certain empirical constructions and I put forward the claim that these constructions attained reliable proportions only when they were made to fit into the self-checking pattern of a double-entry system of accounts. I also suggested that this pattern must conform to certain primary economic concepts. As economists, and probably some accountants will know, these primary concepts in their simplest form are independently related in a closed economy in two ways. Thus, if we adopt the symbols—

	I	=	Income or Product
	C	=	Consumption
	S	=	Saving
	AF	=	Asset Formation
then	I	=	C + S
and	S	=	AF

It will be recognised that these are the Keynesian identities of any accounting structure relevant to a nation's transactions. It is my view that these primary economic concepts as formally related give birth to a series of fundamental accounts which are just as relevant for firms or companies as for the nation as a whole. In fact, I would want to suggest that they are not only fundamental but universal as well, and that they constitute the key to all accounting designs. It should not be difficult to see that income is equal to consumption expenditure plus saving and that fundamentally saving is resolved in asset forming, or (as most accountants will prefer) capital, expenditure which constitutes addition to wealth. The series of related accounts, which taken together seem to me to constitute a formal principle of accounting design, may be expressed in the following manner. There should first be an account measuring periodic income, thereafter an account is required to show the transfer and disposition of that income; a third account is wanted to explain the application of retained income or saving, its effect upon wealth, and capital changes. A fourth and final form of accounting presentation is required to measure and portray those resources which together make up the wealth of an entity. Although accountants have been very largely placed at some distance from economic ideas, nevertheless they have come very near to using this type of structure. Thus, if I

choose to rely on the terminology of accounting usage and relate it to a business enterprise you will recognise a profit and loss account, an appropriation account, a capital reconciliation statement and a balance sheet. In a series of lectures which I gave to the Australian Universities in 1949 I used the descriptions Operating or Activity, Income and Outlay, Resting, and Capital or Balance Sheet, but I did this for the economic reasons which I there assigned to them. Nevertheless, you will see that the formal pattern is much the same for whatever entity we choose to account for, whether it be a nation or a firm.

17. It is the function of a profit and loss account to assess the operating income of business activity. In America the same account is more commonly described as the Income Statement. In my opinion this is a title which should not be disregarded. In recent years both the profit and loss account and the income statement have undergone some modification. In England it is probable that some impetus was given to this development by the Kysant case, which did much to draw attention to the desirability of disclosing the operating earnings of public companies. It also brought into prominence the unsatisfactory nature of undisclosed reserves. The Committee on Company Law Amendment specifically recommended that the profit and loss account should give a true and fair indication of the earnings or income of the period covered by the account, and that it should disclose any material respects in which it included extraneous or non-recurrent transactions or transactions of an exceptional nature. This recommendation further provided "that if in any such period a material change was made in the basis on which the account or any item therein was calculated, attention should be called to the change and to the effect thereof by way of a note on the account."<sup>11</sup>

18. It seems to me that these recommendations are significant; they indicate a new trend in accounting thought, the general tenor of which is marked by a design which first lays emphasis on operating activity. Thus, the operating section of the profit and loss account should draw attention to the result of the economic activity of an enterprise. As is well known, at the present stage of accounting technique this account is prepared in terms of a monetary dimension based on historical costs and historical revenues. For my part I should prefer a measure of operating profit or loss which did, in fact, encompass the effect of changes in the value of money in so far as these can be specifically related to adjustments for depreciation and the valuation of inventories, but I will comment rather more fully on these questions shortly. The operating section of a company's profit and loss account should be related to the main objects and purposes for which the company was constituted. Many companies are also engaged in other subsidiary activities which themselves yield profits or losses apart from the main activity. These subsidiary profits or losses should be calculated and portrayed by means of separate and subsidiary operating accounts. Thus, the first part of the appropriation account ought to receive the main operating profit or loss of the company and be followed by the subsidiary profits or losses arising from its lesser activities. It should thereafter pick up the non-operating incomings and outgoings of the company on current account. These are entries very largely financial in character, as in

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<sup>11</sup> Report of the Committee on Company Law Amendment, p. 61.



the common example of a transfer income denoted by the entry "dividends and interest on security investments." In this way we should arrive at the total income of the company.

Thereafter we should also expect to find in the appropriation account these extraneous, non-recurrent or exceptional items which are considered relevant to the results of the period. I feel that a break should then be made in the appropriation account to show the manner in which the total income of the company (derived from all sources) is devoted to taxation and dividends, thereby resulting in a balance which is equivalent to the undistributed income or saving of the period. It might be well to make a further provision for the publication of such abnormal credits or charges as turn out to be related to previous periods and to show any withdrawals from reserve in the form of past accumulated savings covering current distributions. In one sense, however, such items are more appropriately dealt with in a capital reconciliation statement or, as I should prefer to call it, a resting account.

19. *Design of Accounts*, a Research Committee publication of the Society of Incorporated Accountants, which first appeared in 1944, recommended that "published company revenue accounts should give a clear statement of operational profit, of non-operational items of income and expenditure, of provisions to meet liabilities defined as to time of accrual, of transfers to or from reserves clearly enunciated as such, and of the appropriation of residual balances." In this book it was also suggested that every effort should be made to show the manner in which the true operating profit was built up, and the statement was made that "accurately analysed revenue figures constitute a test of management, and in the case of published revenue accounts the share of each factor in production should be disclosed, as well as the net amount available for the owners."

20. These developments have been partially given the force of statutory provision in the English Companies Act of 1948 with its requirements that "every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year"<sup>12</sup>; and that "there shall be shown: (a) the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets; (b) the amount of the interest on the company's debentures and other fixed loans; (c) the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing where practicable between income tax and other taxation; (d) the amounts respectively provided for redemption of share capital and for redemptions of loans (e) the amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves; (f) . . . the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof; (g) the amount of income from investments, distinguishing between trade investments and other investments; (h) the aggregate amount of the dividends paid and proposed."<sup>13</sup>

<sup>12</sup> Section 149 (1).

<sup>13</sup> Eighth Schedule 12 (1).

