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PARTNERSHIP ACCOUNTING IN A NINETEENTH CENTURY MERCHANT BANKING HOUSE

Abstract: This article focuses on the contents of two nineteenth-century letters which discuss the allocation of income among the partners of a leading Anglo-American merchant banking firm, the House of Brown. The writers debate alternative methods of valuing assets and determining yearly income. In addition, the handling of doubtful accounts and their subsequent collection is examined. In both letters the writers argue for the development of clearly defined accounting principles and consistency in applying them. These letters reveal that an unusually high degree of financial sophistication had emerged in the merchant banking field by the 1850s.

While much of the recent historical literature has been devoted to analyses of business and railroad operations in the nineteenth century, the accounting methods and contributions of banking firms have remained relatively unexplored.[1] Now two previously unpublished letters written in the mid-nineteenth century by partners of the House of Brown, a leading Anglo-American merchant banking firm, offer new insight into the evolution of accounting methods and the emerging degree of sophistication in accounting thought. These letters indicate that some of the senior members of the firm were acutely aware of the problems associated with the development of principles and procedures for determining and allocating partnership profits in an equitable and consistent manner. The issues which stimulated discussion within the firm were controversies over, first, alternative methods of valuing assets and consequently the calculation of yearly income and, second, the collection of funds on doubtful accounts which had been written off directly against the senior partners' capital accounts. In both letters the writers expressed very conservative attitudes about the valuation of assets and the measurement of income.

The firm was founded in 1800 by Alexander Brown, who emigrated to Baltimore from Ireland in the 1790s. Beginning as a linen merchant, Brown soon expanded his activities to include the merchan-

dising of other products, shipping, and the provision of various financial services. His four sons eventually joined the business, and by 1825 three of them had established branches of the partnership in Philadelphia, New York, and Liverpool.[2] By midcentury, the firm had become the market leader in two major Anglo-American financial markets—the issuance of letters of credit to American importers and the buying and selling of foreign exchange in the United States. Profits were so high in these specialized fields that the two senior partners who held the bulk of the firm's capital—William Brown in Liverpool and James Brown in New York—decided, in the 1850s, to embark on a program of diversification by making "outside" investments in railroad securities, transatlantic passenger ships (the famous Collins Line), and other properties. Some of the junior partners opposed these outside investments calling them unduly speculative; the leaders of this group were two non-family members of the firm residing in England, Francis Hamilton and Mark Collet (later Governor of the Bank of England), who had assumed day-to-day administrative control of the Liverpool branch in 1853.

Eventually, many of these peripheral investments did, in fact, decline in market value, just as Collet and Hamilton had feared. This setback intensified the debate within the partnership about the merits of investing partnership funds in railroad stocks and bonds. It led to discussions of the valuation of assets generally. As the following letter from Collet and Hamilton so succinctly reveals, the problem of declining asset values stimulated a lively discussion about the application of a "cost or market" approach in determining the partnership's income for 1856:[3]

Persia *Private*

Liverpool 12 Nov. 1856

Messers Brown Brothers & Co.
New York

Dear Sirs:

. . . .

We exceedingly regret that there should exist between us any difference of opinion, as to the mode of treating assets, not immediately convertible, in the yearly statement of accounts, but we trust the difference may be rather apparent than real, & that you have only misunderstood our meaning.

What we intended to propose was not that every asset should be absolutely sold & turned into actual Cash on the 30 Nov[r.] & that every asset not so converted should be written off to Profit & Loss; but, that every asset should be reduced on the Books to such a sum as it could, beyond a doubt, be actually sold for, within a reasonable space (say of *weeks* or *months,* but not of *years*); and that everything beyond such actual money value—whether the assets be absolutely worthless, or only doubtful—should be written off. In fact, as we view it, there is only one process by which the profits of a current business can be "ascertained"; namely by comparing the liabilities with the assets, after *both* have been reduced to their cash value on the day, up to which the profits are to be calculated; by means of the interest account this is done most accurately with the *Liabilities*; but, if in dealing with the *Assets*; prospective values are applied to them which may or may not be realized at some future day, instead of bringing them to their *present Cash* value, a totally different standard is at once applied to the assets, & the result can only show an amount of "assumed", but not of "ascertained" profits.

We are not insensible to the disadvantage which under our present partnership agreement might accrue to the heirs of a junior partner by this strict course; and W[m] Brown, having his attention drawn to it by your remarks, is willing & suggests that a supplementary article should be introduced to preserve to the heirs of juniors their just interest in the Bad Debt Account; and he writes to his brother to this effect by the present conveyance.

On the other hand it may not perhaps have occurred to you that if assets are left on the Books at nominal amounts beyond their convertible value, the Senior Partners are placed at a corresponding disadvantage under their obligation to pay off a junior in Cash at the rate of the previous years profits; which would of course have been less had the assets been appraised upon what appears to us the only sound principle.

