Inventory of generally accepted accounting principles for business enterprises; Accounting research study no. 07

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INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES

By Paul Grady
INVENTORY
OF GENERALLY
ACCEPTED ACCOUNTING
PRINCIPLES FOR
BUSINESS ENTERPRISES
STATEMENT OF POLICY

Accounting research studies are designed to provide professional accountants and others interested in the development of accounting with a discussion and documentation of accounting problems. The studies are intended to be informative, but tentative only. They furnish a vehicle for the exposure of matters for consideration and experimentation prior to the issuance of pronouncements by the Accounting Principles Board.

The responsibility for this study is that of the Director of Accounting Research and those who have been associated with him in the project. The conclusions and recommendations have not been approved, disapproved, or otherwise acted upon by the Accounting Principles Board, the only agency of the American Institute of Certified Public Accountants having authority to make or approve public pronouncements on accounting principles. The study does not necessarily reflect the views of the Board, nor has it been acted upon by the membership or by the governing body of the Institute.

Individuals and groups are invited to express their views in writing on the conclusions and recommendations contained in this study. These views will be considered by the Accounting Principles Board in forming its own conclusions on the subject.
INVENTORY
OF GENERALLY
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BUSINESS ENTERPRISES

By Paul Grady

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Director’s Preface

I am privileged to authorize publication of this “Inventory of Generally Accepted Accounting Principles for Business Enterprises” by virtue of the fact that putting the finishing touches on the manuscript and seeing it through publication has taken time. The bulk of the work was done while Paul Grady was Director of Accounting Research, however, and he should rightfully be the one to sign this preface.

I have been an interested bystander as this Inventory grew from its beginning stages. No one can really appreciate the magnitude of the task of making an inventory of generally accepted accounting principles without having tried it. Mr. Grady's immense capacity for work, his wealth of experience, and his broad knowledge of the subject matter have been important factors in bringing this project to a successful conclusion.

Some have expressed concern that because of the nature of this document and because of the widespread reproduction within its pages of bulletins and opinions of committees of the American Institute of CPAs and releases of the Securities and Exchange Commission, this study may be interpreted as more authoritative than it is intended to be. Accounting Research Studies represent the views of their authors, however, and are tentative rather than authoritative. The publication of this Inventory in no way affects the status of the Accounting Research Bulletins or of previously published Opinions of the Accounting Principles Board. A number of the elements included in the Inventory are presently under study by the Accounting Research Division and/or the Accounting Principles Board and may be changed by the Board when it considers the Inventory or in separate Opinions.

This Inventory of Generally Accepted Accounting Principles for Business Enterprises is published as an accounting research study in
order to bring its contents before the members of the profession. The profession can use it to look back on substantial accomplishments or to look forward to future progress; the document serves both purposes. The Board's major objective in authorizing the study was the latter, and the Inventory will truly prove a major milestone in accounting if it serves as a foundation for increased progress in financial accounting and reporting.

One member of the project advisory committee, Professor Carl L. Nelson, was out of the country during the final consideration of this study by the project advisory committee.

New York, N.Y., March 1965

Reed K. Storey
Preface Regarding Plan For This Project and Acknowledgments

In June 1963, the Accounting Principles Board approved undertaking a research project to prepare an Inventory of Generally Accepted Accounting Principles for Business Enterprises. The task of assembling and classifying the pertinent information in a useful pattern has been done by the author, during the period he was director of accounting research, and with substantial assistance from other staff members of the Accounting Research Division of the American Institute of Certified Public Accountants.

As the word inventory suggests, the task was not a mission to discover new or improved accounting principles. It was rather an undertaking:

(a) To discuss the basic concepts to which accepted accounting principles are oriented;

(b) To establish a list or summary of the accounting principles (or practices) now regarded as essential to the fulfillment of fiduciary accountabilities of a business enterprise to persons who have invested in the enterprise or have other bona fide interests in its financial position and results of operations;

(c) To present the opinions of the APB and its predecessor committee and other authoritative accounting pronouncements, now in effect, analyzed in a manner reasonably related to this summary of generally accepted accounting principles; and

(d) To supply the explanatory and connecting language needed to create a practical accounting codification for the use of business enterprises and certified public accountants.
The report of the special committee on research program, as modified and approved by Council of the AICPA, said, in part:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues.

The broad problem of financial accounting should be visualized as requiring attention at four levels: first, postulates; second, principles; third, rules or other guides for the application of principles in specific situations; and fourth, research.

Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear its understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations. Also, the Institute should encourage cooperative study with other representative groups to determine that its understanding and interpretation of the postulates are valid and to provide a forum which will command sufficient respect to bring about a change in the postulates when any of them become outmoded.

A fairly broad set of coordinated accounting principles should be formulated on the basis of the postulates. The statement of this probably should be similar in scope to the statements on accounting and reporting standards issued by the American Accounting Association. The principles, together with the postulates, should serve as a framework of reference for the solution of detailed problems.

Rules or other guides for the application of accounting principles in specific situations, then, should be developed in relation to the postulates and principles previously expressed. Statements of these probably should be comparable as to subject matter with the present accounting research bulletins. They should have reasonable flexibility.
In the preparation of this Inventory, attention has been given to the elements or levels of financial accounting visualized by the special committee, namely, postulates, principles, and rules. The first three steps of the project, as previously outlined, are in accord with the committee’s suggestions. The term “postulates” is not being used. It is believed that the term “basic concepts,” which had been used in the pamphlet on Corporate Accounting Standards, published by the American Accounting Association, is better understood. Some modification, or interpretation, has been made in the special committee’s views that principles rest on the basic concepts. This study takes the view that the relationship is more a meaningful orientation, rather than a literal foundation.

The conception and outlining of the content of this book were substantially aided by two pioneer works having similar objectives. One was *A Statement of Accounting Principles* by Sanders, Hatfield, and Moore, published by the AICPA in 1938, and the other was *An Introduction to Corporate Accounting Standards* by Paton and Littleton, published by the American Accounting Association in 1940. The burden of drafting explanatory and connecting comments on Accounting for Income and Expense, Equity, Assets, and Liabilities, Chapters 4 to 7 inclusive, was substantially reduced by the generous permission granted by Lybrand, Ross Bros. & Montgomery to use, alter and merge the accounting contents of *Montgomery’s Auditing* with this work without the complications of numerous separate quotations and acknowledgments. The author was aided also by ideas obtained from accounting articles and books either quoted directly or listed in the bibliography.

From the inception of this research project, substantial aid and support were received from members of the advisory committee. Their helpful suggestions covered both the structure and wording of the Inventory. Members of the committee were: Carman G. Blough, Chairman, Andrew Barr, Dudley E. Browne, Thomas J. Cogan, William D. Gaillard, George S. Hills, Arnold W. Johnson, Donald F. MacEachern, Carl L. Nelson, Weldon Powell, A. O. Savage, Leonard Spacek, A. Carl Tietjen and Phillip L. West.

My special thanks go to Cecilia V. Tierney and Leonard Lorensen for preparing initial drafts of the explanatory and connecting comments in chapters IV to VII, inclusive; and to Eleanor Foley, Margaret Breslin, Ann O’Rourke, Barbara Shildneck, and Muriel Sternfield for performing the arduous tasks of typing, proofreading, preparing the manuscript for printing, and supervising production of the book.
Inasmuch as this Inventory is published as an accounting research study, it is paged seriatim for the entire volume and has a fixed binding. When and if the Accounting Principles Board adopts the approach to an accounting codification, as herein illustrated, it is suggested that consideration be given to the use of a looseleaf form with index tabs for the respective chapters. On that basis the paging should be by chapters, rather than for the entire book, in order to facilitate future additions and revisions.

New York, N. Y. March 1965

Paul Grady
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The Function of Accounting for Business Enterprises

Accounting is essential to the effective functioning of any business organization, particularly the corporate form. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not merely from that of any one group of interested persons.

The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet changes as they occur. In the past fifty years, there has been an increasing use of the corporate system for the purpose of converting into readily transferable form the ownership of large, complex, and more or less permanent business enterprises. This evolution has brought in its train certain uses of the processes of law and accounting which have led to the creation of new controls, revisions of the laws, and reconsideration of accounting procedures.

As a result of this development, the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise, with consequent increased recognition of the significance of the income statement and a tendency to restrict narrowly charges and credits...
CHAPTER 1: FUNCTION, RESPONSIBILITIES AND AUTHORITIES

to surplus. The fairest possible presentation of periodic net income, with neither material overstatement nor understatement, is important, since the results of operations are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers. With the increasing importance of the income statement, there has been a tendency to regard the balance sheet as the connecting link between successive income statements; however, this concept should not obscure the fact that the balance sheet has significant uses of its own.

The foregoing paragraphs are taken from the introduction to Accounting Research Bulletin No. 43. Accounting Terminology Bulletin No. 1 dealt with the words accounting and accountancy as shown in the succeeding eight paragraphs.

Define of accounting. "No words [accounting and accountancy] are employed more commonly than these, either in the practice or in the teaching of the subject; yet many differences arising in accounting writings have their roots in different conceptions of these basic terms. A careful consideration of these words will therefore add to understanding, not only among accountants themselves, but also among those outside the profession who have to do with accounting.

"That publishers of general dictionaries had not, before the committee on terminology first expressed itself publicly, given adequate attention to the special uses of accounting terms was very evident from what the committee found with respect to their treatment of the words here under consideration. One dictionary consulted contained no definition of accounting, though it used the word in defining the verb account as 'To furnish or receive an accounting.' For the noun accounting, the more formal accountancy was made to serve, and was defined as 'The work or art of an accountant.' Turning therefore to accountant, hoping to find a definition which did not use the word to be defined, the committee found only that he is 'one who keeps, examines, or is skilled in accounts; one whose business is to keep or examine books of a mercantile or banking house or in a public office.'

"After extensive consultation and careful consideration, the committee in 1941 formulated the following definition:

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."
“Public accounting is the practice of this art by one whose services are available to the public for compensation. It may consist in the performance of original work, in the examination and revision of the original work of others, or in the rendering of collateral services for which a knowledge of the art and experience in its practice create a special fitness.

“If accounting were called a science, attention would be directed (and perhaps limited) to the ordered classifications used as the accountant’s framework, and to the known body of facts which in a given case are fitted into this framework. These aspects of accounting cannot be ignored, but it is more important to emphasize the creative skill and ability with which the accountant applies his knowledge to a given problem. Dictionaries agree that in part art is science, and that art adds the skill and experience of the artist to science; it is in this sense that accounting is an art.

“Except as in the two preceding paragraphs, the committee chose not to amplify the definition which it put forth. It rejected suggestions that the definition be made more explicit by mention of other details of accounting, because it questioned the desirability of writing its definition in terms which, while perhaps sharpening its presentation, might also unduly limit its scope. After the passage of more than ten years, this choice of broad but significant language continues to seem wise, and the definition to appear comprehensive as well as succinct.

“From the establishment of the Interstate Commerce Commission and of other regulatory commissions, accounting has served these bodies and the railroads and other utilities under their jurisdiction in the solution of rate-fixing and related problems. Following the adoption of the income-tax amendment, it quickly became and has ever since remained apparent that in the implementation of that amendment accounting is a sine qua non for ascertaining the income to be taxed. The complexities of modern business have brought to management some problems which only accounting can solve, and others on which accounting throws necessary and helpful light. With the widening of corporate ownership, accounting was found both necessary to and capable of an intelligible presentation, within reasonable compass, of the financial data required to be furnished by management to investors. Although all of these facets of accounting, and many others, had long been well known to the business world, the committee included in its definition no specific mention of any of them; but careful attention to such phrases as ‘summarizing in a significant manner,’ ‘transactions and events . . . of a financial
character,' and 'interpreting the results thereof,' will reveal that the definition is in fact broad enough to cover them all.

"Similar careful attention to the significant words, 'the art of recording, classifying, and summarizing,' will rule out any interpretation that no more is indicated than bookkeeping. The recording and classifying of data in account books constitute an accounting function, but so also and on a higher level do the summarizing and interpreting of such data in a significant manner, whether in reports to management, to stockholders, or to credit grantors, or in income tax returns, or in reports for renegotiation or other regulatory purposes."

It should be recognized that any terse definition necessarily has limitations, particularly where the subject is a broad and complex one. The foregoing definition and the related comments have served useful purposes over an extended period of years. This period has witnessed great strides in improvement of systems and machinery for data processing, clearer understanding of the elements and importance of a coordinated system of internal control and better recognition of the needs of management and of the reports required to fulfill fiduciary responsibilities to others.

These developments have broadened the responsibilities and usefulness of accounting. As a general proposition, the preparation of an "inventory" does not include modification of existing definitions. However, it is believed that the advance of practice makes it desirable to expand the definition of accounting by specifying certain additional factors, which were perhaps inferred in the earlier wording. The following revised wording is submitted:

Accounting is the body of knowledge and functions concerned with systematic originating, authenticating, recording, classifying, processing, summarizing, analyzing, interpreting, and supplying of dependable and significant information covering transactions and events which are, in part at least, of a financial character, required for the management and operation of an entity and for the reports that have to be submitted thereon to meet fiduciary and other responsibilities.

The professional status of accounting makes it appropriate to place the "body of knowledge" on a coordinate basis with the "functions" of accounting. The attachment of "systematic" to the activities and of "dependable" to the information brings out the need for planning and control; and "required for the management and operation" covers the major internal purposes, while "the reports . . . to meet fiduciary and other responsibilities" covers the major external purposes of accounting.
Limitations of Inventory. This Inventory of generally accepted accounting principles deals primarily with the standards for meeting fiduciary responsibilities to investors and others, outside of management, having bona fide interests in the business entity. Accordingly, most of the dynamics and creative factors inherent in the design and operation of a modern accounting and budgetary system required to supply the needs of management are not dealt with. The existence of such a system is assumed as a condition precedent to fulfillment of external reporting requirements.

The limitations referred to result, also, in the omission of important segments of accounting literature, such as publications by the Financial Executives Institute, the National Association of Accountants and the American Accounting Association. Thus, the Inventory here undertaken is in no sense an encyclopedia of accounting.

Responsibilities and Authorities for Accounting

Accounting often is called the language of business since it is a primary tool in the control of operations and in reporting accomplishments of commercial entities. It has been compared, also, with the common law since neither is static in concept and both have the flexibility and capacity for growth and adaptation to meet the changing problems of a complex business community.* Both extend in terms of usefulness, considerably beyond the contours of statutory requirements.

A full understanding of the pattern of responsibilities and authorities for accounting by business enterprises in the United States requires knowledge of the political and economic history since the establishment of this nation. While such knowledge is presupposed, it is pertinent to observe that both governmental and economic institutions reflect systems of checks and balances against abuses of power and other human weaknesses. Accordingly, the responsibilities and authorities for accounting and financial reporting of business enterprises constitute a mosaic in which the primary responsibility and authority of the board of directors and management is supplemented by secondary responsibilities and authorities of stock exchanges, independent certified public accountants, regulatory commissions and the Securities and Exchange Commission. The nature of the respon-

sibility and correlative authority of each of these groups are dealt with in the following paragraphs.

The board of directors and management. By common law, the powers of the board of directors in carrying out its management responsibilities are powers held in trust, and it is the duty of the directors to the corporation and to the entire community of interests in the corporation to act as a fiduciary in exercising these powers. Pepper v. Litton 308 U.S. 295, 306 (1939).

The responsibility of the board of directors for the management of the enterprise, of course, includes responsibilities with reference to accounting matters. Most states have statutes dealing specifically with certain aspects of management, including aspects which involve accounting. For instance, statutory liabilities are imposed on directors for improper dividends or distributions, payment for the corporation's own shares out of improper funds, unlawful loans to directors, officers or shareholders, preferential transfers, commencing business without the required minimum paid-in capital.

Corporation laws of course vary from state to state, and impose liabilities on directors in varying degrees. That the board must delegate responsibility and authority for accounting and other management functions is obvious. Some state laws specifically provide that directors shall be fully protected in relying in good faith upon the books of account, or upon financial statements presented by the corporate financial officers or independent public accountants. As an example, the new Business Corporation Law in New York provides:

717. Duty of directors and officers.

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In discharging their duties, directors and officers, when acting in good faith, may rely upon financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation.