Moreover, the following matters are required to be stated by way of a note to the profit and loss account, if not otherwise shown: “(2) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be. (3) The basis on which the charge for United Kingdom income tax is computed. (4) Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax. (5) . . . the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account. (6) Any material respects in which any items shown in the profit and loss account are affected:—

(a) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

(b) by any change in the basis of accounting.”<sup>14</sup>

We notice by way of comment that much emphasis is placed, and in our view rightly placed, on exposing to view a class of transaction which is related to the non-operating part of a company's income. It is good that there shall be a growing social consciousness of the necessity for reasonable disclosure in the publication of company accounts. Nevertheless, as I commented in my book on *The Measurement of Profit*: “With such a marked stress on the one part of a company's current account in the interests of shareholding proprietors, it cannot but strike the impartial observer as a little odd that no such requirements have been thought essential to cover the highly significant make-up of a company's operating account, more particularly when we come to regard the evident importance attached to the separate statement (aside from what should be its logical context) of ‘amounts charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets.’ This wears an air of but half a story, and whatever the expedient arguments adduced to convince the legislature, presumably on the over-pressed score of protecting competing interests, we are sometimes tempted into feeling that at least one great opportune step to further the cause of such economic inquiries as are directed to the service of over-all financial stability has been lost by this failure to provide for a reasonable portrayal of the working account. Yet again, we may ask, what is the real objective significance attaching to the disclosure of an item of so-called profit which is, before charging or crediting a number of other operating and non-operating items, specifically required to be separately stated under the Act? By itself, whatever the purpose sought, such a figure is plainly ambiguous when judged from the standpoint of any acceptable accounting definition of operating surplus.”<sup>15</sup>

21. It behoves us to look a little more closely into the operating section of a profit and loss account, for it is in this part of the account that we measure the real income derived from economic activity. Since it is real income in money terms that we are concerned with, we must first face the valuation problems implicit in its measurement. It will be known to most of you that accounting practices, as now

<sup>14</sup> Eighth Schedule 14 (1) to (6).

<sup>15</sup> Op. cit., p. 45.

applied to the periodic measurement of business income, were conceived in a time of relative price-level stability. I think it is no exaggeration to say that persistent depreciation in the value of money has called into question, with gathering momentum, the validity of some of these practices and has reached a point which compels their re-examination. The finance required to preserve operating assets so as to maintain production is a cause of anxiety to all who are concerned with the management and efficiency of industrial enterprises. Moreover, there is a serious danger of real capital consumption which accounting practices tend to veil.

22. Depreciation of real assets is an essential constituent of the input allocation for capital in any account of operating activity to measure business income. I do not think that company legislation, in attempting to define this account, should confine itself to questions of disclosure and form without touching upon the valuation of such an imputed item as depreciation. The conventional accounting view of depreciation has been described in terms of "that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned. The assessment of depreciation involves the consideration of three factors: the cost of the asset, which is known; the probable value realisable on ultimate disposal, which can generally be estimated only within fairly wide limits; and the length of time during which the asset will be commercially useful to the undertaking. In most cases this last factor is not susceptible of precise calculation. Provisions for depreciation are, therefore, in most cases matters of estimation based upon the available experience and knowledge rather than of accurate determination. They require adjustment from time to time in the light of changes in experience and knowledge, including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset." Nothing could be clearer than this statement of depreciation accounting as commonly understood by professional accountants. It is quoted from the recommendations on accounting principles made by the Council of the Institute of Chartered Accountants in England and Wales: IX—Depreciation of Fixed Assets.<sup>16</sup>

23. This approach takes the general point of view that: "Fixed assets, whatever be their nature or the type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purpose of sale in the ordinary course of business. The amount at which they are shown in the balance sheet does not purport to be their realisable value or their replacement value, but is normally an historical record of their cost less amounts provided in respect of depreciation, amortisation or depletion."<sup>17</sup> As I have remarked elsewhere,<sup>18</sup> the accountant is necessarily concerned with the interests of proprietors, and by adopting this approach to depreciation he impliedly follows a course

<sup>16</sup> London. Gee and Co. (Publishers) Ltd.

<sup>17</sup> *Op. cit.*

<sup>18</sup> *The Measurement of Profit*, p. 67. Oxford University Press, 1949.

which looks both to the maintenance and stewardship of money capital expended on fixed assets, and the eventual recovery of all money costs out of revenues by way of the operating accounts. This practical solution, as I have already indicated, was developed during a period of relatively stable prices, and historically it is not difficult to show that it was bound up with a legal insistence on the stewardship of contributed money capital. As things have turned out it is doubtful whether this traditional accounting approach can now be supported. I am inclined to the view that we can still preserve by portrayal in company balance sheets the stewardship of contributed money capital, while at the same time providing an adequate measure of *real* profit earned in company-operating accounts. The whole question takes on a different aspect as soon as we look beyond the money capital contributed by shareholders, and dividend distributions, to the means of safeguarding productive capacity by way of the maintenance of operating or activity assets; for then we begin to see our way through to a measurement of profit which does not disregard variations in *real* resources while concentrating upon variations in monetary claims.

24. For my part, I have never properly understood what was meant by the qualification "fixed" as applied to assets. Apparently it has to be apprehended in conjunction with its sister qualification "current," and the testing decision on whether or not assets are fixed or current is resolved by applying an accounting rule which answers the question whether or not assets are held for realisation in the ordinary course of business. In the previous paragraph I quoted the statement of the Council of the Institute of Chartered Accountants in England and Wales that: "Fixed assets, whatever be their nature or the type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purposes of sale in the ordinary course of business."<sup>19</sup> I add another statement of the same Institute to the effect that current assets include "such assets as are held for realisation in the ordinary course of business." I do not myself think that the asset grouping test of realisation in the ordinary course of business is particularly fundamental. In my view entity wealth is made up of real assets and monetary claims, and the problems of accounting classification, as well as those of accounting measurement, appear in a new light as soon as we recognise the dichotomy between the real and the financial.

25. When we regard the matter from this standpoint we see that for a continuing entity it is the function of depreciation accounting to provide resources adequate to the replacement of *real* assets. Wear and tear by user, deterioration through time, and obsolescence take place quite independently of money values. Nevertheless, for the purposes of income measurement it is necessary periodically to attach some monetary value to these happenings. The orthodox accounting methods constitute a backward-looking view. They reach back to historical costs for their value assessments of current depreciation. The economic method is a more forward-looking approach, for the reason that it endeavours to measure depreciation by reference to current costs. No one can doubt, however, that the practical attempt to measure anticipated replacement costs of fixed operating assets within the period of their useful lives does present a number of awkward problems, although, as is always the case with comparatively new

<sup>19</sup> Recommendations on Accounting Principles IX—Depreciation of Fixed Assets.

conceptions, some of the difficulties are over-exaggerated. At periodical accounting dates, when the question of depreciation falls to be considered, the sensible approach would seem to require at least some reference to current replacement costs as better indicative of eventual replacement costs than original costs. This is particularly relevant in a period in which prices are steadily rising. Although it may be difficult to determine the current replacement cost of particular items of equipment, it should not prove impossible to arrive at a reasonable approximation for main groups of fixed operating assets, if necessary by reference to statistical compilations of the periodical costs of capital goods.