Further, for the last three or four years, large amounts have had to be written off annually to supply the inadequate provisions made for Bad Debts, at the time they occurred; & upon these sums, which for the time swelled the profits, we have been all along paying a heavy Income tax.

But all such questions as these are quite minor & unimportant when compared with the grand objection, that by retaining assets on the Books at sums [other] than their convertible value, & so dividing profits which have not been fully earned, a most insidious

& deceptive principle is admitted, which has no single advantage to recommend it, but on the contrary is fraught with serious dangers.

Within our own memory American Houses that. . . .felt fully confident of their position, as we do now, have been brought to ruin by it; first bolstering up questionable accounts or bad debts with fresh advances, instead of facing out the loss at first, and then retaining the assets upon their Books at nominal values, which, if they were not purely arbitrary, could only have been realized under some concurrence of circumstances, which was waited for in vain; in the meantime they shut their eyes to the dangers of a system, which could not be remedied except at a serious sacrifice, until it slowly, but surely, brought them down. Smaller concerns, from their limited means are comparatively exempt from this risk; but it is the peculiar snare which lies in the way of large Houses with extensive means & unbounded credit, and in this light it does seem to us of vital importance that we should not give place to so dangerous a principle in any form or shape. We have no other object that the common interest of all in urging these views upon you, & we sincerely trust that they will of themselves receive your approbation & be adopted.

. . . .

We are,
Dear Sirs
Yours faithfully,
Brown Shipley & Co.

Although it is impossible to determine exactly what developments and forces influenced the Liverpool partners' consideration of accounting principles, this correspondence did coincide with several legislative alterations in English financial laws. The Joint Stock Companies Act of 1856 passed Parliament just prior to the writing of this letter. Because the new law prescribed new financial practices for certain business organizations, public discussion of the act had stimulated in England a reappraisal of basic accounting concepts.[4]

Specifically, the Joint Stock Companies Act required that the directors of each corporation "cause true Accounts to be kept":

> Of the Stock in Trade of the Company; Of the Sums of Money received and expended by the Company, and the Matter in respect of which such Receipt and Expenditure takes place; and Of the Credits and Liabilities of the Company.[5]

The annual presentation of income statements was required so that "a just Balance of Profit and Loss may be laid before the Meeting." Furthermore, the act specified that "a Balance Sheet shall be made out in every Year, and laid before the General Meeting of the Company, and such Balance Sheet shall contain a Summary of the Property and Liabilities of the Company. . ."[6]

The act did not specifically address the issue of valuation of assets nor did it detail the preparation of financial statements. However, the mere fact that for the first time presentation of accurate financial statements was required by law may have stimulated discussion of accounting principles.

Aside from these legislative actions, we have been unable to discover any direct stimulus for Hamilton and Collet's interest in the lower of cost or market principle. However, the principle had clearly been introduced into accounting thought by the mid-nineteenth century. A. C. Littleton in an article, "The Geneology of Lower of Cost or Market," traces application of the principle to fourteenth-century Italy, when a very heavy tax burden may have been an incentive for recognizing all possible losses.[7] During the seventeenth century French businessmen seem to have adopted the practice of writing down slow inventories, but Littleton argues that it was done primarily for the purpose of determining the degree of solvency. By 1862, J. Sawyer referred to the "recognized principle that stock should be valued at least at cost price (unless depreciated in value) and that no profit should be estimated until realized."[8] Meanwhile, we are unaware of any Anglo-American accounting literature that discusses the issue of lower of cost or market in terms of its impact on the measurement of income. It is conceivable that Collet and Hamilton's letter represents one of the earliest preserved discussions of this topic.

In a second letter written four years later, Collet and Hamilton focused on inconsistencies in the handling of bad debts and subsequent collections on delinquent accounts:[9]

Niagaria *Private*

Liverpool 24 March
1860

Messers Brown Brothers & Co.
New York

Dear Sirs:

. . . .