The Model Business Corporation Act, which has been enacted with modifications in a number of states, contains a similar provision in § 43.
The board of directors always remains obligated, however, to exercise good faith and due care in the discharge of its management responsibilities, including the fulfillment of fiduciary accountabilities to stockholders.

Stock exchanges. The New York Stock Exchange, in particular, and other exchanges following its example have had considerable influence over the years in improving financial reporting of business corporations. This influence is exercised through the standards of information set forth in listing requirements which the companies agree to maintain in subsequent reports to the Exchange and to stockholders. The prestige of the practices of listed companies has in turn served as an example in raising the reporting practices of all companies whose securities are held by the public. The stock exchanges also maintain continuous surveillance over the interim and annual reports of listed companies to detect misleading statements, material omissions and violations of listing agreements.

The New York Stock Exchange in the early 1930's participated with an Institute committee in laying the foundation for generally accepted accounting principles. This was represented in the pamphlet called “Audits of Corporate Accounts” published in 1934 which, in retrospect, was one of the major forward steps in accounting and financial reporting of business corporations.

The stock exchanges continue their influence for the improvement in accounting and financial reporting both through their listing requirements and continuous review and also by recommending to listed companies that they follow opinions of the Accounting Principles Board. The authority of the stock exchanges rests upon their prestige for intellectual influence and upon the value to the corporations and their investors of the privileges of having their securities traded in these organized markets.

The Securities and Exchange Commission. Under the Securities Act of 1933 and the Securities Exchange Act of 1934, as amended, the SEC has broad authority over prospectuses, and subsequent annual reports required to be filed, of companies seeking to obtain capital by the sale of securities to the public, as well as over annual reports required to be filed with the Commission by companies whose securities are listed for trading on stock exchanges and by certain companies whose securities are dealt with “over the counter.” The primary purpose of these acts was to provide full and fair disclosure and substantial penalties may be imposed if the prospectus or finan-
cial report "includes any untrue statement of a material fact or omits to state any material fact required to be stated therein as necessary to make the statements therein, in the light of the circumstances under which such prospectus is or is to be used, not misleading."

In addition to the broad authority conferred to meet the purposes of the acts, the Commission is given the following specific authority over financial statements and methods of accounting:

... the Commission shall have authority, for the purposes of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; ...

The Securities and Exchange Commission has exercised its authority over financial reporting by issuance of regulations, such as Regulation S-X, to cover the form and content of required reports and through Commission decisions and Accounting Series Releases containing opinions by the Commission and its Chief Accountant. The number of decisions and releases covering accounting principles and practices is relatively limited, which reflects the view of the Commission that it would not be in the public interest for the government to undertake extensive accounting rule making.

The Commission has consistently held, under the acts it administers, that management has the primary responsibility for financial statements and for the accounting principles on which they are based. The Commission considers that independent accountants lend authority by their opinions as experts and operate as a check in assuring that generally accepted accounting principles are used and that figures are fairly determined and presented in accordance with generally accepted auditing standards. The distinction between the responsibility of the management and that of the independent auditor was dealt with In the Matter of Interstate Hosiery Mills, Inc. 4 SEC 721 (1939) as follows:
The fundamental and primary responsibility for the accuracy of the information filed with the Commission and disseminated among investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.

The Commission's view of its own role in the development of accounting principles and practices was described in Release 96, as follows:

In Accounting Series Release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting Series Release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant's certificate and footnotes will be accepted in lieu of conformance to the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance.

Regulatory agencies. A large segment of industry is subject to regulation by state and Federal commissions. Transportation, communication, electricity, gas, insurance and banking services are so vested with the public interest that the state and national legislatures have created commissions to supervise and control their operations to the extent necessary to protect the public. In most of these industries the regulatory authority includes approval of the rates of charges for services rendered and the power to establish uniform systems of accounts, if deemed necessary to accomplish other regulatory objectives.

From an historical viewpoint, the system of accounts prescribed
more than fifty years ago by the Interstate Commerce Commission for railroads and telephone and telegraph companies developed accounting thought considerably. Similarly, the uniform systems for electric and gas companies developed or adopted by the National Association of Railway and Utility commissioners and adopted by the respective Federal and state commissions contributed certain improvements to accounting techniques. The regulatory bodies in the past twenty-five years have been so prone to use accounting as a means of accomplishing predetermined regulatory ends that they have neglected the opportunity of contributing to the objective development of generally accepted accounting principles. Since the rate-making and accounting authority of the Federal commissions has been upheld by the courts in practically all litigated cases, the commissions do not need to use accounting as an instrument to effect rate-making policies. Accordingly, it is hoped that these commissions will recognize the advantages of keeping their accounting orders compatible with generally accepted accounting principles.

Recently, progress has been made in gaining agreement by the ICC that companies subject to its jurisdiction may report to stockholders on the basis of generally accepted accounting principles if a reconciliation is provided with the Commission's accounting system. Efforts are being made to extend this viewpoint to other regulatory agencies, particularly in the insurance industry.

The accounting profession. The certified public accountant renders a broad variety of services to the business community in auditing, accounting, taxation and various management advisory services. The functions of independent auditing and reporting on financial statements, prepared from corporate accounting records, are the only ones involved in the responsibility and authority for accounting principles or practices of business enterprises.

The topic of professional responsibility and authority may be regarded from a collective professional viewpoint and from the viewpoint of the individual CPA or firm of CPAs. The collective viewpoint encompasses actions taken within the committee structure of the AICPA, the national organization of CPAs which, by ratification or other action by the Council, the governing body of the Institute, or by the full membership, become binding on all members. The members of the Institute have long recognized that in any skilled activity worthy of professional standing there must be a well-organized program of self-discipline. The following may be called the major steps in the coordinated program of self-discipline voluntarily
adopted by the independent accounting profession through collective action:

1. Establishment of generally accepted auditing standards, approved by the membership, and the issuance of the codification of statements on auditing procedure and subsequent statements by the committee on auditing procedure.

2. Issuance of statements on accounting principles by the Accounting Principles Board and its predecessor, the committee on accounting procedure.

3. Organization of a consultation service whereby members may discuss the handling of difficult technical problems in advance of the release of their reports.

4. Establishment of staff training and professional development programs in order that members may have appropriate means of adult professional education.

5. Establishment of the code of professional ethics, approved by the membership, violation of which may result in disciplinary action by the ethics committee through the institution of proceedings before the Trial Board.

6. Organization of the practice review committee to encourage compliance with generally accepted accounting principles and auditing standards and to eliminate, insofar as possible, substandard reporting practices through education and persuasion rather than by disciplinary action.

Further information on points one, two, five and six are required for an understanding of the professional responsibilities of the CPA in regard to the accounting practices of business entities. A summary of generally accepted auditing standards, approved by the membership of the Institute, is shown below:

**General standards**

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

**Standards of field work**

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing in-
ternal control as a basis for reliance thereon, and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles of accounting have been consistently observed in the current period in relation to those in the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of an opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor’s name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor’s examination, if any, and the degree of responsibility he is taking.

It is generally recognized that (a) financial statements are representations by management, (b) the CPA has the responsibility for conducting his examination in accordance with generally accepted auditing standards, and (c) the CPA has the sole responsibility for writing his report stating, among other things, whether the financial statements are presented in accordance with generally accepted principles of accounting (reporting standard number 1).

Further light on the responsibilities of the CPA may be gained by reference to the Code of Professional Ethics adopted by the membership. Articles in the Code deal with (1) Relations With Clients and Public, (2) Technical Standards, (3) Promotional Practices, (4) Operating Practices, and (5) Relations With Fellow Members. The preamble to the Code and the section on technical standards are set forth below since they bear most directly on the CPA’s responsibility for reporting which includes his opinion on the fairness
of presentation of the financial statements and on whether they are based on generally accepted accounting principles:

The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality and integrity. To this end, a member or associate of the American Institute of Certified Public Accountants shall at all times maintain independence of thought and action, hold the affairs of his clients in strict confidence, strive continuously to improve his professional skills, observe generally accepted auditing standards, promote sound and informative financial reporting, uphold the dignity and honor of the accounting profession, and maintain high standards of personal conduct.

In further recognition of the public interest and his obligation to the profession, a member or associate agrees to comply with the following rules of ethical conduct, the enumeration of which should not be construed as a denial of the existence of other standards of conduct not specifically mentioned:

Article 2: "Technical Standards"

2.01 A member or associate shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member or associate of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

2.02 In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if

(a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(b) he fails to report any material misstatement known to him to appear in the financial statement; or

(c) he is materially negligent in the conduct of his examination or in making his report thereon; or

(d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose
any material omission of generally accepted auditing procedure applicable in the circumstances. [See below, Opinion No. 8, committee on professional ethics.]

2.03 A member or associate shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall:

(a) express an unqualified opinion; or

(b) express a qualified opinion; or

(c) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor; or

(d) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited. [See below, Opinion No. 8.]

2.04 A member or associate shall not permit his name to be used in conjunction with any forecast of the results of future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast. [See below, Opinion No. 10, committee on professional ethics.]

Opinion No. 8: "Denial of Opinion Does Not Discharge Responsibility in All Cases"

When a member believes financial statements are false or misleading, denial of opinion is insufficient.

Rule 2.02 deals with a member's responsibilities in expressing an opinion on representations in financial statements. The rule does not, however, specifically refer to situations where an opinion is denied, either by disclaimer or by reference to the statements as "prepared without audit." When an accountant denies an opinion on financial statements under Rule 2.03, which incorporates the provisions of Auditing Statement 23,* he is in effect stating that he has insufficient grounds for an opinion as to whether or not the statements constitute a fair presentation. Rule 2.03 provides that where an opinion is denied, the accountant must indicate clearly his reasons therefor.

In a circumstance where a member believes the financial statements are false or misleading as a whole or in any significant respect, it is the opinion of the committee that he should require adjustments of the accounts or adequate disclosure of the facts, as the case may be, and failing this the independent accountant
should refuse to permit his name to be associated with the statements in any way.

* Now incorporated in Statements on Auditing Procedure No. 33, "Auditing Standards and Procedures."

Opinion No. 10: “Responsibility of Members for Pro Forma Statements and Forecasts Under Rule 2.04”

In preparing for management any special purpose financial statement anticipating results of future operations, a member must disclose the source of the information used and the major assumptions made, and he must indicate that he does not vouch for the accuracy of the forecast.

Rule 2.04 provides that “A member or associate shall not permit his name to be used in conjunction with any forecast of the results of future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.”

The ethics committee is well aware that pro forma statements of financial position and results of operation, cost analyses, budgets and other similar special purpose financial data, which set forth anticipated results of future operations, are important tools of management and furnish valuable guides for determining the future conduct of business.

The committee is of the opinion that Rule 2.04 does not prohibit a member from preparing, or from assisting a client in the preparation of, such statements and analyses. However, when a member associates his name with such statements and analyses, or permits his name to be associated therewith, there shall be the presumption that such data may be used by parties other than the client. In such cases, full disclosure must be made of the source of the information used, or the major assumptions made, in the preparation of the statements and analyses, the character of the work performed by the member, and the degree of responsibility he is taking. Such disclosure should be made on each statement, or in the member’s letter or report attached to the statements. The letter or report of the member must also clearly indicate that the member does not vouch for the accuracy of the forecast. It is the opinion of the committee that full and adequate disclosure would put any reader of such statements on notice and restrict the statements to their intended use.

In discussing the responsibility of the CPA for the accounting principles followed by the client corporation, we are not referring to legal responsibility, which would rest upon determination by the courts,
but rather to his professional responsibility as reflected in the Code of Ethics and other technical literature previously referred to.

It is abundantly clear that the CPA has a strong responsibility for determining whether the accounting of the entity being reported upon is in accordance with generally accepted accounting principles and must direct attention in his report to any material departures from such accepted principles.

The term accepted accounting principles was defined in "Audits of Corporate Accounts," a pamphlet setting forth important recommendations agreed upon some thirty years ago by an Institute committee and the Committee on Stock List of the New York Stock Exchange, as those principles having substantial authoritative support back of them. The meaning of substantial authoritative support was not specifically defined but in the intervening thirty years CPAs have considered that evidence of support is found in opinions of committees of the Institute to which authority for dealing with accounting has been delegated by Council, the Securities and Exchange Commission, certain regulatory commissions, to the extent that their rulings are not in conflict with accepted accounting principles from other sources, textbooks of recognized standing, experienced and competent CPAs and in the practices commonly followed by business entities. (See the section on "Meaning of Generally Accepted Accounting Principles.")

Whether a given principle or practice has authoritative support is both a question of fact and a matter of judgment. The individual CPA or accounting firm has the responsibility of collecting the available evidence of authoritative support and judging whether it is sufficient to bring the practice within the bounds of generally accepted accounting principles. Opinions of the Accounting Principles Board and its predecessor committee on accounting procedure and of the Securities and Exchange Commission, in the areas in which they have spoken, would be given greater weight than other single sources. Where both the APB and the SEC have issued opinions which are in agreement on the same subject the evidence of acceptability would tend to be conclusive. In case of differing opinions on the same practice, the CPA has a more difficult task but cannot avoid the responsibility of determining whether or not the client company's practice has substantial authoritative support and of rendering his opinion according to his determination.

The foregoing explanation of the CPA's responsibility for accounting may be regarded by some as too detailed, but it is easy to miss the nature of this responsibility without a study of pertinent source
documents. This brings us to the point of considering the authority of the CPA in dealing with the accounting practices of client corporations. The direct authority is limited to his intellectual influence in persuading the clients to adopt accounting practices which he considers most suitable to the enterprise. Corporate executives and boards of directors usually give serious consideration to the advice received from the CPA on accounting matters. If any of their practices represent material departures from generally accepted accounting practices, the CPA must call attention to the matter by a qualification in his report. If this does not cause management to change the practice, the qualification will call the matter to the attention of investors and to stock exchanges and the SEC who have greater authority than the CPA.

The Accounting Principles Board. Consideration of the independent accounting profession’s responsibility and authority would be incomplete without a résumé of the responsibility and authority of the APB. These can be found in the Board’s Charter which was approved by the Council of the Institute and in the Board’s own rules. The provisions of the Charter relating to authority for issuance of pronouncements on accounting principles and to their nature follow:

1. **Authority for Issuance**
   The Board shall have the authority and the duty to issue, in its own name, pronouncements on accounting principles. It may, in its discretion, revise or revoke, in whole or in part, or issue interpretive statements as to any pronouncements previously issued.

2. **Nature**
   Such pronouncements are expected to comprehend basic postulates, broad principles, and rules or other guides for the application of accounting principles in specific situations, such rules or other guides being developed in relation to basic postulates and broad principles previously expressed. They are to be based on what the Board determines to be adequate research and are expected to be regarded as authoritative written expressions of generally accepted accounting principles.

One of the basic considerations specifically incorporated in the Charter is contained in the following paragraph:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the
CHAPTER 1: FUNCTION, RESPONSIBILITIES AND AUTHORITIES

guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues.

The concept of reliance on persuasion rather than compulsion is consistent with the following notation regarding authority which has been carried in all fifty-one Accounting Research Bulletins issued by the committee on accounting procedure and in the Opinions issued to date by the APB:

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

The basic question of the authority of Opinions by the APB over the reports issued by CPAs was considered at the 1964 spring meeting of the Council. The following resolution was adopted:

RESOLVED—That it is the sense of this Council that reports of members should disclose material departures from opinions of the Accounting Principles Board, and that the President is hereby authorized to appoint a special committee to recommend to Council appropriate methods of implementing the substance of this resolution.

In accordance with this resolution, a special committee was appointed by the President in May 1964. This committee reported to Council in October 1964. The conclusions and recommendations in the committee's report were adopted by Council after amendment. The applicable part of the report, as amended by Council, is reproduced below.

1. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

2. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

3. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.
4. No distinction should be made between the Bulletins issued by the former Committee on Accounting Procedure on matters of accounting principles and the Opinions of the Accounting Principles Board. Accordingly, references in this report to Opinions of the Accounting Principles Board also apply to the Accounting Research Bulletins.1, 2

5. If an accounting principle that differs materially in its effect from one accepted in an Opinion of the Accounting Principles Board is applied in financial statements, the reporting member must decide whether the principle has substantial authoritative support and is applicable in the circumstances.

a. If he concludes that it does not, he would either qualify his opinion, disclaim an opinion, or give an adverse opinion as appropriate. Requirements for handling these situations in the reports of members are set forth in generally accepted auditing standards and in the Code of Professional Ethics and need no further implementation.

b. If he concludes that it does have substantial authoritative support:

(1) he would give an unqualified opinion and

(2) disclose the fact of departure from the Opinion in a separate paragraph in his report or see that it is disclosed in a footnote to the financial statements and, where practicable, its effects on the financial statements.* Illustrative language for this purpose is as follows:

The company's treatment of (describe) is at variance with Opinion No. _____ of the Accounting Principles Board (Accounting Research Bulletin No. _____ of the Committee on Accounting Procedure) of the American Institute of Certified Public Accountants. This Opinion (Bulletin) states that (describe the principle in question). If the Accounting Principles Board Opinion (Accounting Research Bulletin) had been followed, income for the year would have been increased (decreased) by $_______, and the amount of retained earnings at (date) increased (decreased) by $_______. In our opinion, the company's treatment has substantial authoritative support and is an acceptable practice.

If disclosure is made in a footnote, the last sentence might be changed to read: In the opinion of the independent auditors, ______________, the company's treatment has substantial authoritative support and is an acceptable practice.

6. Departures from Opinions of the Accounting Principles Board which have a material effect should be disclosed in reports for fiscal periods that begin:

a. After December 31, 1965, in the case of existing Bulletins and Opinions;
b. After the issue date of future Opinions unless a later effective date is specified in the Opinion.

7. The Accounting Principles Board should review prior to December 31, 1965, all Bulletins of the Committee on Accounting Procedure and determine whether any of them should be revised or withdrawn.

8. The Accounting Principles Board should include in each Opinion a notation that members should disclose a material departure therefrom.

9. The failure to disclose a material departure from an Accounting Principles Board Opinion is deemed to be substandard reporting.† The Practice Review Committee should be instructed to give its attention to this area and to specifically report to Council the extent of deviations from these recommendations.

10. The Committee on Professional Ethics and the Institute’s legal counsel have advised that the present By-Laws and Code of Professional Ethics would not cover an infraction of the above recommendations. Whether the Code of Professional Ethics should be amended is a question which should be studied further.‡

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† This is in accord with the following resolution of the Accounting Principles Board at its first meeting on September 11, 1959:

"The Accounting Principles Board has the authority, as did the predecessor committees, to review and revise any of these Bulletins [published by the predecessor committees] and it plans to take such action from time to time.

"Pending such action and in order to prevent any misunderstanding meanwhile as to the status of the existing accounting research and terminology bulletins, the Accounting Principles Board now makes public announcement that these bulletins should be considered as continuing in force with the same degree of authority as before."

‡ The Terminology Bulletins are not within the purview of the Council’s resolution nor of this report because they are not statements on accounting principles.

* In those cases in which it is not practicable to determine the approximate effect on the financial statements, this fact should be expressly stated.

† In discussion at the Council meeting it was explained that the phrase “substandard reporting” was used in the sense of reporting practices not in conformity with recommendations of the Council.

‡ By order of the Council a special committee is now reviewing the entire matter of the status of Opinions of the Accounting Principles Board, and the development of accounting principles and practices for the purpose of recommending to Council a general statement of philosophy, purpose and aims in this area.
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Basic Concepts

Basic Concepts to Which Accepted Accounting Principles Are Oriented

Accountants are generally agreed that accounting principles cannot be derived from or proven by the laws of nature. They are rather in the category of conventions or rules developed by man from experience to fulfill the essential and useful needs and purposes in establishing reliable financial and operating information control for business entities. In this respect they are similar to principles of commercial law and other social disciplines.

There is general agreement, also, among accounting teachers and practitioners that there are a number of concepts which underlie or permeate accepted accounting principles. The first comprehensive exposition of concepts in accounting literature was in An Introduction to Corporate Accounting Standards, by W. A. Paton and A. C. Littleton. This pioneering classic in accounting thought, published in 1940 by the American Accounting Association, discusses seven concepts. A lesser number of concepts had been discussed by Professor Paton in an accounting textbook written some twenty years earlier, and George O. May's monograph, Business Income and Price Levels in 1949 states that the "going concern" concept was adequately presented in Dicksee's Advanced Accounting, published in England at a still earlier date.

Concepts, as well as principles, are derived from experience in observing the conduct of business and the meeting of its accounta-
bilities within our society whose objectives include: (a) the exercise of government power in a manner responsive to the will of the people, and (b) the maintenance of an economic system based upon individual incentives and opportunities for employment and investment in competitive business enterprise.

Different authors, on a basis of the analysis of their own experience, probably would select somewhat differing lists of concepts; and it is impossible to eliminate personal views from the discussion. Nevertheless, it is believed that each of the ten concepts listed below may be justified as providing qualities of usefulness and dependability to accounting information or as setting forth limitations inherent in financial statements produced by the accounting process:

1. A society and government structure honoring private property rights
2. Specific business entities
3. Going concern
4. Monetary expression in accounts
5. Consistency between periods for the same entity
6. Diversity in accounting among independent entities
7. Conservatism
8. Dependability of data through internal control
9. Materiality
10. Timeliness in financial reporting requires estimates

A Society and Government Structure Honoring Private Property Rights

The mere statement of the caption for this concept immediately brings to mind the fact that our form of accounting and reporting for business enterprises for external purposes clearly has no application in totalitarian countries such as Soviet Russia, its satellite areas, or Communist China. In these areas citizens do not have the right to invest in business. The concept, however, has a much broader meaning than just this and is of real significance in the accounting for business entities in countries embraced in the free part of the world.

From an international perspective, it is obvious that different nations have different degrees of dedication to the two objectives previously set forth relating to the protection of freedom of the individual in political and economic matters. Structures of government are different and the extent of regulation of and participation and interference
in economic activities vary a great deal. In other words there are varying degrees to which governments honor private property rights and permit private business decisions, resulting in substantial variances in environment and in the risks surrounding business operations. It follows that generally accepted accounting principles, whether or not that term is used, may mean substantially different things in different countries at any given time.

In the United States, the people are the reservoirs of political and economic power. The state and Federal Government structures are organized under constitutional provisions delegating the necessary powers for protection of the public interests, but reserving the economic area primarily for development by the people. This concept necessarily carries with it not only the honoring of private property rights but the legal means of protecting and enforcing them, so long as their use does not interfere with the rights of others or with the public interest. Practically every entry made in the accounts of a business entity rests on this concept.

The advantages of using corporations as an instrumentality for the conduct of business enterprises were recognized, through passage of statutes permitting incorporation, by the various states about the middle of the nineteenth century. Since that time, the history of industrial economic development in the United States is largely the story of the growth of large-scale corporate business enterprise, the diffusion of equity investments to millions of people, the growth and increased political and economic power of labor unions and the expanding role of government, particularly the Federal Government, as the subsidizer of some businesses, as the regulator of a great many more, including banking, insurance, transportation, communication, electric and gas industries, and more recently as the owner and operator of numerous business activities and as the largest customer of many corporations due to the enormous expenditures for defense.

Fortunately, the extension of the government's activities has been accomplished, for the most part, without destroying the initiative and productivity which flows from freedom and decentralization in the exercise of business judgment and decision-making. The extensive participation of governmental agencies in business affairs, in the several ways previously indicated, has a tremendous impact on economic climate or environment, which varies widely by industries and by particular entities in a given industry.

On balance, the greater participation of the government in business affairs is regarded by the majority of people as desirable and perhaps
necessary from the viewpoint of the public interest. This creates a condition, however, in which business enterprise is subject not only to the protective aspects of law and order which implement the concept on honoring of private property rights of the enterprise and its investors, but also, to risks of arbitrary bureaucratic actions and decisions. With respect to such risks, it is not customary, under present generally accepted reporting practices, to call attention to these risks or to provide for possible costs or losses in advance of the actual events.

**Specific Business Entities**

A business entity consists of an organization of persons and properties which have been brought together for certain economic objectives. These objectives usually are the supply of products or services to customers with the expectation that a margin of profit will be earned in order to pay returns to stockholders and creditors furnishing the capital required to establish and maintain the enterprise. Profits, of course, are essential to the continuity of the enterprise.

The business corporation created under incorporation statutes is recognized as an entity in its own right, separate and distinct from its stockholders. Stockholders in the typical widely owned corporation are almost completely divorced from day-to-day operations. The more important powers exercised by stockholders include the election of directors and control over the number of shares and classification of capital stock. In behalf of stockholders the directors select management, furnish policy guidance and continuously appraise management's performance. The board of directors has the responsibility of voting dividends payable to the stockholders.

The separation of ownership from management of the business entity is a primary factor in imposing on the entity the fiduciary accountabilities to its stockholders. The summary of generally accepted principles later set forth is classified in relation to these fiduciary accountabilities.

A subdivision or department of a corporation cannot be a reporting entity. Departmental assets, liabilities and earnings may be reported to stockholders as a part of the complete financial statements of the entity but separate departmental statements standing alone for external use must be considered of a "special purpose" nature. Where one corporation owns the controlling interest in the voting stock of other corporations, the consolidated group of companies becomes the business
CHAPTER 2: SPECIFIC BUSINESS ENTITIES

entity. In these circumstances, the parent company has the primary fiduciary accountabilities to its stockholders and also, as a practical matter, to minority stockholders of the subsidiaries. The parent company's own report to stockholders usually includes consolidated financial statements and sometimes includes separate parent company statements. It also includes separate statements or summary information regarding any unconsolidated subsidiaries, together with reasons for nonconsolidation. Minority stockholders of a subsidiary are furnished financial statements for that particular company. It is axiomatic that the reporting entity should be clearly identified in financial statements and reports to stockholders.

Although circumstances sometimes justify departures, the general basis for historical accounting for business corporations is cost to the present entity. Obviously the cost to another entity is of little significance, assuming there has been a bona fide purchase transaction. It is possible, of course, for mergers and consolidations to be carried out in forms which constitute a pooling of interests. In these circumstances, the historical basis of accounting of the previously separate entities carries through without change to the continuing enlarged entity.

Going Concern

It is a commonplace that business activity has changed over the past century or so from a series of separate ventures to a pattern of continuous activity. As a consequence, a large part of accounting practice as well as theory is based on the presumption that the accounting entity will continue in operation and not be liquidated in the foreseeable future. In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely.

Corporate managements must view their operations as a continuing process. No enterprise of any consequence could operate from day to day under the cloud of expected liquidation. The complexities of present-day business operations, with their high degree of technology, require long-range planning and research. Operating facilities with long-lived usefulness must be acquired, often by incurring long-term debt. Labor contracts with long-term benefits, such as pensions, must be negotiated to assure the necessary manpower for operations. All of these factors support the basic proposition that business managements assume, and properly so, the indefinite continuation of operations.
An obvious corollary of this proposition is that in the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely. Under these circumstances the form, content, and descriptive captions of the financial reports should make clear this characteristic of limited life; pricing rules and other formulas for expressing assets and liabilities, and for assigning revenues and costs to periods, should be appropriate to the expected terminal date of the entity and to the type of liquidation anticipated. There are many exceptions to the assumption of a "going concern," including large areas where it is not applicable at all (e.g., receivers' statements; statements of affairs; statements of companies in the developmental or exploratory stage; joint ventures; etc.). It is nevertheless a unifying force behind a whole array of accounting practices and procedures in the so-called "normal" cases.

"Going concern" implies indefinite continuance of the accounting entity under scrutiny. Indefinite continuance means that the business will not be liquidated within a span of time necessary to carry out present contractual commitments or to use up assets according to the plans and expectations presently held. This view makes the concept a tentative judgment, subject to revision in the future as contractual agreements are changed and plans and expectations with respect to operations shift.

The "going concern" concept has been useful in broadening the scope of accounting beyond the limitations of liquidation value and of strictly construed legal rights and obligations. Some specific cases are presented below:

1. **Accounts receivable.** We ordinarily recognize an account receivable (and the related revenues) whenever future cash receipts from customers are definitely expected and can be measured. The size of the receivable is geared to the size of the anticipated future cash receipts, not to the present realizable (liquidation) value of the receivable in the market. In addition, some legal defect in the transaction may be present, e.g., an incomplete transfer of title in the goods sold, but it will ordinarily be ignored in accounting for the transaction. These considerations of liquidity and legality are of some relevance, but only in those cases in which the expected cash receipts from the customer are in doubt or in jeopardy. In addition, the device of an allowance for uncollectibles is not based upon either (a) immediate market or liquidation value, or (b) the right to sue and to obtain judgment.
2. Inventories. In the usual case, work in process and finished goods are assumed to be worth more than raw materials by the amount of labor and other production costs added; this is a rational attitude if the inventories will be disposed of in the normal course of business by a going concern. As others have pointed out, however, the immediate market (liquidation) value of work in process is usually low compared with the market value of the materials before processing. Plain white paper, for example, is worth more than printed pages, unless the process can be completed by assembling the printed pages into a book or magazine which can be sold for some price above cost. In pricing inventories at cost, then, we assume a going concern which will finish the work in process and which will sell the finished output.

3. Buildings and equipment. The influence of the going-concern concept is particularly pronounced in the case of the depreciable assets. In the first place, we are enabled to avoid the effects of random changes in immediate market prices (liquidation values) of the depreciable items because we assume a using-up of the services supplied by these assets rather than sale in the market of the depreciable assets themselves. In the second place, any depreciation formula which employs an estimate of useful life is based upon the concept of a going concern (among other concepts) which will operate at least as long as this useful life and, furthermore, will be able to recover the undepreciated cost of the assets from future revenues.

4. Intangibles. The allocation of intangible costs to future periods, for the most part, rests upon the validity of the going-concern concept in the particular circumstances. This applies to many prepaid items as well as to research and development, patents, trade-marks, bond discount and expense and other limited-term intangibles. The carrying of unlimited term intangible costs such as goodwill and organization expense is based, also, on this concept.

5. Liabilities. The case of estimated liabilities for guaranties, for collection costs, etc., comes to mind. In this area, accounting has shown a tendency to follow through on the going-concern concept, whereas the courts and the taxing authorities have usually insisted on the existence of a legally enforceable obligation before permitting recognition of the liability and the related expense. For accounting at its present stage of development, the existence of probable future outlays, arising from or related to past transactions, is sufficient in
most cases to warrant the recognition of a liability; for legal purposes (including income taxation) a further condition is usually necessary; namely, the identification of a specific legal person to whom the obligation runs, and who has the right to sue for payment, if necessary.

The recognition of continuity of business operations leads directly to the conclusion that financial reporting is also continuous. To be useful for making decisions, financial reports are issued regularly and are interrelated in that one report picks up where the previous one left off. In this continuous reporting process, estimates or judgments made in a preceding period, which hindsight proves to have been too high or too low, are usually adjusted in the next year's operations, unless the difference is so large as to distort the earnings for the respective periods.

NOTE: The comments in Chapter 5 of Accounting Research Study No. 1 on going concern are incorporated above almost verbatim. Three additional paragraphs have been added.

Monetary Expression in Accounts

Many business transactions could be stated in physical or time units of measurement. The diversity of the units, however, would make record-keeping and particularly summarization of position and results of operations very cumbersome procedures. So, if there were no monetary system, one would have to be created as a medium of exchange and as a standard of exchangeability. As a matter of convenience and usefulness, therefore, transactions of business entities are reflected in the accounts in terms of the monetary unit at the time of the transaction. Usually the monetary unit used is that of the country in which the entity is organized and in which most of the operations actually take place.