26. I also think it well that it should not be overlooked in times of relatively temporary variations in prices, whichever way they go, that it is better to have regard to the general trend of replacement costs rather than place too great a reliance on the last cost at the accounting date. Moreover, a situation will often arise in which an enterprise will not replace its worn-out equipment with something which is exactly the same. It may be more common to find that it will take on a new and possibly cheaper form of equipment contrived to fulfil similar functions more effectively. Much will depend upon the relevance of the immediate cost of the new asset to the original cost of the old asset, but in so far as the preservation of the money claims of the proprietors of the business is concerned, it seems clear to me that fixed asset cost recoveries by way of operating accounts should not fall below allocations based on the money expended as capital on the original asset. In this way we preserve the stewardship of contributed money capital.

In my book on *The Measurement of Profit* I have commented on the esoteric sense in which it is possible to urge that the purchasing power in real terms which was equivalent to the money cost of the original asset at the time of its acquisition should be stabilised, in which case the stewardship of contributed money capital is converted into a stewardship of real capital, and to comply with this view depreciation might be validly provided on the basis of the trend of general price levels at accounting dates.<sup>20</sup>

27. It is my view that if we are to deal properly with the accounting implications of changing money values, then we must have in front of us a clear analysis of assets on the following lines:—

- (i). Real or physical
- (ii). Intangibles.
- (iii). Monetary claims.

It is my opinion that the whole problem of changing money values as a question of accounting measurement should be limited to real or physical assets. There is a plain distinction to be drawn between measurement and policy. In my opinion monetary claims are correctly measured at their current value, but if they are inadequate to the level of activity that a particular enterprise is attempting, then as a matter of policy funds should be brought into the business either by retention or borrowing to cope with the situation. If company accounting is to be ideal, therefore, the measurement questions associated with changing money values should be restricted to real or physical assets. I quote from some comments which I made in 1948 and which I still see no particular reason to change:—

<sup>20</sup> Cf. *Measurement of Profit*. Oxford University Press, 1949, p. 68.

"The essence of the accounting problem, as related to *homogeneous* measurements of capital and income, is largely centred upon those costs applied to *real* assets (as distinct from what might be called natural financial claims), which are carried over from one accounting period to another as short-term and long-term charges against the future operations of continuing enterprises. Somehow we must strive to get the suspense entries appearing in our balance sheets which measure employed capital, on the same plane of reference. Somehow we must reasonably attempt the same thing with our profit and loss accounts which measure periodic income. Many of us are convinced that the answer lies in the virtual restatement of carried-over costs in terms of current standards of money value. The problem is not one of keeping pace with the purchasing power of money for all purposes, neither does it involve any departure from the objectively dependable basis of accounting record in terms of original costs. It is merely a question of converting those original costs, which are out of time relationship, into current costs, in order that in our statements of measurement all significant entries shall rest on a homogeneous basis."<sup>21</sup>

28. Most accountants will want to know the manner in which the analysis I have indicated above is to be applied to particular assets appearing in the balance sheets of companies. I would answer the type of question that I should expect to be raised in some such terms as the following. Intangibles, such as Goodwill, depend upon organising ability and the maintenance of income. In my opinion they have little or no value until they are in fact realised. Therefore there can be no question of maintaining goodwill by any mere device of accounting measurement. Debtors, cash and liabilities all fall within the class which I would designate monetary claims. Accordingly they do not create any problem of accounting measurement. Investments are also more or less monetary claims; nevertheless, quoted investments do have a market value. I should, therefore, like to see quoted investments stated in the balance sheets of companies at their market value, and for this purpose I would pass valuation adjustments through a Capital Reserve Account. I expect to be asked what would I do with shares in subsidiary companies. Again, I should like to see these valued on a net assets basis at each accounting date and valuation changes dealt with in much the same manner as for any other investments. I should assume from this that subsidiary company balance sheets would be consistent with that of their parent company, and so record current values. Fixed assets are usually the real assets. I incline to the view that an inventory of fixed assets should be re-priced at current costs (i.e., the costs at the accounting date) of specific assets suitably modified to eliminate temporary fluctuation due to speculative, seasonal or exceptional influences. I should have thought that most accounting entities would be able to maintain their own indices, for although it may be difficult to determine the current costs of particular items of equipment it should not prove impossible to arrive at a reasonable approximation for main groups of fixed assets. There is here a clear case for a central capital goods index. An alternative suggestion would require indices to be maintained by Trade Associations. In any case enterprises dealing

<sup>21</sup> The Accountant, 11th September, 1948.

in capital goods ought to know what the last cost is, inasmuch as this will be included in their stock valuations. On the subject of building prices, perhaps some resort might be made to revised rating valuations. It is possible that a central machinery index may be available. In any case the critical requirement is to revalue physical fixed assets at the accounting date in order to measure the amount of depreciation at the current price level which is to be charged to the operating account. In so far as technical mechanics are concerned, the re-priced cost of fixed assets, less accumulated depreciation to the beginning of the accounting period on this re-priced basis, should be compared with the original cost written down value. The difference will represent the valuation adjustment which should be passed through to the price change account, an account which, in my view, is best shown among the capital reserves. Current depreciation would then be deducted to arrive at the written down value on a current cost basis. It is my view that bygones must be bygones, and the past provisions for depreciation will only be inadequate if they have been invested in depreciated monetary claims. If this situation has arisen the deficiency should be dealt with as a policy reserve and not as a matter of measurement. I add one last point: Excess provisions arising from falling values should be taken to the credit of the operating account in exactly the same way as the difference between under provisions were debited to the same account. As soon as the credit balance on the price change account has been exhausted no further transfers should be made, and depreciation accounting will have to revert to an original cost basis if contributed money capital is to be preserved.