Referring to your private letter of 5 March about the private accounts, we see nothing to remark upon, except this: there ap-

pears to us an inconsistency in the principles upon which some accounts are brought under the operation of the Suspense Account & others excluded; we do not wish to raise the question by correspondence; indeed it could never have arisen had the principle been clearly defined in 1857, on what terms the Seniors assumed the Juniors' losses; but to illustrate the inconsistency that presents itself to our minds, we could say that if *all* the Surplus that may be realized from Mathison & Litchfield is to go to Credit of the Suspense Acct, (even *beyond* the amount *specifically* written off in 1857) then the loss written off in 1859 for the Thompson property should have gone to the Suspense A/c too; but if the latter was properly charged to Profit & Loss A/c, *then* any recoveries beyond the Sums which were specifically written off in 1857 should revert to the Profit & Loss account of the year when the recovery is made. The question in fact turns upon this — whether the Seniors guaranteed the Juniors for losses *beyond* what the Am[t]. placed to Suspense A/c 1857 would satisfy? If *they did,* then they should bear the loss upon Thompson's property, on the ground that it was a lock-up, left standing at an estimated value; & then too they are entitled to *all* recoveries from the assets as they then stood; but if, as we conceived at the time—the Seniors did not engage to supply anything more (if needed) than the Suspense account would suffice to cover, *then* the loss [on] Thompson's property has been correctly charged *last* year to Profit & Loss; but then also the recoveries beyond losses *specifically* provided for (& not left to be worked out under the gross estimate) should also go to Profit & Loss. It is inconvenient now to settle the point when there is no longer any doubt as to the out-turn of the Suspense Account, viz. that it will be more than sufficient to pay all losses, and of the two original alternatives only one remains; and we do not wish or ask you to discuss it by letter; but only to settle it on your side before Mr. J. M. Brown comes out, so that we can have an understanding about it, when we can discuss it verbally.

. . . .

Yours faithfully,
Brown Shipley & Co.

To place this second item of correspondence in the proper context, it is necessary to know that during the financial panic of 1857 many American importers holding letters of credit from Anglo-American merchant bankers got into serious financial difficulties. In many cases the merchant banking firms in England who had

faithfully met their obligations under letter of credit agreements were not fully reimbursed by their American customers. Because the Browns had been cautious in issuing letters of credit and had usually insisted on a margin of 20 percent in tangible assets against contingent liabilities arising under their letters of credit, the firm had weathered this crisis in much better shape than most competitors. Nonetheless, the firm did face the possibility of absorbing some losses. In these cases, the Browns retained the assets assigned to them as an initial margin and occasionally they received additional collateral from importers hoping to survive the panic.

To record these immediate losses and potential losses, the Brown partnership used at least two different methods.[10] Some moderate losses were simply written off against the partnership's profit and loss statement in 1857. In this instance, the losses were shared by both the junior and senior partners according to the pre-arranged agreement about the allocation of profits and losses. In the second method, the senior partners, James and William Brown, agreed to permit writeoffs against their individual capital accounts. Debits were made to a "suspense account" which was a contra-account to the senior partners' capital accounts. The goal of this magnanimous policy was to protect the other members of the partnership from the possibility of incurring unusually high losses in the event most of the questionable debts in 1857 were never fully collected. The amounts written off to the seniors' capital accounts were normally only a portion of a specific account that was considered doubtful, and the remaining balance was left standing on the partnership's balance sheet at its currently "estimated" value. This procedure seems to have been at the root of the problems which arose in later years.

By 1860 the House of Brown had recovered nearly all the amounts written off to the suspense accounts of 1857. At this point, questions emerged about how to record the recovery of the collected amounts. In those cases in which the senior partners had assumed personal liability for at least a partial loss on a specific account, it was not clear whether the collected amount was to be credited in its entirety to their contra-accounts or whether that sum should be divided as follows—with an amount credited to the suspense accounts equal to the original writeoff and the excess credited to the general partnership. The question could be stated as follows: at the time of the debits to the capital contra-accounts was there created thereby an implied agreement that the senior partners had assumed full responsibility for all potential losses on

the designated accounts? If that interpretation was correct, then Collet and Hamilton felt that the seniors were indeed entitled to benefit individually from all sums collected, including the amounts above original writeoffs. But, on the other hand, if the senior partners had assumed liability for only a portion of the potential loss on a specific account, then any excess should accrue instead to the general partnership.

Because the matter had never been settled in 1857, uncertainties remained about accounting procedures. In their letter Collet and Hamilton noted that in 1859 the firm had finally recognized a loss on the Thompson account which was in excess of the amount originally placed in the senior partners' suspense accounts. In that case, the additional loss was charged to the partnership accounts and was consequently borne by all members of the firm. Now in 1860, the seniors proposed to credit all the sums collected from Mathison & Litchfield to their contra-accounts, including the amounts beyond the original writeoff. Collet and Hamilton felt that the handling of the two situations was inconsistent.

Unfortunately, we do not know how this matter was finally resolved. Yet it is interesting to note the intricacies which surrounded the drafting and interpretation of partnership agreements formulated over 100 years ago. Although we cannot point in this case to any external events which might have stimulated this discussion, we are aware of several developments inside the firm that almost certainly played some role in encouraging an interest in refining accounting procedures.