Historical dollar accounting by its very name contemplates that the accounts reflect the price aggregates or costs at the various dates at which transactions are consummated. Thus, continued adherence to historical dollar accounting is based on the assumption that changes in the purchasing power of the monetary unit are not of sufficient importance as to require adjustment. It is well recognized, even by the staunchest supporters of historical accounting, that dollars of different time vintages are not of equal purchasing power. For this reason they are not referred to herein as the "common denominator"
of business transactions but rather as the monetary expression of them.

The substantial changes in the purchasing power of money, particularly in periods of inflation, result in rather important limitations on the usefulness of financial statements based on historical cost. These limitations are discussed in later sections of this Inventory.

**Consistency Between Periods for the Same Entity**

One of the most important improvements in accounting and reporting, resulting from the correspondence between the Institute committee and the New York Stock Exchange in the early nineteen thirties, was the increasing recognition given to the concept of consistency in accounting as between periods for a given business entity. This correspondence, published as “Audits of Corporate Accounts,” reflects the views that responsibility for financial statements of corporations (a) rests primarily on management, who has the duty to employ methods of accounting best suited to the needs and purposes of the corporation, and (b) requires disclosure of the methods employed and consistency in their application from year to year.

The correspondence wisely did not preclude desirable changes in accounting practices; but when a significant change is made that fact is required to be disclosed, including the dollar effect upon the financial statements and particularly the effect on net income for the period. The certified public accountant is required to report in the opinion paragraph that the statements present fairly the financial position and results of operations, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. In case of a change in accounting principles, the report is required to be appropriately qualified.

The concept of consistency, developed only thirty years ago, adds greatly to the usefulness and comparability of the financial statements of specific entities as between periods. With the disclosures and qualifications now required, the users of financial statements are informed as to whether changes in financial position and results of operations from one period to another are the result of actual transactions or the result of changes in accounting practices. Where changes in accounting practices have been made, the users are provided with the information required to make the successive financial statements comparable.

As protection against possible misunderstanding of the scope of this
concept, it should be understood that it does not imply uniformity or even comparability among independent units. In fact it does not mean consistency among existing accounting practices of affiliated units or even in the internal practices regularly followed by one corporation. For example, many corporations follow the Lifo inventory method for certain inventory items and the Fifo method for others. This requires disclosure in the financial statements but is not a violation of the concept of consistency. If a material shift of items of inventory is made from one method to the other, then there is inconsistency among accepted principles from one period to the next requiring the explanations and qualifications described in the preceding paragraph.

Diversity in Accounting Among Independent Entities

In 1932, the Institute special committee on co-operation with stock exchanges considered alternative ways of improving corporate accounting and financial reporting. The following comments are taken from that committee’s report to the Committee on Stock List of the New York Stock Exchange:

In considering ways of improving the existing situation two alternatives suggest themselves. The first is the selection by competent authority out of the body of acceptable methods in vogue today of detailed sets of rules which would become binding on all corporations of a given class. This procedure has been applied broadly to the railroads and other regulated utilities, though even such classifications as, for instance, that prescribed by the Interstate Commerce Commission allow some choice of method to corporations governed thereby. The arguments against any attempt to apply this alternative to industrial corporations generally are, however, overwhelming.

The more practicable alternative would be to leave every corporation free to choose its own methods of accounting within the very broad limits to which reference has been made, but require disclosure of the methods employed and consistency in their application from year to year.

Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year.
It is evident from the foregoing that the joint undertaking for improvement in financial reporting between the Institute and the New York Stock Exchange, which as previously noted created the concept of consistency in accounting between periods for the same entity, recognized and deliberately did not change the previously existing concept that there is diversity in accounting as among separate independent entities. The judgment of the special committee of the Institute and Committee on Stock List of the New York Stock Exchange in rejecting an attempt to bring about uniformity in accounting, was corroborated in a publication "Reports to Stockholders" by the Business and Planning Council for the Department of Commerce in 1934 and, also, in *A Statement of Accounting Principles* by Sanders, Hatfield and Moore, published in 1938.

The Accounting Research Bulletins issued by the committee on accounting procedure during most of its existence recognized the concept of diversity among separate entities, many of them having set forth alternate choices in accounting treatments to be exercised by management with appropriate disclosure. In a recent Opinion, Number 4, the Accounting Principles Board has approved an alternate method of accounting for the investment tax credit, although it expressed a preference for the method it had previously recommended, exclusively, in Opinion Number 2. Thus members of the Board, in common with most experienced accountants, recognize that diversity in accounting among independent business entities is a basic fact of life.

There is a minority view which urges uniformity in accounting as the panacea for all accounting and reporting deficiencies. The following pertinent factors indicate the unreality of such suggestions or expectations:

1. Judgment and estimates play a substantial role in accounting on an accrual basis, which is the only useful basis for presenting statements of financial position and results of operations for complex business entities. It is axiomatic that when there is diffusion in decision-making, a necessity to the free enterprise system, there is bound to be diversity in the accounting results.

2. Each business entity must follow generally accepted accounting principles, i.e., those which have substantial authoritative support, in order to obtain an unqualified opinion from the certified public accountant. However, as shown in chapter 10, there are rather numerous alternative methods of applying such principles, and it is not possible,
short of government fiat, to prescribe a one and only method. Under the circumstances, it is inconsistent and impossible of performance to expect the management of an entity to (a) choose the accounting practices and methods of application most suitable to the needs and purposes of the entity and which, in the judgment of management, will most fairly present the financial position and results of operations, and (b) at the same time, follow accounting practices and methods of application which are "uniform" with other business entities.

3. The attainment of a substantial degree of uniformity would require the preparation and adoption of a comprehensive manual prescribing a uniform code of accounts, with full directions as to the items to be charged and credited to each account, directions as to elements of cost to be included in fixed assets including direct costs and overheads, catalogue of property units, directions as to elements of cost to be included in inventories and how to determine market values, prescription of whether Lifo, Fifo or average cost is to be followed, detailed instructions on allocation of costs between periods including methods and rates of depreciation by classes of property and innumerable other instructions.

4. It is obvious that no single manual of instructions would fit the needs of all industry. Therefore, the broadest possible approach would be to prepare suggested uniform systems for each type of industry. Such systems have been developed for certain industries, but most of the companies in such industries find it necessary to develop their own systems to fulfill better their particular requirements for management information and control.

5. Even in those industries, such as railroads, communications, electric and gas, where the companies follow prescribed uniform systems, diversity in accounting is not and cannot be eliminated. As previously stated, judgment and estimates play a substantial role in accounting and where there is diffusion in decision-making there is bound to be diversity in the accounting results. Another reason for diversity in the accounting for regulated industries is the substantial influence of the rate-making policies followed by various Federal and state commissions on the timing of cost allowances. The diversity in rate-making decisions regarding allowance for income taxes, for example, is the cause of the diversity in accounting by public utilities as represented by the "flow through" method and the "normalization" or deferred tax methods of treating the income tax effect of accelerated depreciation.
Recognition of the concept of diversity in accounting among independent entities, as a fact of business life, in no way imperils the objective of the Accounting Principles Board to "narrow the areas of difference in accounting" and to promote continuous improvement and greater comparability in financial statements. It does, however, place the objective within realistic limits which fall considerably short of uniformity.

Conservatism

Conservatism is not a justification for deliberate understatement. It is rather a quality of judgment to be exercised in evaluating the uncertainties and risks present in a business entity to assure that reasonable provisions are made for potential losses in the realization of recorded assets and in the settlement of actual and contingent liabilities.

The uncertainties and risks inherent in business create a situation somewhat comparable to Alice in Wonderland; the enterprise must run rather fast to stay where it is and it must run even faster to be successful. Statistics of losses experienced in the past may be helpful to the extent that the nature of the risks and attendant circumstances are comparable; but judgment, more than logic, is the primary resource in evaluating unresolved risks.

Some accounting texts often discuss the concept of conservatism in terms of more or less deliberate understatement of assets to reflect liquidation values in line with the views of ultra-cautious short-term creditors, "the pounce theory," or as a result of the designs of management to create secret reserves. These critics of the concept then point out that such understatements are likely to produce overstatements in subsequent net income and conclude that the concept of conservatism is of doubtful usefulness or validity in accounting.

The foregoing viewpoint may have been applicable in numerous cases many years ago and it may have some applicability today in closely held corporations anxious to minimize income taxes. The viewpoint has no present applicability to widely held corporations and the association of deliberate understatement of income in one period followed by overstatement in another misses the entire significance of the concept of conservatism.

The concept of conservatism is an essential quality in the performance of the auditing function by the certified public accountant. Competent sales and operating executives are naturally optimistic...
in their appraisal of business matters. A proper balance in the judgment of unresolved risks requires a counterweight of caution on the part of financial executives and the certified public accountant. The inquiring analytical mind and "show me" attitude, reflecting the concept of conservatism, may have caused some distortion in the public popularity image of the CPA, but they are essential to his basic function of independent professional attestation of financial reports.

From the viewpoint of generally accepted accounting principles, the concept of conservatism comprehends the twin ideas that:

Sales, revenues and income are not to be anticipated. Recognition ordinarily requires consummation of sale and delivery, and

All known liabilities or losses should be recorded regardless of whether the definite amounts are determinable.

These items often have been dealt with as a separate concept of "realization." For the purposes of this compendium it has been considered preferable to include these ideas, or rules drawn from experience, as a part of the broader concept of conservatism. Further comments on the application of the realization rule are presented in the section of the Inventory dealing with income and expense.

**Dependability of Data Through Internal Control**

Many accounting texts include objectivity as a basic concept of accounting. Usually the texts attempt to draw sharp distinctions between objective and verifiable documentary evidence, as illustrated by a properly approved sales or purchase invoice, and subjective decisions resting on the personal judgment of some probably biased person. Since the highest degree of objective and verifiable documentary evidence is found in the vouchers covering acquisitions of assets and services, objectivity is used as the key argument supporting the cost principle in accounting.

This type of presentation probably is all right as far as it goes, but it does not adequately cover all of the problem areas of accounting having to do with the distribution of costs between fixed assets, inventories and expense and the allocation of costs between periods. In all of these areas accounting treatments necessarily rest upon decisions and estimates by people based upon their judgment and opinion, after considering relevant facts and circumstances.

Study of this matter has brought the author to the view that ob-
jectivity is merely part of a broader and more useful concept that
dependability of all accounting data, including purchase and sales
invoices, is obtained through appropriate measures of internal control.
Several years ago the committee on auditing procedure of the In­
stitute defined internal control as comprising the plan of organization
and all of the co-ordinate methods and measures adopted within a
business to safeguard its assets, check the accuracy and reliability
of its accounting data, promote operational efficiency, and encourage
adherence to prescribed managerial policies. The committee's report
said that a satisfactory system of internal control included the follow­
ing characteristics:

A plan of organization which provides appropriate segregation of
functional responsibilities,

A system of authorization and record procedures adequate to
provide reasonable accounting control over assets, liabilities,
revenues and expenses,

Sound practices to be followed in performance of duties and
functions of each of the organizational departments, and

A degree of quality of personnel commensurate with responsi­
bilities.

The interdependence of these characteristics is described by these
comments:

These elements, as important as each is in its own right, are all so
basic to proper internal control that serious deficiencies in any
one normally would preclude successful operation of the system.
For example, no plan of authorization and record procedures for
accounting control may be considered adequate without person­
nel capable of performing the procedures designed to make such
a system work, nor can one consider the practices followed in
the performance of duties in the organizational departments
sound unless there is departmental independence so that respon­
sibilities can be placed and interdepartmental controls enforced.

The segregation of operation, custodian and accounting functions,
with each being performed by properly qualified personnel, obviously
must include qualities of objectivity and due care in the handling
of business transactions. The same qualities must be present, also,
in the maintenance of dependable documentary evidence of trans­
actions and estimates affecting accounting distributions. This has
become of increasing importance with the extensive use of electronic
data processing systems.
Thus, when management has met its responsibility for devising, installing and currently supervising a system of internal control adequate to meet the objectives set forth in the preceding definition, it necessarily follows that accounting data, including external transactions and internal judgmental decisions, from which financial statements are prepared, will possess a high degree of dependability.

From the viewpoint of the user of the financial statements, the trustworthiness of the data presented is further reinforced by the examination and report of the certified public accountant, who has brought to bear the quality standards of proficiency in auditing, independence of mental attitude and due professional care in the performance of his work.

**Materiality**

Accounting and auditing literature and pronouncements are replete with references to items and matters which are: material, significant, of substantial importance, substantial, materially distorting, immaterial, inconsiderable in amount, of little or no consequence, not significant, etc. These references make it abundantly clear the concept of materiality is applicable in many aspects of auditing, accounting and reporting of financial position and results of operations for business entities. This may be illustrated by the following excerpts from three well-known authorities:

... to express an unqualified opinion, he [the independent auditor] must have reason to believe and must believe that the financial statements fairly present the financial position and results of operations and that they disclose all material facts necessary to make them not misleading. (*Codification of Statements on Auditing Procedure*, AICPA, 1951, p. 18. Emphasis supplied.)

The committee [on accounting procedure] contemplates that its opinions will have application only to items material and significant in the relative circumstances. (*Accounting Research Bulletin No. 43*, AICPA, 1953, p. 9. Emphasis supplied.)

The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered. (*Regulation S-X, Rule 1-02, SEC*)

The fact that no committee of the Institute has defined the terms material, significant, or consequential merely serves to emphasize the
CHAPTER 2: MATERIALITY

fact that the problem involved is largely a matter of judgment to be exercised in the light of all the then-existing surrounding circumstances. As a result, precision in definition is not possible. It is suggested, however, that a general definition, with an indication of the various criteria involved, may be helpful to accountants and others who are required to distinguish between what is material and what is immaterial.

The problem of materiality is a very old one and a very broad one. In the field of law, for instance, a well-known rule of trial practice requires the exclusion of evidence which is immaterial. In matters of tort and contract, fraud under the common law is commonly defined as “a false representation of a material fact,” and there are many cases dealing with materiality. Under the laws administered by the Securities and Exchange Commission, a statutory type of fraud is defined in substance as an “untrue statement of a material fact” or omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” Numerous other illustrations of the problem, as it exists in the field of law, could be cited.

In view of the nature of the problem it is not surprising that there are relatively few definitions of the term materiality. There are some, however, which may be noted:

1. In the Restatement of the Law of Contracts, Chapter 15, it is suggested that “Where a misrepresentation would be likely to affect the conduct of a reasonable man with reference to a transaction with another person, the misrepresentation is material.”

2. In “Accountants and the Securities Act” (JofA, Dec.33) Spencer Gordon suggests that, as applied to the Securities Act of 1933, a material fact “is a fact the untrue statement or omission of which would be likely to affect the conduct of a reasonable man with reference to the acquisition, holding or disposal of the security in question.”

3. The Securities and Exchange Commission has commented upon materiality” in several cases:

   (a) In Matter of Howard, et al., 1 SEC 6, the Commission said: “A material fact is a fact which if it had been correctly stated or disclosed would have deterred, or tended to deter, the average prudent investor from purchasing the security in question.”

   (b) In Matter of Winnebago Distilling Company, 6 SEC 926, the Commission said: “A material contract is in our opinion one concern-
ing which an average prudent investor ought to be informed before purchasing the registered security."

On the basis of the foregoing discussion several general conclusions may be drawn:

1. The question must be resolved on the basis of the surrounding circumstances, and the setting within which statements are made or within which the item in question appears. It is manifestly improper to pass on materiality in the light of subsequent events, i.e., on a "hindsight" basis.

2. The question must be resolved on the basis of the effect which statements are likely to have upon the person, or class of persons, to whom the statement is made. Where the person is a member of a group or class, the test is applied in such terms as a "reasonable man under the circumstances," or as the "average prudent investor."

3. The basic test is the probable effect of the statement upon the conduct of the person to whom made; i.e., it must be capable of influencing that conduct. If it affects his conduct it need not be the sole motivating factor. Thus the problem is essentially one of avoiding "misleading inferences" on the part of another person.