29. I touch on the question of inventories and I would like to repeat what I said at a recent course in Cambridge in very simple explanation of what is meant by the economic expression, "inventory profit or loss," and for this purpose I engaged in some abstractions. Assume an enterprise which begins and ends its accounting period with identical quantities of identical stocks. Assume that the bases of valuation are those of more or less traditional accounting practice (that is, first cost or lower market value), that stocks are frequently and regularly turned over in their entirety, and that the enterprise has encountered substantial short-period increases in the buying prices of its stocks. In these circumstances it should be clear to all of us that the carrying value of the closing stocks will be greater than the carrying value of the opening stocks, despite the fact that they are identical in quantity and kind. This means that the difference between the two valuations will form part of the accounting measure of profit. It is this part which is called inventory profit. I leave it to you to work out for yourselves what is meant by inventory loss.

Now, although my assumptions may seem unreal, they are not so far distant from that situation in which by far the greater part of a company's investment in inventories is virtually a fixed asset, because it is essential to the *continuation* of the company's operations at an effective level of output. You will recognise that this situation is *not* uncommon. I am myself convinced that inventory profits and losses are substantial in periods beset by noticeable price changes, and this circumstance is peculiarly relevant to those enterprises which *have to carry* heavy inventories. If selling margins happen to be low we can easily see what a disconcerting and distorting influence is

brought to bear on the accounting measurement of operating income. Moreover, as some writers never tire of telling us, an element of inventory profit is itself represented in the closing inventory valuation. Plainly this is not yet a realised profit available for *immediate* distribution; nevertheless it will almost certainly involve an increased tax liability. Again, I would like to reiterate the conclusions I came to in the course of the discussion to which I have referred. In so far as the major portion of the inventory of an enterprise *does* constitute a fixed asset necessary to the *continuation* of effective operations, it is my view that it should be classified as such in the balance sheet. In this case, it also seems to me that inventory profits or losses should be excluded from the measurement of operating income, but I add the proviso, perhaps only very exceptionally required, that a loss must be recovered by appropriation out of either previously accumulated price-change profits (the usual means), or current income, where not to do so would do anything to impair the protection of contributed money-capital implied by legal sanction. I also wish to make clear my view that where inventories can be liquidated without doing hurt to the long-run stability and operating activity of an enterprise, then there is little need to bother with inventory profits or losses, for then the inventories themselves are little more than speculative asset claims. The essence of the inventory problem resides in the fundamental distinction between fixed and speculative holdings. The measurement of current inventory costs does not present great difficulties, and there is a clear case for *pegging* opening and closing valuations in those cases where the physical content constitutes a *continuing* investment necessary to activity. Surely no one can urge that accounting practices should countenance the inclusion of unrealised windfall gains within a customary measurement of operating income. I add one further comment. A change in the design of plant output may bring additional inventories into the continuing investment category. These additions should be financed either out of savings or borrowing, because they constitute *real* asset formation. If for any reason this revised level of inventory investment is drawn upon without any conscious change in the scale of output, then provision must be made to cover its replacement in conditions of rising current costs<sup>22</sup> if continuity is to be financially safeguarded.<sup>23</sup>

30. On the mechanics of inventory valuation I do not myself greatly favour the L.I.F.O. method because of the balance sheet undervaluation which this involves. In point of fact I favour a method of maintaining the lower of opening and closing stocks. This will allow stock reserves, debits or credits, to be passed through the profit and loss account according to the difference between the pricing out of opening and closing inventories. Alternatively I would rehabilitate the method of base stocks. In either case the intention is to remove inventory profits or losses.

31. Having dealt with the valuation issues affecting the revenue accounts of companies, I would now like to pass on to the general question of the form of company accounts. I start with the operating section of the profit and loss account, and would like to declare from the outset my view that there is no particular merit in limiting this

<sup>22</sup> Equivalent to current costs less liquidated carrying cost.

<sup>23</sup> Cf. "Accounting Principles." Vol. 2, No. 4, Accounting Research. October, 1951, pp. 259-361.



account to a statement of the trading profit to be more or less adjusted by a number of items calling for special disclosure. The best of the public corporations in America have long ago discarded this approach and, in point of fact, they are only too anxious to give details of their turnover and other operating incomings as a sign of their effectiveness. Equally they are prepared to disclose the main details of their operating outgoings. It is my view that a simple operating account could be designed in primary terms to give the major part of the information which anybody is likely to require from company accounts. Most of you will be familiar enough with its traditional form and I do not think there is any great necessity to lay it out again here. What I would like to see is a redesigned form to give a reasonably clear idea of the output value added by a company as achieved through its input allocations of labour and capital. I incline to the view that a redesigned operating account in the manner I am about to put forward to you would give the operating profit arising from the particular piece of economic activity undertaken by the company—a most important figure for everyone concerned. Although simple in structure, I think it is an account which can be made to fit in with all reasonable disclosure requirements. I set it out below.

OPERATING ACTIVITY:	
INPUT ALLOCATIONS	OUTPUT VALUE ADDED
<b>I. LABOUR</b> —Wages and salaries and social insurance contributions. <ul style="list-style-type: none"> <li>(i) Director or operative ... .. x</li> <li>(ii) Ancillary ... .. x <u>x</u></li> <li>(iii) Selling and distribution ... .. <u>x</u></li> <li>(iv) Administration and management ... .. x x</li> </ul>	<b>I. NET SALES</b> of goods and services† ... .. x  <b>II. MINUS</b> net purchases of goods and services varying with output‡ ... .. x — x  <b>III. CHANGES</b> in inventories§ ... .. x — x
<b>II. CAPITAL</b> <ul style="list-style-type: none"> <li>(i) Rents (imputed or actual)               <ul style="list-style-type: none"> <li>1. Factory ... .. x</li> <li>2. Warehouse and salesroom ... .. x</li> <li>3. Office ... .. x <u>x</u></li> </ul> </li> <li>(ii) Depreciation of <i>real</i> assets, measured in terms of end-period prices* ... .. x</li> <li>(iii) Interest on <i>real</i> assets (excluding buildings), employed during the period of account, and measured in terms of end-period prices ... .. x x                —                x</li> </ul>	<b>IV. MINUS</b> net purchases of goods and services related to productive facilities, <i>not</i> varying with output ... .. x
<b>III. OPERATING SURPLUS</b> ... .. x — x	<b>Total Value Added</b> ... .. x

**NOTES:**

\*I am aware that this conceptual measurement involves serious practical difficulties.

†After deducting returns, allowances, discounts and bad debts.

‡After deducting returns, allowances and discounts. Indirect taxes are included in purchases.