By the 1850s, the House of Brown was no longer a small family business, but a medium-sized enterprise with seven branch offices and several non-family members. Moreover, all the members were committed to preserving the business for their heirs, which suggests the emerging concept of an on-going concern. Because the firm actually had two main offices—one in New York and another in Liverpool—there was internal pressure to commit all major policies and operating rules to paper for later reference. The rapidly increasing volume of business after midcentury also placed greater demands on regularizing procedures. Part of this process was the desire by some firm members for a uniform, well-specified system of accounting. In concert, these factors made preestablished rules increasingly desirable for continued harmony within the partnership.

Collet and Hamilton were among the most vocal advocates of the benefits of uniformity. In both letters, they lamented the ab-

sence of consistency in handling the partnership accounts; in 1860, they argued that "had the principle been clearly defined" at the outset, the subsequent debate could have been avoided. The problems of maintaining consistency demonstrates clearly the growing need for outside accounting authorities and specialists, who could relieve the partners of the additional burden of establishing the firm's own accounting criteria. Since neither England nor the United States had an active accounting association in the 1850s, it became the responsibility of individual managers to establish their own rules for valuing assets, measuring income, and handling doubtful accounts.

From another historical perspective, it is intriguing to examine the interchange of accounting thought between the United States and Great Britain. Previously, James Edwards has argued that "just as customs, common law, and commercial practice came to the United States from England and Scotland, so did the practice of accountancy."[11] In contrast, R. A. Irish favors the United States as the source of much fresh thinking about accounting principles: "This new country, uninhibited by tradition, brought forth an examination of accounting fundamentals which was free of inborn European prejudices."[12] In this one instance, the letters originated in England, however, which raises questions about Irish's views but supports Edward's position. More research on the origin of fresh accounting thinking is clearly in order.

In conclusion, these two letters offer insights on the evolution of accounting practices and thought during the mid-nineteenth century. The debate inside the Brown firm focused on the drafting and amending of a fair partnership agreement and the judicious interpretation of its provisions. The letters provide evidence of the increased emphasis on the measurement and distribution of income. The letters indicate that the increased complexity and larger volume of business led many partners to attempt to establish permanent guidelines for accounting procedures which might avoid *ad hoc* discussions of financial principles in future years. In formulating and applying these guidelines, Francis Hamilton and Mark Collet, two of the firm's non-family, English partners, saw consistency as a crucial factor. In addition, they advocated a conservative attitude toward valuing assets on the firm's balance sheet and in the measurement of income. Finally, this need for consistent, standardized procedures later spread throughout the business environment and created a favorable climate for the establishment of a cohesive accounting profession.

FOOTNOTES

[1]G. A. Lee, "The Concept of Profit in British Accounting, 1760-1900," *Business History Review* (September, 1975), provides a general survey of the advance of accounting principles during this period. Other sources which provide background are Edey and Panitakdi, "British Company Accounting and the Law: 1844-1900," in Littleton and Yamey, eds., *Studies in the History of Accounting* (Homewood, Ill.: R. D. Irwin, Inc., 1956); M. Chatfield, *A History of Accounting Thought* (Hinsdale, Ill., Dryden Press, 1974); Nicholas Stacey, *English Accountancy: A Study in Social and Economic History, 1800-1954* (London: Gee, 1954); and A. C. Littleton, *Accounting Evolution to 1900* (New York: Russell & Russell, 1966).

[2]The history of the firm is found in Edwin J. Perkins, *Financing Anglo-American Trade, 1800-1880* (Cambridge, Mass.: Harvard University Press, 1975).

[3]Brown Brothers Harriman & Co. Papers.

[4]In the chapter entitled "Development of Experts in Accounts," A. C. Littleton, in his *Accounting Evolution to 1900*, discusses the ebb and flow of business during the nineteenth century and correlates these movements with the growth of social control through statutory regulation of public works and joint stock companies.

[5]*Collection of the Public General Statutes*, p. 433.

[6]*Collection of the Public General Statutes*, pp. 433-434.

[7]A. C. Littleton, "A Genealogy for Cost or Market," *The Accounting Review* (June, 1941). For further discussion of the history of this principle see R. H. Parker, "Lower of Cost or Market in Britain and the United States: An Historical Survey," *Abacus*, I (1965), and Kenneth O. Elvick, "Acquisition Cost Versus Revaluation: A Historical Perspective," *The International Journal of Accounting*, IX (1974).

[8]Sawyer, p. 158.

[9]Brown Brothers Harriman & Co. Papers.

[10]For discussions on the use of reserves for bad debts, see M. Chatfield, *A History of Accounting Thought*, p. 83, and A. C. Littleton, *Accounting Thought to 1900*, p. 301.

[11]Edwards, p. 144.

[12]Irish, p. 63. Also see G. J. Previts, "Origins of American Accounting," *The CPA Journal*, XLCI (May, 1976).

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