4. While a distinction may be made as between such words as "material" and "significant" on the ground that the former relates primarily to dollar amount, in the last analysis both words come to substantially the same result where the controlling factor is the effect upon the judgment or conduct of the person to whom statements are made. It is suggested, therefore, that a definition of materiality should cover such alternate words as significant or consequential.

5. While it is clear that there are degrees of materiality and that in some cases the importance of the items in question must be greater than is ordinarily required by the use of the word material, any general definition should be limited to basic distinction as between material and immaterial.

The following general definition is suggested:

A statement, fact, or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person. The same tests apply to such words as significant, consequential, or important.
The foregoing definition and the bulk of the preceding comments were adopted almost verbatim from an article in the July 1950 issue of *The Journal of Accountancy* written by James L. Dohr, a former director of research of the Institute. Neither the definition nor the comments furnish specific criteria to guide the certified public accountant or others faced with the exercise of judgment on questions of materiality in auditing, accounting and financial reporting. It may be observed, however, that "the giving of full consideration in the surrounding circumstances" means that facts and rational analysis available to such persons can be used as far as possible to assist in arriving at an unbiased and intelligent judgment. This is not too much to expect from the members of a learned profession.

**Timeliness in Financial Reporting Requires Estimates**

Business activities are continuous but vary in volume and profitability from period to period. The problem of recognition and allocation to specific periods is difficult because the transactions and events do not neatly fit the monthly, quarterly and annual periods for which financial reports must be rendered. Such reports must be timely to have any usefulness for management and investor decisions. This means that in many unresolved situations allocations and provisions must be made on the basis of estimates and opinions rather than definitely ascertainable facts. Chapter 8 of *Accounting Research Bulletin No. 43* describes the situation as follows:

Profits are not fundamentally the result of operations during any short period of time. Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement.

In the case of most estimates made and judgments exercised in relation to periodic reporting, actual facts or hindsight will follow rather closely in the subsequent period. Usually, the differences between the actuals and the estimates are relatively unimportant and they are absorbed without identification in the operations of the subsequent period. In some instances, such as disputed income taxes and depreciation estimates, the determination of actual amounts may
not be available for years and revised estimates may be necessary from time to time prior to final determination.

Even in the long drawn-out cases, it is desirable to absorb any necessary adjustments in operations of subsequent periods unless the amounts are so large as to distort the net income. In this connection reference is made to Chapter 8 of ARB No. 43, reproduced in Chapter 4, for a discussion of criteria for determining which extraordinary charges or credits should be excluded from the determination of net income.

The absorption of differences between "estimates" and "actuals" in the operations of subsequent periods is in no sense glossing over or covering up accounting errors. In fact a strong argument can be made that no error has been committed when estimates have been based on rational analysis, to the extent possible, and the best judgment available in the circumstances. The practice reflects a realistic appraisal of the inherent nature of accounting by recognition that compliance with timeliness required for usefulness in financial reporting requires estimates. In view of the inherent limitations in the "measurement instruments" of accounting, the preferable and more accurate procedure, in the long run of financial reporting, is to absorb these differences in current income statements rather than have a plethora of interperiod adjustments charged and credited to surplus.
Appendix to Chapter 2

Comparison of Concepts
Presented Herein With Those in Accounting Research Study No. 1

It may be of interest to compare in a general way the concepts presented in the preceding pages with those set forth in Accounting Research Study No. 1. Seven of the fourteen concepts in ARS No. 1 are dealt with in this study. The manner of presentation differs probably because ARS No. 1 was closely integrated with ARS No. 3, "A Tentative Set of Broad Accounting Principles for Business Enterprises," reflecting the authors' views of what the accounting principles ought to be; whereas the present study is concerned with the concepts related to principles and practices which have general acceptance now.

The following items in ARS No. 1 have been omitted as basic ideas in this study:

Postulate A-1. Quantification. Quantitative data are helpful in making rational economic decisions, i.e., in making choices among alternatives so that actions are correctly related to consequences.

Postulate A-2. Exchange. Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers.

These two matters are part of the environment of business, but they are not considered to be basic concepts to generally accepted accounting principles.
Postulate A-4. Time period (including specification of the time period). Economic activity is carried on during specifiable periods of time. Any report on that activity must identify clearly the period of time involved.

The matter of time periods has been incorporated to the extent necessary in the broader concept that "Timeliness in Financial Reporting Requires Estimates."

Postulate B-1. Financial statements. (Related to A-1.) The results of the accounting process are expressed in a set of fundamentally related financial statements which articulate with each other and rest upon the same underlying data.

Postulate B-2. Market prices. (Related to A-2.) Accounting data are based on prices generated by past, present or future exchanges which have actually taken place or are expected to.

Postulate C-4. Stable unit. Accounting reports should be based on a stable measuring unit.

Postulate C-5. Disclosure. Accounting reports should disclose that which is necessary to make them not misleading.

For the purposes of this Inventory it is believed that financial statements, market prices and disclosure are a part of generally accepted accounting principles rather than basic concepts to which the principles are related. The stable measuring unit is the essential instrument in presenting financial statements adjusted for changes in purchasing power of the monetary unit. The summary of generally accepted accounting principles in this Inventory is presented in relation to historical dollar accounting. The present status on the matter of the responsibility of business for reporting on a current-dollar basis in addition to reporting in historical or nominal dollars is dealt with in Chapter 9 of this Inventory.

The following four concepts presented in this study were not included in ARS No. 1:

A society and government structure honoring private property rights
Diversity in accounting among independent entities
Conservatism
Materiality

Conservatism and materiality were discussed but rejected as basic concepts in the earlier study.
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Meaning and Summary of GAAP

Meaning of Generally Accepted Accounting Principles

The term "accepted principles of accounting" came into general use in the reports of certified public accountants as a result of the correspondence between an Institute committee and the New York Stock Exchange. Such correspondence occurring in 1932-1934 and a standard form of report was reproduced in a pamphlet called "Audits of Corporate Accounts." In the earlier correspondence the term "accepted accounting practices" was used and a letter from the president of the exchange to the presidents of listed companies had stated that auditors' reports should provide answers to the following questions:

4. Whether in their opinion the form of the balance-sheet and of the income, or profit-and-loss, account is such as fairly to present the financial position and the results of operation.

5. Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.

6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.

Nine accounting firms participated in a joint letter to the president of the stock exchange, which presented the following comments on the foregoing questions:
Your fourth question relates to the form in which the accounts are submitted. We take it that you desire to be informed whether the accounts in the opinion of the auditor set forth the results fairly to the extent that they purport to do so, and that the inquiry does not go to the question whether regard for the interests of the stockholders calls for more detailed statements of the financial position and the operations of the company than those now given. The question how much information should be given to stockholders is one on which wide differences of opinion exist, and it is not our understanding that the Exchange is attempting to deal with this point in this inquiry.

Referring to the fifth question — we attach as great importance as the Exchange evidently does to consistency of method in the presentation of financial statements by corporations. The only further comment on this question which seems called for is to emphasize the part which judgment necessarily plays in the determination of results, even if principles are consistently adhered to. There would, we take it, be no objection to an accountant answering the fifth question in the affirmative, even though in his opinion the judgment of the management had been somewhat more conservative at the close of a year than a year earlier, or vice versa. We think it well to mention this point and to emphasize the fact that accounts must necessarily be largely expressions of judgment, and that the primary responsibility for forming these judgments must rest on the management of the corporation. And though the auditor must assume the duty of expressing his dissent through a qualification in his report, or otherwise, if the conclusions reached by the management are in his opinion manifestly unsound, he does not undertake in practice, and should not, we think, be expected to substitute his judgment for that of the management when the difference is not of major importance, when the management's judgment is not unreasonable and when he has no reason to question its good faith.

Your sixth question, apart from the specific reference to the principles enumerated, aims, we assume, to insure that companies are following accounting practices which have substantial authority back of them. Answers to this question of an affirmative character will not, of course, be understood as implying that all of the clients of a given firm observe similar or equally conservative practices, either in the case of companies engaged in the same industry or in the case of different industries, or even that the accounting principles adopted are precisely those which the accountant would have himself selected, had the sole choice rested with him.

We agree with the five general principles enumerated in the
memorandum attached to your letter, but it may, we suppose, be understood that rigorous application of these principles is not essential where the amounts involved are relatively insignificant. We mention this point not by way of any substantial reservation but to avoid possible later criticism based on narrow technicalities.

The words "practices" and "principles" were used interchangeably through the correspondence and the wording finally selected in the standard form of opinion resulted from conferences between the Institute committee and a committee of the Controllers Institute of America, predecessor to the Financial Executives Institute. The comments of the nine firms regarding question six make it clear that "accepted accounting principles or practices" at that time were understood to be the five general principles enumerated in the memorandum attached to the president's letter, which were later adopted by Council and by the membership of the Institute, and other accounting practices which have substantial authority back of them. The letter makes it clear, also, that an opinion in the accountant's report that financial statements "... fairly present, in accordance with accepted principles of accounting ..." "... will not, of course, be understood as implying that all of the clients of a given firm observe similar or equally conservative practices either in the case of companies engaged in the same industry or in the case of different industries. . . ."

The definition of accounting was dealt with in the first chapter of this compendium. The committee on terminology added the following four paragraphs in its consideration of the meaning of accounting principles.

"It is desirable that the accountant conceive of his work as a complex problem to be solved and of his statements as creative works of art, and that he reserve to himself the freedom to do his work with the canons of the art constantly in mind and as his skill, knowledge, and experience best enable him. Every art must work according to a body of applicable rules, but it also must reserve the right to depart from the rules whenever it can thereby achieve a better result."

"Dictionaries agree in giving at least three orders of definitions of principle. The first is: 'source, origin, or cause,' which is of little help to accountants except as it emphasizes the primary character of some principles. The second is: 'A fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths.' The third is: 'A
general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice...

“This third definition comes nearest to describing what most accountants, especially practicing public accountants, mean by the word principle. It is not convenient, either in conversation or in writing on accounting subjects, to add ‘(meaning number three)’ each time the word principle is used, though that essentially is understood.

“Care should be taken to make it clear that, as applied to accounting practice, the word principle does not connote a rule from which there can be no deviation. An accounting principle is not a principle in the sense that it admits of no conflict with other principles. In many cases the question is which of several partially relevant principles has determining applicability.”

The report developed out of the Institute—Stock Exchange correspondence was a substantial forward step in reporting by CPAs in the United States. It was widely used in the profession during the five-year period 1934-1939. A special committee on auditing procedure was created by the Institute in 1939 to study problems arising from the McKesson and Robbins case. The report of the committee entitled “Extensions of Auditing Procedure” was approved at the 1939 annual meeting and it included a revised form of standard short-form report. The report stated: “The major changes recommended [in the form of report] pertain to the description of the scope of the examination, specifically to include reference to the system of internal control.” The committee gave brief reasons for such changes. The revised form of report also made changes in the wording of the opinion paragraph but no explanation was given for these changes, presumably because they were regarded as not major in character. With regard to accounting principles the revised wording was: “... in conformity with generally accepted accounting principles.” Thus the word generally was added to the previous phrase without indication of the significance, if any, to be drawn from the change.

The word generally means in a general manner and the word general has a great many meanings. Webster’s New Intercolligate Dictionary, 1961, lists eight meanings of which the fifth seems most suitable to the use in accountants’ reports: “5. Pertaining to many persons, cases, or occasions; prevalent.” A synonym for general is universal, but it is certain that that meaning could not have been attributed either in 1939 or at the present time without completely disregarding the facts. In the light of the circumstances at that time, it is probable that the addition of the word generally was intended to add
something to the responsibility of CPAs for determining that accounting practices in use by a client really have substantial authority back of them. This responsibility has been inherent in the wording used in the opinion paragraphs of the standard forms of reports since 1934. It is obvious that the mere existence of a practice in one or a few instances does not automatically constitute substantial authoritative support; it may well demonstrate the reverse conclusion. The judgment and knowledge required in meeting this responsibility was dealt with in “Generally Accepted Auditing Standards,” first issued in 1947, and reissued with no change in substance in 1954, as follows:

The determination of whether “generally accepted accounting principles” have been adhered to requires the exercise of judgment on the part of the independent certified public accountant, as well as knowledge as to what principles have found general acceptance even though certain of these in manner of application may have received only limited usage. An accounting principle may be found to have only limited usage but still have general acceptance—for example, the sinking-fund principle of depreciation accounting. Moreover, as in all other matters with which the auditor is concerned, materiality is the essence of this standard. The fact that one concern capitalizes certain minor, relatively short-lived items of plant equipment and then depreciates the amount so capitalized, whereas another concern charges off such items forthwith upon purchase or installation, does not operate against recognizing both alike as complying with the depreciation requirement of generally accepted principles of accounting.

In addition to this matter of an accounting principle’s being generally accepted even if not generally followed, it is necessary also to bear in mind that there may be a considerable diversity of practices between different concerns in the application of an accounting principle. Whether with regard to provision for depreciation or provision for losses on receivables or any other matter where there will be general agreement as to the end to be achieved, there may be a considerable lack of similarity in the detailed processes by which those principles are effectuated. Thus, while one concern may follow an accounting procedure distinctly peculiar to itself, this in no way disqualifies it from being accorded a recognition of following “generally accepted accounting principles,” if the broad principle which that procedure seeks to implement is, in fact, a generally accepted one.

It is thus important not to regard the matter of “generally accepted accounting principles” from a rigidity of viewpoint that could not possibly comport with the wide variety of operating
conditions which will be encountered in business resulting in an equally wide variety of detailed accounting processes.

The distinctions drawn in the foregoing comments between the general agreement on the broader principles or ends to be achieved and the diversity in the detailed processes by which those principles are effectuated are equally pertinent today.

In the first chapter the responsibilities and authorities for accounting have been dealt with at some length. The primary purpose was to bring out the over-all picture of the system of checks and balances in which the primary responsibility and authority of business corporations is blended with the secondary responsibilities and authorities of stock exchanges, regulatory commissions for certain industries, the Securities and Exchange Commission and the profession of certified public accountants. In 1934 and today, the sources for determining whether an accounting practice has substantial authoritative support are:

1. In the practices commonly found in business. This does not follow from the mere fact that a practice exists, but from the fact that experience of the business has demonstrated that the practice produces dependable results for the guidance of management and for the information of investors and others.

2. The requirements and views of stock exchanges as leaders in the financial community; similarly the views and opinions of commercial and investment bankers would be entitled to weight.

3. The regulatory commissions' uniform systems of accounts and accounting rulings exercise a dominant influence on the accounting practices of the industries subject to their jurisdiction. The commissions sometimes depart from generally accepted accounting principles and, in such cases, it may be necessary for the certified public accountant to make appropriate qualifications in his report.

4. The regulations and accounting opinions of the Securities and Exchange Commission have the controlling authority over reports filed with the Commission. The Commission and its chief accountants have demonstrated a high degree of objectivity, restraint and expertness in dealing with accounting matters. The regulations and opinions issued to date are entitled to acceptance by their merit as well as on the basis of the statutory authority of the Commission.

5. The affirmative opinions of practicing and academic certified public accountants constitute authoritative support for accounting
principles or practices. These may be found in oral or written opinions, expert testimony, textbooks and articles.

6. Published opinions by committees of the American Accounting Association and of the American Institute of CPAs.

Quite naturally, the formal opinions of the Accounting Principles Board and its predecessor committee carry the greatest weight with members of the AICPA in their determination of generally accepted accounting principles. The committee, in the introduction to ARB No. 43, made the comments contained in the five succeeding paragraphs regarding the applicability and authority of its opinions.

"Underlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate. While opinions of the committee are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the committee recommends similar application of the procedures mentioned herein by those who prepare the accounts and financial statements.

"The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar nonprofit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

"Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of opinions reached by the committee rests upon their general acceptability. The committee recognizes that in extraordinary cases fair presentation and justice to all parties at interest may require exceptional treatment. But the
burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment.

"The committee contemplates that its opinions will have application only to items material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expediently with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant.