§Subject to valuation adjustments.

¶Net Purchases of Goods and Services. A separate indication might be required of provisions to meet liabilities for goods and services, not determined at the accounting date with substantial accuracy.

The Input allocation under the heading of Administration and Management might require specific separate disclosures in respect of the remuneration and benefits of directors.

32. You will at once notice that, so far as traditional accounting practice is concerned, this form is revolutionary. It is not so revolutionary to economists, since it brings out the concept of value added by the organisation and utilisation of production factors in operating activity. As you will know, this concept is a familiar feature of census returns. It is a concept which is readily susceptible to accounting treatment. Purchases of goods and services adjusted for changes in inventories (a device for carrying over unmatched costs from one accounting period to another), when brought within the net of the operating activity of a period of account, are transformed into sales of goods and services at the values placed upon them in the market. Nevertheless there is one major problem which has to be faced in giving accounting significance to the value added concept. I have already touched upon inventory profits or losses which are of the nature of windfall gains and losses bearing no direct relation to operating activity. In addition there are other windfall gains and losses. As you will know, these are usually the outcome of marked changes in those prices which directly affect the purchases or sales of goods and services entering into the calculation of the product of activity. If we are relating the value added to the factor costs of activity, then these are windfall profits or losses which should be removed and dealt with separately in the appropriation account. It is probable, however, that this would make for too many complications in ordinary company accounting. I therefore suggest that, as a start, we should consider the form I have proposed—deal with depreciation on a current cost basis and maintain inventories at their *real* level. Operating profit is itself a test of effectiveness, since it measures the difference between the value added by reason of the company's activity and the total inputs of labour and capital which it has engaged to secure that added value. Efficiency ratios using operating profit suggest themselves in the following terms:—

1. Operating profit as a function of the current value of the *real* assets employed in the activity.
2. Operating profit per unit of output.
3. Operating profit as a function of total input factor costs.
4. Operating profit as a function of the product (i.e., the value added).

33. It will be noticed that, under the heading of Capital, we meet a rather unusual entry for interest on real assets employed during the period of account, measured in terms of end-period prices. The intention behind this entry is to cover the economic conception of profit in the limiting terms of the reward of risk-bearing and organisation. The reward of management is properly looked upon as a labour input. The interest on borrowed money is excluded from operating debits on the grounds that it properly forms part of the interest on capital employed. It seems, therefore, that there is much to be said for an accounting disclosure which reflects the economic distinction between the reward of capital and the reward of risk-bearing and organisation. As a first start to the statement of this view, interest on borrowed money is relegated as a purely financial transaction to the Appropriation Account. In order that the measurement of operating profit should conform to its economic conception it is necessary to put through a debit for interest on real assets employed in the operating account and to carry an equivalent credit into the

**Appropriation Account.** In this view the interest charged is related to the real assets employed in the working of the company. I know that there are difficulties in the way of determining the rate. Even so I should not have thought it was too great an approximation to use a rate equivalent to the average yield on the market values of gilt-edged securities at accounting dates.

34. I append a form of Appropriation Account. You will see that it is the purpose of this account to measure the retained income of a company after bringing to account its financial incomings and disposing of its financial outgoings. The income of the entity is then subject to transfers in respect of direct taxation and dividends. The retained income of the period is brought down to the second section of the Appropriation Account, in which transfers to and withdrawals from reserves and provisions also appear. By bringing in the retained income at the beginning of the period we finally arrive at the retained income to be carried forward to the next period; this is a revenue reserve item appearing in the balance sheet. It is the purpose of the Appropriation Account to measure the company's total income from all sources, to deal with the amount of its income which it is required to transfer away (a) by means of taxes and (b) by means of dividend distribution to shareholders, so as to arrive at the retained income of the period of account. The second part of the account merely deals with certain disclosure provisions in relation to reserves and shows the accumulated saving of the company.

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**APPROPRIATION ACCOUNT:**

<p>I. Interest on borrowed money ... ..</p> <p>II. Direct income taxes ... ..</p> <p>III. Dividends paid and proposed ... ..</p> <p>IV. Retained income ... ..</p>	<p>I. Operating profit ... ..</p> <p>II. Interest on real assets employed ... ..</p> <p>III. Income from investments ... ..</p>
<p>V. Transfers to reserves ... ..</p> <p>VI. Retained income carried forward to next period ... ..</p>	<p>IV. Retained income of the period ... ..</p> <p>V. Withdrawals from reserves and provisions ... ..</p> <p>VI. Retained income brought forward from last period ... ..</p>

35. Information on the source and use of industrial finance would be greatly facilitated if companies could be induced to publish a summary account of their capital incomings and outgoings, much as the best companies do in America. It would also explain balance sheet changes. I use the technical name by calling it a resting account and suggest the following form:—

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**RESTING ACCOUNT:**

CAPITAL OUTGOINGS:	CAPITAL INCOMINGS
<p>I. Real asset formation (including changes in inventories) ... ..</p> <p>II. Movements in deferred assets ... ..</p> <p>III. Lending ... ..</p> <p>IV. Net purchase of existing securities ... ..</p> <p>V. Changes in current net indebtedness ... ..</p> <p>VI. Changes in monetary balances ... ..</p>	<p>I. Retained income ... ..</p> <p>II. Depreciation of real assets and other internal operating provisions ... ..</p> <p>III. New capital ... ..</p> <p>IV. Borrowing ... ..</p> <p>V. Movements in deferred liabilities ... ..</p>

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36. I turn to the balance sheet. As I have said before, I regard this document as the accounting means of employing certain valuation conventions to measure entity wealth, capital and reserves, net worth, or whatever expression you choose to select for what is nothing more than a measure of capital. In a general sense the fundamental and ultimate purpose of a balance sheet is to measure capital and to show its set-up in the form of integral aggregates of assets and liabilities. Whilst it is important to indicate ownership claims on capital, they are secondary to its primary measurement. In the context of the valuation concepts I have already discussed, this would require that real assets were brought into account at balance sheet dates on the same basis as current assets, i.e., at their current costs at the accounting date. It is probable that this view of the matter is as yet too advanced for company legislation, and while I have indicated my preference for a measurement of profit which carries in depreciation on a current cost basis and which maintains the physical content of inventories, I would not necessarily commit myself to the logical view of the balance sheet as a measurement of capital, in the sense I have indicated, in interim company legislation. I would think that greater advances had been made if income was correctly measured. I would then regard the balance sheet as a document to illustrate the stewardship of contributed money capital and savings. Such increased amounts of depreciation over original cost as the measurement of real profit would require, together with stock reserves, I should prefer to deal with in a price change account to be included in the balance sheet reserves. Accountants usually denote the money valuation contents of an ordinary balance sheet in terms of what they are accustomed to regard as a fundamental equation of accounts. It is explained in simple terms, as follows:—

Real Assets, plus Asset claims, minus Liability claims, equals Capital. This points to a fundamental classification in forming the structure of all balance sheets, which needs emphasising. It brings out the pivotal significance of monetary claims for the process of consolidation and it isolates a measure of real wealth. Asset and liability claims can be conveniently brought within the categories of long term, short term and deferred. Real assets will ordinarily comprise the fixed assets of accounting terminology and inventories. I would, therefore, like to deal with fixed assets in terms of:—

1. Real or physical assets.
2. Deferred expenditure benefiting the activities of future accounting periods.
3. Intangible assets.
4. That part of the inventories of the company required to ensure the continuation of its effective operations.

The balance of the inventories may be regarded as speculative and included as a monetary claim in the short-term department of those claims. All other balance sheet aggregates are virtually financial and, as I have already said, these are conveniently and concisely categorised as long term, short term and deferred. Whatever additional disclosure items may be required, either by statute or otherwise, I have a preference for such descriptions of claims, whether asset or liability; they seem to me simple, clear and universal. I therefore suggest the following form of balance sheet adapted to a

minimum of disclosure requirements which legislation may regard as necessary :—

BALANCE SHEET	
<p><b>I. AUTHORISED CAPITAL (detailed)</b></p> <p><b>II. ISSUED CAPITAL AND CAPITAL RESERVES.</b></p> <p>1. Issued (detailed) ... .. x</p> <p>2. Capital Redemption Reserve Fund ... .. x</p> <p>3. Premium Accounts ... .. x</p> <p>4. Price Change account ... .. x</p> <p>5. Capital reserves ... .. x</p> <p>... .. -</p> <p>... .. x</p> <p><b>III. REVENUE RESERVES AND RETAINED INCOME</b> ... .. x</p> <p>... .. - x</p> <p><b>IV. LONG TERM LIABILITY CLAIMS (with a separate disclosure of those which are secured)</b> ... .. x</p> <p><b>V. SHORT TERM LIABILITY CLAIMS AND PROVISIONS (with a separate disclosure of that part which is secured).</b></p> <p>1. Short term borrowing ... .. x</p> <p>2. Creditors and accrued expenses ... .. x</p> <p>3. Provisions ... .. x</p> <p>4. Proposed dividends ... .. x</p> <p>5. Current tax liabilities ... .. x</p> <p>... .. - x</p> <p><b>VI. DEFERRED LIABILITIES</b> ... .. x</p> <p>... .. x</p>	<p><b>I. FIXED ASSETS.</b></p> <p>1.— (i) Real or physical ... .. x</p> <p>(ii) Minus accumulated provisions for depreciation ... .. -</p> <p>... .. x x</p> <p>2. Deferred expenditure benefiting the activities of future accounting periods ... .. x</p> <p>3. Intangible ... .. x</p> <p>4. Standard inventories ... .. x</p> <p>... .. - x</p> <p><b>II. LONG TERM ASSET CLAIMS.</b></p> <p>1. Investments (with a separate disclosure of trade, quoted, and unquoted investments) ... .. x</p> <p>2. Lending (with a separate disclosure of loans to employees, directors or officers) ... .. x</p> <p>... .. - x</p> <p><b>III. SHORT TERM ASSET CLAIMS.</b></p> <p>1. Speculative inventories ... .. x</p> <p>2. Debtors ... .. x</p> <p>3. Bank and Cash balances ... .. x</p> <p>... .. - x</p> <p>... .. x</p>

### NOTES.

1. Particulars of share options.
2. Arrears of fixed cumulative dividends.
3. Charges on the Company's assets to secure other people's liabilities.
4. Contingent liabilities.
5. Estimated capital expenditure commitments.
6. Market value of quoted investments.
7. Basis of conversion of foreign currencies.

It might be convenient to classify the real or physical assets under the sub-heading of structures and equipment.

37. The balance sheet should be signed by at least two directors and I should prefer to see the auditors' report adapted to the new British form. For the sake of completeness I give an example of it :

" We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes

of our audit. In our opinion proper books of account have been kept by the Company so far as appears from our examination of those books. We have examined the above balance sheet and annexed profit and loss account which are in agreement with the books of account. In our opinion and to the best of our information and according to the explanations given to us the said accounts give the information required by the Companies' Act, 1948, in the manner so required and the balance sheet gives a true and fair view of the state of the Company's affairs as at ..... and the profit and loss account gives a true and fair view of the (profit/loss) for the year ended on that date."

Whenever possible in the accounts the corresponding figures should be stated for the immediately preceding financial period. I hope I have succeeded in indicating such a design for published company accounts as will portray the best part of that information which shareholders, creditors, economists, statisticians and the general public may require from them.

38. If I may, I should like to close the provocations implicit in this paper on a forward note. You will remember I remarked earlier on that in the long run there is little lost but much gained by disclosing the economic status of those organised entities which substantially contribute to the wants and add to the wealth of enlightened nations. This view springs from a conviction that our understanding of the mechanics of economic stability at a high level of activity must, in part, depend upon a study of empirical measures. Accounting provides some of these measures. These accounting measures, in their turn, should arouse reflections upon interpretations which pass beyond the boundaries of measurement in subordination of quantity to quality. It is at this point that the accountant and the economic statistician conjoin.

## DISCUSSION.

*Mr. J. C. M. Eason.*—The paper read to-night raises a number of questions regarding company accounts. Mr. Bray indicates, but does not in fact keep them separate, two aspects which he denotes as (a) financial and (b) economic according to their interest for (a) shareholders and creditors, (b) statisticians, economists and the general public (presumably politicians). He links them together in the first paragraph "Company accounts which disclose clear reports of stewardship have beneficial social implications. Company accounts . . . are sources of vital statistical information. . . ." and in paragraph 38, at the close, he refers to "information" which those groups noted as (b) (above) may require from them (i.e., accounts).