"No opinion issued by the committee is intended to have a retroactive effect unless it contains a statement of such intention. Thus an opinion will ordinarily have no application to a transaction arising prior to its publication, nor to transactions in process of completion at the time of publication. But while the committee considers it inequitable to make its statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if it appear to be desirable in the circumstances."

The Accounting Principles Board has continued to operate in accordance with the foregoing rules.

Nature of the Summary of Generally Accepted Accounting Principles

The summary of accounting principles deemed to have reached accepted status in the United States is classified in this Inventory in relation to the principal fiduciary accountabilities of the business enterprise. The approach followed necessarily is pragmatic since the purpose is to list, within these classifications, those principles, practices or standards concerning which there is little or no disagreement among business executives, professional accountants and government officials concerned with this matter. This is not intended to imply that there can be no disagreement with the content or manner of presentation of this Inventory project.

The points listed in the summary are not of the same nature. They include broad objectives, standards of accounting performance and measurement and standards of disclosure. The nature of the points will be evident to the knowledgeable reader and no useful purpose would be served by a more meticulous sub-classification.

The broad objectives or fiduciary accountabilities are set forth in the lettered sectional headings oriented to fair presentation. One contemporary publication argues that fairness is the one and only basic
concept of accounting and another supports the view that *fair presentation* is the only generally accepted accounting principle. Both viewpoints may find a measure of support in combining the objective headings of this summary. These varying viewpoints, including the arrangement followed herein, tend to demonstrate that accounting principles are not drawn from natural laws nor do they rest on inductive or deductive logic. The foundation for their existence usually is based on business experience, contractual arrangements and legal requirements.

Not many decades ago, it was often said that accounting was a reflection of good business practice. In proper perspective this is equally true today. It does not mean that any accounting practice found in business is automatically acceptable or that the businessman's view dominates the view of the accountant. It does mean that both good business and good accounting judgments are based upon the experiences of business.

The words "account for" have been used to introduce the broad objectives related to the sections dealing with income and expense, equity, assets and liabilities. An explanation of the meaning intended to be conveyed may avoid narrow or technical interpretations. "Account for" is intended to comprehend the entire fulfillment of corporate fiduciary accountabilities to stockholders, creditors and others having bona fide interests. Investors have intrusted their capital to the corporation to be invested in the kinds of assets and activities required to produce the products and services which constitute the corporate economic purposes. The fulfillment of this trust includes all the planning, selection and training of people, the development of products and services, and the conduct of purchasing, manufacturing, distribution and administrative functions. Good faith and due care on the part of directors and management in the conduct of the business are inherent requirements for meeting their fiduciary accountabilities. Due care includes attention to the establishment of a system of internal control adequate to safeguard the corporation's assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. Thus "account for" as used in this summary of generally accepted accounting principles comprehends the actual performance of the corporate business as well as the reporting on the financial status and results of operations.

Section E of the summary presents principles specifically applicable to the presentation of financial statements, which are discussed in greater detail in chapter 8 of the Inventory.
The numbered principles under the respective accounting sections, A to D inclusive, represent the steps or means required in meeting the broad objectives. The Accounting Research Bulletins issued by the committee on accounting procedure during the twenty-one years of its existence and the Opinions of the Accounting Principles Board are reproduced in relation to the principle in this summary to which they are primarily related. Since these Bulletins and Opinions are on a subject basis they usually cover both the income and expense and the financial position viewpoints. Cross-referencing between sections of the Inventory will be made to these Bulletins and Opinions in order to limit their reproduction in full to only one section. The discussion of the numbered principles in this Inventory will be kept as brief as possible. It is hoped the reader will keep in mind that the comments of the earlier sections, particularly basic concepts, have significant relationships to the principles or practices and that repetition of that fact will not be expected.

It will be noted that the summary is specifically related to historical dollar accounting. This has been done to simplify the presentation and also because, despite its limitations, historical dollar accounting is generally followed in the United States. This again illustrates how accounting is influenced by business thought. In The Netherlands, business managements place great importance on current costs. Accounting principles in that country include procedures for reflecting price-level changes in the basic accounts. The emphasis in business thinking in the United States in regard to inflation has been to seek income tax allowance of price-level depreciation before price-level adjustments are made in the accounts. Accordingly, for this and other reasons, we remain for the most part on an historical dollar basis for accounting. Such differences in business economic thinking and in political climate will make it difficult ever to reach full agreement on accounting principles on an international scale.

The summary does not deal with the variety of methods by which accounting principles are implemented. A summarization of various alternative methods is presented in chapter 10, together with comments on the relationship of such methods to the principles presented in the following section.

**Summary of Generally Accepted Principles of Accounting for Business Corporations on an Historical Basis**

Accounting serves many internal and external purposes in the broad fabric of corporate business. The most important external purpose is
to supply the comprehensive and dependable information required so that management may fulfill its fiduciary accountabilities to stockholders, creditors, government and others having bona fide interests. The principles of financial accounting for corporate business enterprises logically and usefully may be classified in relation to these fiduciary accountabilities. Such principles are necessarily stated in broad terms of objectives and major criteria, and the complexities facing modern business make more definitive rules, such as the APB Opinions, necessary to implement the principles in relation to the pertinent circumstances of the time. In a changing world it naturally follows that detailed rules not only may but should be changed to meet changes in conditions or in the mode of thought of the business community, and that such changes do not necessarily affect the broader principles and concepts, all of which are comprehended in the term, generally accepted accounting principles. In this context, the principles of financial accounting for corporate business enterprise are summarized as follows:

Objective A. Account for sales, revenues, income, cost of sales, expenses, gains and losses in such manner as to present fairly the results of operations for the period or periods of time covered.

Principle A-1. Sales, revenues and income should not be anticipated or materially overstated or understated. Accordingly, there must be proper cutoff accounting at the beginning and end of the period or periods.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle A-1  Rule No. 1 Adopted by Membership (ARB No. 43, Chapter 1A)
ARB No. 43, Chapters 4, par. 16; 11A, par. 2; 11C, par. 3
ARB No. 45, par. 15
SEC—ASR Nos. 5; 53; 95
Chapter 3: Meaning and Summary of GAAP

Principle A-2. Costs of sales and expenses should be appropriately matched against the periodic sales and revenues. It follows that there must be proper cutoff accounting for inventories and liabilities for costs and expenses at the beginning and end of the period or periods.

Principle A-3. Appropriate charges should be made for depreciation and depletion of fixed assets and for amortization of other deferred costs.

Principle A-4. Proper distribution of costs should be made as between fixed assets, inventories, maintenance and expense. Direct costs are usually identifiable and common costs applicable to more than one activity should be distributed on appropriate cost incurrence bases such as time or use factors.

Principle A-5. Contingency provisions and reserves should not be misused as a means of arbitrarily reducing income or shifting income from one period to another.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle A-2 Rule No. 1 Adopted by Membership (ARB No. 43, Chapter 1A)
ARB No. 43, Chapters 4, par. 1; 6, par. 4; 9C, pars. 11-13; 10; 11A, par. 3; 11B; 11C, par. 7; 13; 15, pars. 7 and 11
ARB Nos. 44; 47; 51, par. 16
APB Opinions 1; 2, par. 15; 4
SEC—ASR Nos. 53; 85; 96

Principle A-3 ARB No. 43, Chapters 5; 9B; 9C; 15
ARB No. 44, pars. 2 and 5
APB Opinion No. 1
SEC—ASR No. 85; 96

Principle A-4 ARB No. 43, Chapter 4, par. 5
ARB No. 45, par. 10

Principle A-5 ARB No. 43, Chapters 6; 8, par. 2
Principle A-6. Nonrecurring and extraordinary gains and losses should be recognized in the period they occur, but should be shown separately from the ordinary and usual operations.

Principle A-7. There is a strong presumption that all gains and losses will be included in periodic income statements unless they are of such magnitude in relation to revenues and expenses from regular operations as to cause the statements to be misleading.

Principle A-8. Disclose rental charges under material leases and capitalize those which are in effect installment purchases of fixed assets.

Principle A-9. If accounting principles in the determination of periodic results have not been consistently maintained, the effect of the change should be stated.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle A-6  ARB No. 43, Chapters 5, par. 8; 8, par. 13  
SEC—Reg. S-X, Rule 5-03

Principle A-7  ARB No. 43, Chapters 2B, par. 3; 5, pars. 5, 6 and 8; 8; 10B; 11B, par. 9; 12, par. 21; 15, pars. 7 and 17  
ARB No. 47, par. 3  
SEC—ASR No. 53; Reg. S-X, Rule 5-03

Principle A-8  ARB No. 43, Chapter 14  
APB Opinion No. 5  
SEC—Reg. S-X, Rule 3-18

Principle A-9  ARB No. 43, Chapter 4, par. 15  
ARB No. 44, par. 3  
SAP No. 33, Chapter 8  
SEC—Reg. S-X, Rule 3-07
**Objective B.** Account for the equity capital invested by stockholders through contribution of assets or retained earnings in a meaningful manner on a cumulative basis and as to changes during the period or periods covered. The account structure and presentation in financial statements of a business entity are designed to meet statutory and corporate charter requirements and to portray significant financial relationships.

**Principle B-1.** In case there are two or more classes of stock, account for the equity capital invested for each and disclose the rights and preferences to dividends and to principal in liquidation.

**Principle B-2.** From a financial viewpoint the capital invested by stockholders is the corpus of the enterprise and its identity should be fully maintained. Any impairment of invested capital resulting from operating deficits, losses of any nature, dividend distributions in excess of earnings, and treasury stock purchases is accounted for both currently and cumulatively.

**Principle B-3.** Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. There should be no commingling of retained earnings with invested capital in excess of par or stated values.

**References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary**

**Principle B-1** SEC—ASR Nos. 9 and 45; Reg. S-X, Rule 3-19

**Principle B-2** SEC—Reg. S-X, Rules 3-16 and 5-02; ASR No. 45

**Principle B-3** Rules Adopted by Membership (ARB No. 43, Chapter 1A, pars. 2-3)

*ARB No. 43, Chapters 1B; 5, par. 9; 8, par. 12; 15, par. 16*

SEC—ASR Nos. 1; 25; 45
Principle B-4. Retained earnings should represent the cumulative balance of periodic earnings less dividend distributions in cash, property or stock, plus or minus gains and losses of such magnitude as not to be properly included in periodic earnings. The entire amount may be presumed to be unrestricted as to dividend distributions unless restrictions are indicated in the financial statements.

Principle B-5. Retained earnings may be decreased by transfers to invested capital accounts when formal corporate action has, in fact, changed the composition of the equity capital. Accumulated deficit accounts may be eliminated against invested capital accounts through formal action approved by stockholders, which establishes a new base line of accountability.

Principle B-6. The amount of any revaluation credits should be separately classified in the stockholder’s equity section, and it is not available for any type of charge except on reversal of the revaluation.

Principle B-7. Disclose status of stock options to employees or others and changes therein during the period or periods covered.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle B-4  ARB No. 43, Chapters 6, par. 8; 7B; 8, par. 12
SEC—ASR Nos. 9; 35; 53; Reg. S-X, Rule 3-19

Principle B-5  Rule Adopted by Membership (ARB No. 43, Chapter 1A, par. 2)
ARB No. 43, Chapters 7A; 8, par. 12
ARB No. 46
SEC—ASR Nos. 1; 15

Principle B-6  Rule Adopted by Membership (ARB No. 43, Chapter 1A, par. 1)
SEC—Reg. S-X, Rule 5-02

Principle B-7  ARB No. 43, Chapter 13B
SEC—Reg. S-X, Rule 3-20
Objective C. Account for the assets invested in the enterprise by stockholders (through property contributed or retained earnings) and creditors, in a meaningful manner, so that when considered with the liabilities and equity capital of stockholders there will be a fair presentation of the financial position of the enterprise both at the beginning and end of the period. It should be understood that financial position or balance sheet statements do not purport to show either present values of assets to the enterprise or values which might be realized in liquidation.

Principle C-1. Items classified as current assets should be carried at not more than is reasonably expected to be realized within one year or within the normal operating cycle of the particular business. Cash should be segregated between unrestricted and restricted items, and the inclusion of the latter in current assets must be justified by their nature. Receivables should be reduced by allowance accounts to cover expected collection or other losses. Receivables from officers, employees, or affiliated companies should be shown separately. Inventories should be carried at cost or market, whichever the lower. Cost comprises direct costs plus factory overhead costs, and the basis of determination (e.g., Lifo, Fifo or average) should be stated. Prepaid items should be properly chargeable to future periods.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle C-1  ARB No. 43, Chapters 3A, pars. 1-6 and 9; 3B; 4; 11A, pars. 4-5; 11C, pars. 5-6
ARB No. 45, par. 12
SEC—Reg. S-X, Rules 3-13 and 5-02
Principle C-2. Fixed assets should be carried at cost of acquisition or construction in the historical accounts, unless such cost is no longer meaningful. Cost of land should ordinarily be shown separately. Cost of construction includes direct costs and overhead costs incurred, such as engineering, supervision and administration, interest and taxes. Items treated as fixed assets should have at least one year of expected useful life to the enterprise, and normally the life is considerably longer. Practicable yardsticks or criteria should be established in order that consistent distinctions may be made between fixed assets, operating expenses and maintenance. Ordinarily, this should be accomplished by creating a catalogue of property units to be included in fixed assets, any lesser items to be charged to current expense. Items no longer in service should be removed by charge to depreciation reserve or expense in order that fixed assets will represent the cost of properties in service.

Principle C-3. Appropriate provision or allowances should be made in order to charge operations with the investment in depreciable assets over the estimated life thereof. The accumulated allowances, less property retirements, should be shown as a deduction from fixed assets.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle C-2  ARB No. 43, Chapters 5, par. 4; 9B
APB Opinion 2, par. 14
SEC—ASR No. 8

Principle C-3  ARB No. 43, Chapter 9
SEC—Reg. S-X, Rule 5-02
Principle C-4. Long-term investments in securities ordinarily should be carried at cost. When market quotations are available, the aggregate quoted amounts should be disclosed. Investments in affiliates should be segregated from other investments.

Principle C-5. The costs of intangible items, such as debt discount and expense, patents, copyrights, research and development (if deferred) and goodwill should be shown separately. Limited-term items should be amortized against earnings over their estimated lives. The policy in regard to amortization of unlimited-term intangibles should be disclosed.

Principle C-6. The nature and extent of hypothecated or pledged assets should be shown.
Objective D. Account for all known liabilities in a meaningful manner in order that their summarization, considered together with the statement of assets and equity invested by stockholders, will fairly present the financial position of the enterprise at the beginning and end of the period.

Principle D-1. All known liabilities should be recorded regardless of whether the definite amount is determinable. If the amounts cannot be reasonably approximated, the nature of the items should be disclosed on the face of the summary of liabilities or by footnote.

Principle D-2. Current liabilities should include items payable within one year or at the end of the operating business cycle used in the classification of current assets. Accounts should be shown separately for notes payable to banks, notes payable to others, accounts payable (may include payrolls), Federal income taxes accrued, other accrued taxes, accounts or notes payable to officers, and accounts or notes payable to affiliates.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle D-1  ARB No. 43, Chapters 3A, par. 8; 4, par. 17; 10A, par. 16; 11B
ARB No. 47
ARB No. 50, par. 3

Principle D-2  ARB No. 43, Chapters 3A, pars. 7-8; 3B; 10A, par. 16; 11B, par. 6
SEC—Reg. S-X, Rules 3-14 and 5-02
Principle D-3. Long-term liabilities should be described and due dates and rates of interest shown.

Principle D-4. The nature and extent to which specific liabilities are a preferred lien on assets should be shown.

Principle D-5. Deferred income should be separately classified and described.

Principle D-6. Contingent liabilities of importance should be disclosed.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle D-3  SEC—Reg. S-X, Rule 5-02

Principle D-4  SEC—Reg. S-X, Rule 5-02

Principle D-5  ARB No. 43, Chapter 3A, par. 7
APB Opinion 2, par. 14
SEC—ASR Nos. 85; 96

Principle D-6  ARB No. 50
SEC—Reg. S-X, Rules 3-18 and 3-19
Objective E. Financial statements should comply with the applicable reporting standards included in generally accepted auditing standards. Reporting to investors should be performed on an entity basis.