If we refer to page 6, paragraph 15, we find that the Cohen Committee ruled that what was wanted by (b) group should be gathered by an *ad hoc* inquiry on the lines of other census inquiries. Mr. Bray advances no reasons for rejecting this opinion. For my part I am sure that figures required for one object cannot safely be used for a different purpose and a "Dual-Purpose-Account" would be a weak tool to depend upon—it would suit neither group.

Moreover, it leads to a demand that "private" companies should be no longer private: that raises questions not examined by Mr. Bray, and in our economy where there are over 5,000 "private" and only 350 "public" companies it becomes of great importance. Here the disclosures needed to provide data for economists, etc., would have undesirable results for all the small (the average paid up capital is £9,000) companies since their affairs would be the subject of disclosure and those of the partnership or single trader remain hidden. I can imagine that throughout the country this suggestion would meet with intense opposition, and I think rightly so. The Cohen Committee recommendations supplies the answer.

The other aspect of accounts is mainly covered in the references to valuation of assets, and many of the purely accountancy problems are not discussed.

The general conception of a "strait jacket" style for all company accounts prevails with Mr. Bray, but here again there is a conflict between public and private accounts, and even in the public group it would possibly create difficulties. The urge to achieve apparent uniformity in figures at the cost of concealing real differences in meaning is not to be encouraged.

On the question of "asset" valuation Mr. Bray is too easily satisfied: there would be little reality in a process of valuation by index numbers if applied to each individual firm, where the component parts, in fact, are different.

Valuations of inventories is dependent, according to Mr. Bray, on the distinction between "fixed and speculation holdings": in truth there is hardly any item of stock which is not speculative in value and until sold no one can attach to it a "real" value.

As regards stock and debts—these are "liquid" for "winding up" purposes but for a going concern they are relatively "fixed" as compared with investments since they should vary with trading volume but clearly not as "fixed" as buildings, plant, etc.

I pass to the subject of reserves: all my experience has been in favour of the need for, and value of, hidden reserves. I have had testimony over a long period to the danger of shareholders demanding dividends imprudently, of optimistic individuals spending profits rather than conserving them: get an optimist to sell your goods and a pessimist to draw up your balance sheet is a sound rule: I certainly have seen harm done by undue optimism and success achieved by caution.

Perhaps Mr. Bray would reconcile for me an apparent contradiction in the Cohen report, which approves non-disclosure by banker and insurance companies (rightly so in my judgment) despite the recommendation for public companies that a full disclosure of facts makes for sound public opinion on the value of their assets.

The basic error lies in the judgment that the figures concealed are "real" whereas they are subjective opinions on future economic trends made by those in charge of an individual company's prospects: custom has ruled that for convenience there should every year be some general appraisalment of a firm's financial position: this has led to a belief that the appraisalment reflects reality.

*Mr. A. Pakenham-Walsh.*—What is the advantage of the term “asset formation over investments”? There is a danger that asset formation will be interpreted as not including changes in inventories whilst Keynes’ notion of investment did. Can we not use the term “investment” for the acquisition of tangibles and the word “saving” (or dis-saving) for the resting of assets in money claims, including Stock Exchange securities? In aggregating the assets of enterprises in an economy it is the tangibles only which count, since money claims cancel out.

Also  $S=I$  in an after-event sense only because the provisions for depreciation do not match in amount the expenditure on equipment.

The ideal for accounting is a base in fundamental economic concepts.

I express my preference for a general price index on the ground that a higher index for constructional items would tend to drive purchasers away from these items rather than replace worn-out equipment with them.

*Dr. R. C. Geary.*—Mr. Sewell Bray’s presence here this evening is for me the realisation of a hope which I entertained since we were together as Senior Research Fellows in the Department of Applied Economics in Cambridge University six years ago. I might say that we were foundation members of that institute, and we both must rejoice that, at the age of six, it is showing every sign of lusty growth.

Speaking as a statistician I naturally strongly endorse the lecturer’s suggestion that business accounts should be presented in a uniform way, and I have a great liking for the form which he has suggested. It is of interest to hear his proposals endorsed by so eminent an accountancy authority as Mr. Shott. Mr. Sewell Bray has an international reputation as an authority on national income social accounts, and it is highly significant that the form which he proposes for business accounts is just that which would be useful to the official statistician for the compilation of social accounts. This is the more interesting for the fact that I am quite sure that the lecturer, as a professional accountant, approached his problem, not from the viewpoint of national statistics, but having in mind the requirements of the business profession. In the Presidential Address, which I had the honour to present to this Society six years ago, I remarked that “I was brought up in the tradition that accountancy was one thing and statistics another, but accounts and statisticians are now beginning to meet on the plane of national income statistics”. In the person of Mr. Sewell Bray the reconciliation of interests is now complete.

I have a great deal of sympathy with Mr. Eason’s point of view. As he has pointed out, the private company in Ireland is small, and, apart from any returns which they must legally render and which presumably are semi-private and of very general character, I think that their individual affairs should be regarded as confidential. They certainly are in the Central Statistics Office.

From the statistician’s point of view much of the difficulty in dealing with company accounts arises from imputed values of stocks, depreciation and the like. We only know where we are when we are



dealing with actual transactions. On the question of depreciation, I have made a nuisance of myself at various conferences in Europe and America by asking experts foregathered to tell me how to deal with depreciation at cost of replacement which is what is wanted for social accounts. This is the same problem as splitting up gross capital formation (at current prices) into (1) new capital and (2) replacement of existing capital (at current cost). For example, in many cases, perhaps in most cases, new machinery is more efficient than the machinery which it replaces ever was, and I would like to ask the lecturer how, in such a case, the replacement value should be distinguished from the "new" value. I confess that, even with the machinery in the Central Statistics Office, we would find it very difficult to make this segregation.

As to the valuation of inventories, we are finding, as also was found in Great Britain, that the inventory revaluation item tends to put a substantially different aspect on profits for national income purposes as compared with profits as they emerge from the accountancy machine. Here again the difficulty is that of imputing values.

*Mr. MacCormac* said that there were two points which should be made clearer in the general discussion of accounting theory. Firstly, it is necessary to decide what exactly a balance sheet is: whether it is as Professor Hatfield defines it—a dump for unexpired costs, or whether it is a practical statement of the concern's financial position on an up-to-date valuation basis. If the latter alternative be accepted then the problem of asset valuation becomes increasingly difficult as the many different purposes of valuation with their varying results are examined. Secondly, *Mr. Sewell Bray*, in his paper, uses an overall term "depreciation" to cover both the writing-off of historical cost and a charge to cover the increasing cost of replacement of the asset. The two debits are intrinsically different in conception that an overall term to cover both is misleading. I would suggest that before net profit is arrived at the normal charge for depreciation on historical cost and a further provision to cover increased replacement cost should be shown separately.