Principle E-1. Generally accepted reporting standards applicable to financial statements are set forth in Chapters 7, 8, 9 and 11 of Statements on Auditing Procedure No. 33, which are incorporated in this Inventory.

Principle E-2. Where there is a parent company and one or more subsidiaries, there is a presumption that consolidated statements are more meaningful than separate statements.

Principle E-3. The accounts of consolidated subsidiaries or divisions operating in foreign countries should be translated into dollars at the appropriate rates of exchange.

Principle E-4. Where two or more previously independent entities merge or otherwise combine in such a manner as to constitute a pooling of interests, the new entity inherits the bases of accountability of the constituent entities.

References to Authoritative Support in AICPA and SEC Statements for Each Principle of the Summary

Principle E-1  ARB No. 43, Chapters 2; 8, par. 13
  ARB No. 49
  APB Opinion 3
  SAP No. 33, Chapters 7; 8; 9; 11
  SEC—ASR No. 53

Principle E-2  ARB No. 51
  SEC—ASR Nos. 3; 18; 32; Reg. S-X, Rules 4-02; 4-07; 4-08

Principle E-3  ARB No. 43, Chapter 12

Principle E-4  ARB No. 48
In the next five chapters, 4 to 8 inclusive, the preceding objectives and principles are utilized as the framework for the presentation of the opinions of the APB and its predecessor committee, together with explanatory and connecting comments sufficient to create a practical accounting codification for the use of business, certified public accountants and other interested persons.

In order to facilitate reference use of the codification, the numbers (A-1, A-2, etc.) assigned to the principles in the summary are maintained both in the tables of contents and throughout the respective chapters. On this basis, each lettered section of the summary has its own chapter.
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Income and Expense
(Section A of Summary)

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**Objective A**

Account for sales, revenues, income, cost of sales, expenses, gains and losses in such manner as to present fairly the results of operations for the period or periods of time covered.

In an earlier period, accounting conventions developed around the balance sheet as a report on the stewardship of management over the funds placed at its disposal. The income statement was then not so important because enterprise success was measured cumulatively. A characteristic of modern society, however, has been the development of a large market for the purchase and sale of corporate securities. Investors have come to understand that a study of the earnings of business enterprises is more likely to provide clues to future expectations. In this setting, the income statement developed in importance, because a series of past income statements may reveal trends in profitability and earnings on which future rewards to investors naturally depend. Even so, it is emphasized that the income statement is historical and not prophetic. This topic and other points related to the presentation of financial statements are dealt with in chapter 8.

Since the raw materials of the income statement consist of two streams of resources, one incoming and one outgoing, principles of
income determination are similarly grouped. The process usually begins by assigning the incoming revenue stream to time periods. The outgoing expense stream is treated subsequently, because some of it will be directly identifiable with the revenue stream and the remainder will be assignable to time periods. This “matching” of revenues and expenses is one of the most important principles in income determination.

Enterprise income has been defined in several different ways, each dependent upon the objectives of the interested parties. In its accounting sense, the following definition included in Accounting Terminology Bulletin No. 2 is frequently given:

Income and profit involve net or partially net concepts and refer to amounts resulting from the deduction from revenues, or from operating revenues, of cost of goods sold, other expenses, and losses, or some of them. The terms are often used interchangeably and are generally preceded by an appropriate qualifying adjective or term such as “gross,” “operating,” “net . . . before income taxes,” and “net”.

In other words, income is a residual, a computed amount dependent upon the principles employed in determining each of the elements included in its computation. Those elements are discussed in the sections following.

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**Principle A-1**

*Sales, revenues and income should not be anticipated or materially overstated or understated. Accordingly, there must be proper cutoff accounting at the beginning and end of the period or periods.*

This principle contemplates methods of revenue recognition which will satisfy as far as possible both the need for timely financial reporting and the need for conservative judgment in evaluating uncertainties. It also contemplates orderly and consistent procedures of cutoff accounting designed to assure that each fiscal year will include the revenues realized in the period specified.

**Definition of Revenue**

Revenue results from the sale of goods and the rendering of services and is measured by the charge made to customers, clients, or
tenants for goods and services furnished to them. It also includes gains from the sale or exchange of assets other than stock in trade, interest and dividends earned on investments, and other increases in the owners’ equity except those arising from capital contributions and capital adjustments. Revenue from ordinary sales or from other transactions in the ordinary course of business is sometimes described as operating revenue.

The preceding definition was taken from *Accounting Terminology Bulletin No. 2*. The bulletin’s distinction between “operating” and “nonoperating” revenue, however, has not been uniformly made by all accountants. Items such as dividends, interest, rents, and royalties are a regular and normal source of revenue to many enterprises and are therefore reported by some accountants as operating revenue. Other accountants, however, prefer to limit the term to only the principal operating activities, and include these items after such net income from operations has been determined.

**Cutoff Accounting**

The most troublesome problem in recording merchandise sales is the need to account for two distinct events—the agreement to sell and the delivery of the merchandise. These two events often occur at different times and places and may be evidenced by different documents. The two events must be reported in the financial statements of the same period in order to match sales with related costs properly. The danger always exists that when the two events overlap periods, or even occur at the beginning or end of a period, they may not be matched in the financial statements of a single period or the period may include either more or less than a full year’s business.

If no correcting entries are made, sales will be understated if merchandise is delivered in one period, but the customer is not billed until the next. Sales will be overstated if the customer is billed in one period, but the merchandise is not delivered until the next. Sales and net income will be over- or understated if consistent cutoff procedures are not followed. Other possibilities for misstating sales exist, but the point is that a system of cutoff accounting consistently applied is essential to prevent distorting the financial statements.

An analysis of a satisfactory cutoff system is beyond the scope of this study. The system is a component part of internal control as broadly described earlier in this study, but specific procedures will vary depending on the size and complexity of each enterprise.
Methods of Revenue Recognition

It was pointed out in an earlier section of this Inventory that the concept of conservatism comprehends the idea that sales, revenues, and income are not to be anticipated. It was also pointed out that timeliness in financial reporting requires the use of estimates and assumptions as to future events which may be invalidated by experience. A satisfactory method of revenue recognition must satisfy as far as possible both of these requirements. Since conservatism and timeliness are interpreted in relation to experience, the satisfaction of these concepts in different economic situations has resulted in the following methods of revenue recognition.

Recognition at the time of sale. This method was adopted by the membership of the Institute in 1934. Its importance merits the full quotation, as stated in Chapter 1A, paragraph 1, of ARB No. 43:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

It should be noted that the foregoing statement regarding “the impossibility of determining costs” is not valid except in reference to the determination of the separate costs of joint products. Several of the meat-packing companies now carry inventories at cost rather than at net selling prices.

From a legal standpoint the sale is completed by the passing of title, and accountants acknowledge the importance of this criterion. Title passing, however, is a highly technical matter and a convenient procedure for booking revenue from day-to-day is usually employed without stressing legal niceties. The act of invoicing, together with actual delivery or consignment to a common carrier, provides the most popular and suitable occasion. Sales for future production and consignment sales should not be reported as income. In the case of businesses selling services, such as public utilities, the act or process
of furnishing service, together with invoicing, usually provides the occasion for recognition of revenue. If billings are made bimonthly, it is acceptable to record revenues currently by use of an “unbilled” receivables account.

After the sale is made, however, it is a rare business today which will always realize in cash the full amount of the price agreed upon. A part of the invoice price is often canceled by agreement because of merchandise returned or proven defective, errors in billing, shortages, etc. The custom of offering discounts for earlier payment may also reduce the total cash received. And, finally, the customer’s account balance may prove uncollectible in spite of earlier expectations.

Merchandise returns and allowances for deficiencies are generally immaterial, and they are therefore often reported in the income statement of the period when the credit to the customer has been granted, even though the sale was made in an earlier period. When the allowances or returns are expected to be material, however, the amount is estimated and reported in the same period as the related sale or adjustments are made at the beginning and end of fiscal years.

Losses from uncollectible accounts are usually material, and it is therefore customary to estimate and record the probable loss in the same period the sale is recorded. When the losses are estimated accurately, the accounts receivable will be stated at net realizable value. The condition of open accounts and the history of losses must, of course, be periodically reviewed, in order to determine that the rates used in estimating the losses are reasonable in relation to current credit and economic conditions.

There are two methods of recording cash discounts. In the first method, the cash discount is recorded as an income deduction only when the customer takes the discount by remitting earlier. In the second method, the sale is recorded and the customer’s account charged for an amount excluding the discount; if his remittance is made after the discount period is over, the discount lost by the customer is recorded as a gain in that period.

Accounting Terminology Bulletin No. 2 says that “revenue is generally stated after deducting returns, allowances, discounts, freight, and other similar items.” Bad debts are usually shown as an expense rather than as a direct reduction of sales.

Recognition at the time the sales price is collected. Many businesses use the cash basis of recognizing revenue as a convenience when the sales price is collected at the same time as the goods are
delivered or the services performed. Other businesses, however, use the cash basis even when the goods have been delivered or the service performed in a prior period. A common reason is a possibility of cancellation—conditional sales, export sales, and sales on approval are examples.

Installment sales and profit on those sales, e.g., long-term real estate sales, are only rarely reported as the sales price is collected. Even though the collection risk and expense are usually greater than on other sales, the inclusion of appropriate allowances in the financial statements is better practice than reporting revenue in a later period. The Treasury Department permits this method, however, for tax purposes under certain conditions; if the method is not also used for reporting purposes, deferred income taxes should be recognized.

We have up to this point discussed revenue recognition in sales of goods and services to customers, when relatively unvarying and easily defined rules may be incorporated into the accounting system. In other types of operations, however, individual sales may vary from one another, and the judgment of management and the accountant must substitute for hard and fast procedures. Real estate operation is an example which in recent years has developed a variety of sales procedures and customs which are difficult to handle. The Securities and Exchange Commission particularly has been concerned with clarifying this area, and in Accounting Series Release No. 95 it stated:

In some of the situations coming before us, it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for the sale of securities. Moreover, even in bona fide transactions the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition of gain at the time of sale.

It then listed a number of circumstances which would tend to question the propriety of recognizing profit currently.

**Recognition at the time the product is completed.** The Institute clarified this method in Chapter 4 of *ARB No. 43*, and, because of its importance, the statement is quoted fully here:

*Statement 9*

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by
inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

**Discussion**

16. It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

**Recognition proportionately over performance of contracts.** In contracting operations the uncertainties of the market are removed by fixing the sale price before production begins. The contract price is realized not through selling activity, but through proper performance under the contract. The subject of recognizing revenue proportionately over performance of contracts was covered in *ARB No. 43*, Chapter 11 and *ARB No. 45*, reproduced below.

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**ARB No. 43**
**Chapter 11**
**Section A**

**GOVERNMENT CONTRACTS**

*Cost-Plus-Fixed-Fee Contracts*

1. This section deals with accounting problems arising under cost-plus-fixed-fee contracts, hereinafter referred to as CPFF contracts.

**SUMMARY STATEMENT**

2. Fees under CPFF contracts may be credited to income on the basis of such measurement of partial performance as will reflect reasonably assured realization. One generally acceptable basis is delivery of completed articles. The fees may also be accrued as they are...
billable, under the terms of the agreements, unless such accrual is not reasonably related to the proportionate performance of the total work or services to be performed by the contractor from inception to completion.

3. Where CPFF contracts involve the manufacture and delivery of products, the reimbursable costs and fees are ordinarily included in appropriate sales or other revenue accounts. Where such contracts involve only services, or services and the supplemental erection of facilities, only the fees should ordinarily be included in revenues.

4. Unbilled costs and fees under such contracts are ordinarily receivables rather than advances or inventory, but should preferably be shown separately from billed accounts receivable.

5. Offsetting of government advances on CPFF contracts by, or against, amounts due from the government on such contracts is acceptable only to the extent that the advances may under the terms of the agreement be offset in settlement, and only if that is the treatment anticipated in the normal course of business transactions under the contract. In case of offset, the amounts offset should be adequately disclosed.

DISCUSSION

6. Contracts in the CPFF form are used (a) for the manufacture and delivery of various products, (b) for the construction of plants and other facilities, and (c) for management and other services. Under these agreements contractors are reimbursed at intervals for their expenditures and in addition are paid a specified fixed fee. Payments on account of the fees (less 10% or other amount which is withheld until completion) are made from time to time as specified in the agreements, usually subject to the approval of the contracting officer. In most cases the amount of each payment is, as a practical matter, determined by the ratio of expenditures made to the total estimated expenditures rather than on the basis of deliveries or on the percentage of completion otherwise determined.

7. The agreements provide that title to all material applicable thereto vests in the government as soon as the contractor is reimbursed for his expenditures or, in some cases, immediately upon its receipt by the contractor at his plant even though not yet paid for. The contractor has a custodianship responsibility for these materials, but the government usually has property accountability officers at the plant to safeguard government interests.
8. The contracts are subject to cancellation and termination by the government in which event the contractor is entitled to reimbursement for all expenditures made and an equitable portion of the fixed fee.

9. The government frequently makes advances of cash as a revolving fund or against the final payment due under the agreement.

**Major accounting problems**

10. There are a number of basic accounting problems common to all CPFF contracts. This section deals with the four most important, which are:

(a) When should fees under such contracts be included in the contractor’s income statement?

(b) What amounts are to be included in sales or revenue accounts?

(c) What is the proper balance-sheet classification of unbilled costs and fees?

(d) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?

(a) *When should fees under such contracts be included in the contractor’s income statement?*

11. It is recognized that income should be recorded and stated in accordance with certain accounting principles as to time and amount; that profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that collection of the sales price is not reasonably assured; and that delivery of goods sold under contract is normally regarded as the test of realization of profit or loss.

12. In the case of manufacturing, construction, or service contracts, profits are not ordinarily recognized until the right to full payment has become unconditional, i.e., when the product has been delivered and accepted, when the facilities are completed and accepted, or when the services have been fully and satisfactorily rendered. This accounting procedure has stood the test of experience and should not be departed from except for cogent reasons.

13. It is, however, a generally accepted accounting procedure to
accrue revenues under certain types of contracts and thereby recognize profits, on the basis of partial performance, where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Particularly where the performance of a contract requires a substantial period of time from inception to completion, there is ample precedent for pro-rata recognition of profit as the work progresses, if the total profit and the ratio of the performance to date to the complete performance can be computed reasonably and collection is reasonably assured. Depending upon the circumstances, such partial performance may be established by deliveries, expenditures, or percentage of completion otherwise determined. This rule is frequently applied to long-term construction and other similar contracts; it is also applied in the case of contracts involving deliveries in installments or the performance of services. However, the rule should be dealt with cautiously and not applied in the case of partial deliveries and uncompleted contracts where the information available does not clearly indicate that a partial profit has been realized after making provision for possible losses and contingencies.

14. CPFF contracts are much like the type of contracts upon which profit has heretofore been recognized on partial performance, and accordingly have at least as much justification for accrual of fee before final delivery as those cited. The risk of loss is practically negligible, the total profit is fairly definite, and even on cancellation, pro-rata profit is still reasonably assured.

15. The basic problem in dealing with CPFF contracts is the measure of partial performance, i.e., whether fees thereunder should be accrued under the established rules as to partial deliveries or percentage of completion otherwise determined, or whether, in view of their peculiar terms with respect to part payments, the determination of amounts billable by continuous government audit, and the minimum of risk carried by the contractor, the fees should be accrued as they are billable.

16. Ordinarily it is acceptable to accrue the fees as they become billable. The outstanding characteristic of CPFF contracts is reimbursement for all allowable costs, plus payment of a fixed fee for the contractor’s efforts. Delivery of the finished product may not have its usual legal significance because title passes to the government prior thereto and the contractor’s right to partial payment becomes
unconditional in advance thereof; deliveries are not necessarily, under
the terms of the agreement, evidence of the progress of the work or
of the contractor's performance. Amounts billable indicate reasonably
assured realization, possibly subject to renegotiation, because of the
absence of a credit problem and minimum risk of loss involved. The
fee appears to be earned when allowable costs are incurred or paid
and the fee is billable. Finally, accrual on the basis of amounts bill-
able is ordinarily not a departure from existing rules of accrual on
the basis of partial performance, but rather a distinctive application
of the rule for determining percentage of completion.