*The President*, in summing up, expressed his appreciation of the fact that the paper represented a desirable reconciliation of the point of view of the accountant with the point of view of the social economist.

He agreed that the secular trend of monetary depreciation created "inventory profits", which in fact were not real profits at all, and in fact constituted a progressive tendency towards the consumption of real capital assets.

The relevant element in depreciation accounting is not the historic cost of the original asset but the cost of its replacement. In agricultural practice, when the general level of cattle prices is rising, the wise cattle farmer or trader regards as his profit, not the difference between the selling price and the original cost to him of identical animals, but the difference between the selling price of a given bunch of animals and the cost of replacing them with an equal number at an appropriate stage of maturity.

*Mr. Bray*, in reply.—I am indebted to you all for the very interesting discussion on my paper. I agree that much of what I said was not new; nevertheless, there are one or two new concepts of form and measurement. It has always seemed to me that truth in accounting disclosure can do very little harm. I suppose I am not a general purpose man, for it has always seemed to me that we should put more into the art of accounting on a fundamental basis. I do think it is necessary to distinguish real assets from monetary claims, particularly when we are thinking in terms of a continuing enterprise, for continuity seems to imply the preservation of real assets. Moreover, I do think there is a fundamental form of accounts which is the same for all entities, and that aggregation on a national or any other basis, depends upon this.

I have always taken the view that private company accounting should be much the same as public company accounting. The motive of the preparation of accounts is still the same. Stewardship and the measurement of profits are as much matters for private companies as for public companies. Private companies have to make returns to the Inland Revenue for taxation purposes, and I should have thought it was possible to collect statistical information on much the same basis. The distinction between fixed and current assets is the one which appears in the Companies Act of 1948. Liquid assets as such are not defined; the distinction which I would like to consider is that between real assets and money claims. As I have said on the philosophical level it has always seemed to me that there should be a fundamental form of accounts for any and every entity. I can see that managements may require dual purpose accounts, but that does not get away from the primary form suitable to the purposes of aggregation, more particularly when we are trying to constitute national accounts. If we do not provide for changes in price levels, then it seems to me that we are in danger of involving enterprise, on a rising price level, in veiled consumption of capital. I concede the difficulty in the notion of a division of inventories into standard and speculative; nevertheless, a large-scale concern should have some idea of its normal inventory carry appropriate to its normal scale of output. On the question of the necessity for national accounts, it would seem to me that an individual enterprise is only reasonably secure if the economy as a whole is kept on an even keel. I would have thought that national accounts were an essential requirement of this end.

I suppose that banking and insurance companies have always had exemption privileges because they are regarded as standing in a special position in relation to the economy as a whole. It is not so much internal disclosure which might be in point in relation to these companies as external disclosure.

The term asset formation covers inventory formation. I agree that the economic term has always been known as investment; nevertheless it seems to me that this creates confusion, particularly where accountants are concerned. Investments to accountants are mainly constituted in the form of securities. Real asset formation in my terminology is the same as investment in the terminology of economists. I should have thought that there was little doubt that the

accounting identity of saving as equivalent to investment was always reliable as an accounting identity, although the influences at work in determining either side of this identity are no doubt very diverse, as are also the causes. It has always seemed to me that the existing conventions of account tend to amplify the distortions of the trade cycle; a situation is created in which outputs are expanded and capital investment is over-ordered to that end. As a rough measure I should have thought current costs might be measured by reference to the average of retail and wholesale price indices. I recognise that this conversion factor has defects when applied to this purpose; nevertheless, it has the merit of being a broad measure of changing money values. Moreover, it has the advantage of reaching back well into the past and is kept up to date by published monthly calculations. I agree that it is an over-simplification, nevertheless, it is an average of official objective indices and is, therefore, independent and authoritative.

I agree that it is desirable to have different accounts for different purposes, but there are two fundamental concepts which are peculiar to nearly all accounts. I refer to the concept of income and the concept of capital. I agree there is a notion that treats the balance sheet as a collection of unexpired costs. I think there is something to be said for that point of view, but for my part I would prefer to regard the balance sheet as a measure of capital. It seems to me that if you do not get either form or the measurement right, then accounting ratios as such are going to mean very little. I want to bring into play mathematical and statistical devices to aid both the interpretation of accounts and expectation accounting, and for this purpose it seems to me that measurement and form are of paramount importance. If you so desire I see no objection to splitting depreciation provisions into that part which relates to original cost and to that part which is the adjustment by reason of changing price levels. I agree that the first part is implicit in the legal notion of protecting money capital; nevertheless, I do not like the idea of measuring profit before providing for the adjustment necessitated by changing price levels. It seems to me that this involves a wrong measure. I suggest that valuation is determined when a transaction takes place in the market. Transactions do take place in the market in respect of fixed assets, and these transactions should determine accounting valuations. I should have thought that this still preserves the objectively dependable basis of accounting. I agree that when we come to consider such concepts as social costs, and try to make valuations in that context, that we have no transactions in the market as standards of reference. I still favour the application of the last cost principle to inventories, and I would value both opening and closing inventories on that basis. I do not like the notion of gross capital formation, it seems to me a very ambiguous term. I have always thought that the right concept, which I agree has to take into account depreciation, is asset formation.

I would look at the replacement of fixed assets in terms of the maintenance of equivalent outputs. Company Law seems to impose a constraint requiring the preservation or stewardship of contributed money capital. I am, therefore, of the opinion that fixed assets cost recoveries by way of operating accounts in obedience to this principle, of Company Law, cannot fall below allocations based on the money-

expended as capital on the original assets. In times of a rising price level the additional adjustments for depreciation can be dealt with through a price change account, and in times of falling prices this price change account can be let down, but as soon as it reaches the originating datum line then I think it is necessary to remain on an originating cost basis for depreciation allocations until such time as the position is reversed. I am a little doubtful, however, if we shall ever see such a situation for long.

I would like to thank both your President and Dr. Geary for their very kind observations this evening. As you know, Dr. Geary was a colleague of mine at Cambridge, and I am pleased to be with him this evening. May I also thank you for the privilege of addressing your Society.