17. Judgment must be exercised in each case as to whether
accrual of the fee when billable is preferable to accrual on the usual
basis of delivery or of percentage of completion otherwise deter-
mined. While the approval of the government as to amounts billable
would ordinarily be regarded as objective evidence, factors may exist
which suggest an earlier or later accrual. Such factors include indi-
cations of substantial difference between estimated and final cost, as
where preparatory or tooling-up costs were much more than esti-
imated, raw material needs were greatly and unduly anticipated by
advance purchases, or delays in delivery schedules or other circum-
stances suggest that costs are exceeding estimates. While such factors
are normally considered by the government and billings for fees
may be temporarily adjusted to safeguard against too early propor-
tionate payment, the contractor, in accruing income, should also
consider them, particularly when any substantial lag exists between
expenditures and billings and audit thereof. In such cases, the pre-
sumption may be that the fee will not be found to be billable when
the charges are presented, and conservatism in accrual will be nec-
essary. Excess costs may be indicated in some cases to such an extent
that accrual of fee before actual production would be unwise. Where
such a situation exists the usual rule of deliveries or percentage of
completion may be a preferable method of accruing the fee.

18. There are further questions as to whether the fee may be
accrued as it is billed rather than as it becomes billable and whether
accrual should be on the basis of the full fee or the full fee less the
amount withheld. As to the first question, it seems obvious that when
accrual in relation to expenditures is otherwise suitable it should be
on the basis of amounts billable, since such matters as clerical delays
in assembling data for billing should not affect the income statement.
As to the second question, accrual on the basis of 100 per cent of the fee is ordinarily preferable since, while payment of the balance depends on complete performance, such completion is to be expected under ordinary circumstances. Care must be exercised, of course, to provide for possible non-realization where there is doubt as to the collection of claimed costs or of the fee thereon.

(b) What amounts are to be included in sales or revenue accounts?

19. This problem is whether sales or revenue as reported in the income statement should include reimbursable costs and the fee, or the fee alone. The answer to this question depends upon the terms of the contract and upon judgment as to which method gives the more useful information.

20. Some CPFF contracts are service contracts under which the contractor acts solely in an agency capacity, whether in the erection of facilities or the management of operations. These appear to call for inclusion in the income statement of the fee alone. In the case of supply contracts, however, the contractor is more than an agent. For instance, he is responsible to creditors for materials and services purchased; he is responsible to employees for salaries and wages; he ordinarily uses his own facilities in carrying out his agreement; his position in many respects is that of an ordinary principal. In view of these facts, and the desirability of indicating the volume of his activities, it appears desirable to include reimbursable costs, as well as fees, in sales or revenues.

(c) What is the proper balance-sheet classification of unbilled costs and fee?

21. The principal reason for the existence of unbilled costs at any date is the time usually required, after receipt of material or expenditures for labor, etc., to assemble data for billing. The right to bill usually exists upon expenditure or accrual, and that right unquestionably represents a receivable rather than an advance or inventory. There is nevertheless a difference in character between billed items and unbilled costs and distinction should be made between them on the balance sheet.

(d) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?
22. In statements of current assets and current liabilities, amounts due to and from the same person are ordinarily offset where, under the law, they may be offset in the process of collection or payment. An advance received on a contract is, however, usually not offset unless it is definitely regarded as a payment on account of contract work in progress, in which event it will be shown as a deduction from the related asset. An advance on a CPFF contract usually is made for the purpose of providing a revolving fund and is not ordinarily applied as a partial payment until the contract is completed or nears completion. It therefore appears to be preferable to offset advances on CPFF contracts against receivables in connection with the contracts only when it is expected that the advances will be applied in payment of those particular charges. In any case, amounts offset should be clearly disclosed.

ARB No. 43
Chapter 11
Section B

GOVERNMENT CONTRACTS
Renegotiation

1. This section\(^1\) deals with certain aspects of the accounting for those government contracts and subcontracts which are subject to renegotiation.

2. Where such contracts constitute a substantial part of the business done, the uncertainties resulting from the possibilities of renegotiation are usually such that appropriate indication of their existence should be given in the financial statements.

3. It is impossible to lay down general rules which can be applied satisfactorily in all cases. Here, as elsewhere in accounting, there must be an exercise of judgment which should be based on experience and on a clear understanding of the objective to be attained. That objective is to present the fairest possible financial statements, and at the same time make clear any uncertainties that limit the significance of such statements.

4. In keeping with the established accounting principle that provision should be made in financial statements for all liabilities, including reasonable estimates for liabilities not accurately determinable, provision should be made for probable renegotiation refunds
wherever the amount of such refunds can be reasonably estimated. Thus, in cases where experience of the company or of comparable companies with renegotiation determinations is available and would make a reasonable estimate practicable, provision in the income account for an estimated refund affecting the current year's operations is called for. In cases in which a reasonable estimate cannot be made, as where the effect of a new or amended renegotiation act cannot be foretold within reasonable limits or where a company is facing renegotiation for the first time and no reliable precedent is available, disclosure of the inability, because of these circumstances, to determine renegotiation effects and of the consequent uncertainties in the financial statements is necessary.

5. In addition to any provision made in the accounts, disclosure by footnote or otherwise may be required as to the uncertainties, their significance, and the basis used in determining the amount of the provision, such as the prior years' experience of the contractor or of similar contractors if their experience is available and is used, renegotiation discussions relating to the current year, etc. Such disclosure may be helpful in informing shareholders or other interested persons as to the company's status under the renegotiation law. It should also be recognized that, if conditions change, the results of a prior-year determination or settlement are not, in most cases, indicative of the amount probably refundable for the current year.

TREATMENT IN FINANCIAL STATEMENTS

6. Provisions made for renegotiation refunds should be included in the balance sheet among the current liabilities.

7. Accounting treatment in the income statement should conform to the concept that profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sales price is not reasonably assured. Renegotiation refunds are commonly referred to as involving a refund of "excessive profits"; realistically, however, renegotiation involves an adjustment of the original contract or selling price. Since a provision for renegotiation refund indicates that the collection, or retention, of the selling price is not reasonably assured, the provision should preferably be treated in the income statement as a deduction from sales. Because of the interrelationship of renegotiation and taxes on income, the provision for such taxes should then be computed accordingly.

8. The amount refundable is, however, generally a net amount,
i.e., allowance is made for any taxes on income which may have been paid or assessed thereon. Therefore, as an alternative to the presentation indicated in the preceding paragraph, the provision for renegotiation refund may be shown as a charge in the income statement, separately from the provision for taxes on income, or in combination therewith.

RENEGOTIATION REFUNDS FOR PRIOR YEARS

9. A further question arises where a renegotiation refund applicable to a particular year is made in an amount materially different from the provision made in the financial statements originally issued for such year. The committee recommends that the difference between the renegotiation refund and the provision therefor be shown as a separate item in the current income statement, unless such inclusion would result in a distortion of the current net income, in which event the adjustment should be treated as an adjustment of earned surplus. Where an adjustment of earned surplus is made there should be appropriate disclosure of the effect of the adjustment on the prior year’s net income. The committee believes that a major retroactive adjustment of the provision made for a renegotiation refund can often best be disclosed by presenting a revised income statement for the prior year, either in comparative form in conjunction with the current year’s financial statements or otherwise, and it urges that this procedure be followed.

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1 The comments in this section are considered to be applicable also to price redetermination estimated to result in retroactive price reduction.
2 See chapter 1, rule 1.
3 See chapter 8, paragraphs 11, 12, and 13.
4 See chapter 2(a).
specifically with terminated cost-plus-fixed-fee contracts nor with con-
tracts for facilities or services. However, the conclusions reached
herein may serve as guides for the accounting applicable to such
special contracts. Terminations for default of the contractor involve
problems of a different nature and are not considered here.

2. Except where the text clearly indicates otherwise, the term
contractor is used to denote either a prime contractor or a subcon-
tractor, and the term contract to denote either a prime contract or
a subcontract.

SUMMARY STATEMENT

3. The profit of a contractor or a fixed-price supply contract
terminated for the convenience of the government accrues as of the
effective date of termination.

4. Those parts of the termination claim which are reasonably
determinable should be included in financial statements after ter-
mination; when the total of the undeterminable elements is believed
to be material, full disclosure of the essential facts should be made,
by footnote or otherwise.

5. Under ordinary circumstances the termination claim should
be classified as a current asset and unless the amount is relatively
small should be separately disclosed.

6. Advances received on the contract before its termination may
be shown in financial statements after termination as a deduction
from the claim receivable and should be appropriately explained.
Loans negotiated on the security of the termination claim, however,
should be shown as current liabilities.

7. All of the contractor's own cost and profit elements included
in the termination claim are preferably accounted for as a sale and
if material in amount should be separately disclosed. The costs and
expenses chargeable to the claim may then be given their usual clas-
sification in the accounts.

8. When inventory items whose costs are included in the ter-
mination claim are subsequently reacquired by the contractor the
reaquisition value of those items should be recorded as a purchase
and applied, together with other disposal credits, against the termina-
tion claim receivable.
9. So called *no-cost* settlements — those in which the contractor waives the right to make a claim — result in no transaction which could be reflected in sales. The costs applicable to the contract may be given their usual classification in the accounts; the inventory retained should not be treated as a purchase but should be accounted for according to the usual methods and standards applicable to inventories.

**DISCUSSION**

10. Termination of war and defense contracts for the convenience of the government is a means of adjusting the production of materials to the varying requirements of the military services. Since terminations transfer active contracts in process of execution into claims in process of liquidation, they, like contract renegotiations and cost-plus-fixed-fee contracts, may have important effects on the financial statements of defense contractors.

*When profit accrues*

11. An important problem involved in accounting for the effect of terminations is that of determining the time at which profit earned on the contract should be recognized. This problem is similar to that described in other sections of this chapter on renegotiation and cost-plus-fixed-fee contracts in that it involves accrual at a specific date of an element of profit whose original measurement may be difficult and will require informed judgment, and whose final amount may not be determined until some future period.

12. Three dates have been mentioned as dates for the determination of profit from terminated contracts: (a) the effective date of termination; (b) the date of final settlement; and (c) some intermediate date, such as that on which the claim is finally prepared or filed. The effective date of termination is the date at which the contractor acquires the right to receive payment on the terminated portion of the contract. This date is also, of the three, the one most objectively determined.

13. Under the accrual basis of accounting recognition is given to revenues and expenses, to the fullest extent possible, in the period to which they relate. Profit on a contract of sale is ordinarily taken into account upon delivery or performance. However, as stated in section (a) of this chapter it is a generally accepted accounting procedure to accrue revenues under certain types of contracts, and
thereby recognize profits, on the basis of partial performance where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Thus, the accrual of profit under a cost-plus-fixed-fee contract is recognized as the fee becomes billable rather than when it is actually billed. Upon termination of a contract the contractor acquires a claim for fair compensation; the government reserves the option of acquiring any of the inventories for which the contractor makes claim under the terminated contract. Except to effect settlements and to protect and dispose of property, the expenses of which are reimbursable, the contractor need perform no further service under a terminated contract in order to enforce his claim. It follows that any profit arising out of such a contract accrues at the effective date of termination and, if the amount can be reasonably ascertained, should be recorded at that time.

**Determination of claim**

14. Practical application of the accrual principle to the accounting for terminated war and defense contracts rests upon the possibility of making a reasonable estimate of the amount of the termination claim before its final determination by settlement. This involves two principal considerations: (1) whether the costs of the contractor can be determined with reasonable accuracy and (2) whether the amount of profit to be realized can be estimated closely enough to justify inclusion in the accounts.

15. The various acts and regulations, including a statement of principles for determining costs and certain termination cost memorandums, describe in general terms the cost and expenses which are to be taken into account in arriving at fair compensation, as well as certain costs which are not allowable, and establish uniform termination policies and procedures.

16. While the total claim, and particularly the profit allowance, is subject to negotiation, the termination articles provide for a formula settlement allowing definite percentages of profit based on costs in the event of the failure of negotiations. This in effect fixes a minimum expectation of profit allowance since the formula percentages have also been recognized by regulation as a basis of negotiating settlement in the event of failure by the parties to agree on any other basis. The same regulations give other guides for estimating a fair profit allowance, which in some cases may be greater than the
amount computed by the formula percentages. When the contractor, because of lack of prior negotiation experience or uncertainty as to the application of the principles of these regulations to a particular case, is unable to determine a more appropriate profit allowance, he may accrue the minimum amount determined by the formula percentages.

17. The profit to be included in the accounts of the contractor upon termination is the difference between (a) the amount of his recorded claim and (b) the total of the inventory, deferred and capitalized items, and other costs applicable to the terminated contract as they are currently included in his accounts. This profit may exceed the amount specified as profit in the claim because costs applicable to the terminated portion of the contract may be allowable in the claim even though they may have been properly written off as incurred in prior periods.

18. In some cases it will be impossible to make a reasonable estimate of a termination claim in time for inclusion in the financial statements of the period in which the termination occurs. Effect may then be given in the statements to those parts of the termination claim which are determinable with reasonable certainty and disclosure made, by footnote or otherwise, of the status of the remainder.

19. When the contractor's claim includes items of known controversial nature it should be stated at the amount estimated to be collectible. When a particular termination claim or part thereof is so uncertain in amount that it cannot be reasonably estimated, it is preferable not to give effect to that part of the claim in the financial statements; but if the total of such undeterminable elements is material, the circumstances should be disclosed in statements issued before the removal of the uncertainty. In an extreme case involving undeterminable claims, consideration should be given to delaying the issuance of financial statements until necessary data are available.

*Presentation in financial statements*

20. Termination has the effect of converting an active contract in process into a claim, or, from an accounting standpoint, from inventories and other charges into an account receivable. This receivable arises in the regular course of business; it is part of the working capital; and in view of the provisions made for financial assistance to the contractor during the period of termination, collection in large part may be expected within a relatively short time. The termination
claim should therefore be classified as a current asset, unless there is an indication of extended delay, such as serious disagreement pointing to probable litigation, which would exclude it from this classification.

21. Although a claim may be composed of several elements representing reimbursable items of special equipment, deferred charges, inventories, and other items, as well as claims for profit, it is preferable to record the claim in one account. When the total of termination claims is material it should be disclosed separately from other receivables. It is also desirable to segregate claims directly against the government from claims against other contractors where the amounts are significant.

22. To assure adequate financial assistance to contractors, the acts provide in some cases for partial payments and in others for such payments or guaranteed loans from the effective date of termination until final settlement. Partial payments are, of course, to be recorded as reductions of the termination claim receivable. Termination loans, on the other hand, are definite liabilities to third parties, even though guaranteed in whole or in part by the government, and accordingly should be shown in the balance sheet as liabilities, with appropriate cross-reference to the related claim or claims. When a terminated contract is one on which advance payments had previously been received, the financial statements of the contractor issued before final collection of the claim ordinarily should reflect any balance of those advances disclosed as deductions from the claim receivable. Financial statements issued before the termination claim is recorded should disclose, by footnote or otherwise, the relationship of such liabilities to a possible termination claim receivable.

23. Ordinarily, a termination will result in the cessation of a contractor’s activity through which materials or services have been supplied under the contract and of the related transactions which have been reflected in the contractor’s income accounts as sales and cost elements. In effect, termination policies and procedures provide a basis upon which the contractor’s costs in process may become the elements of a final sale under the terminated portion of the contract. Accordingly, the amount of the contractor’s termination claim representing his cost and profit elements should be treated as a sale and the costs and expenses chargeable to the claim given their usual classification in the income statement. Because these termination
sales are of a special type, their financial results should not be appraised in the same manner as are those of regular sales and they should, if material in amount, be separately disclosed in the income statement. Any items which the contractor chooses to retain without claim for cost or loss are, of course, not sold but remain as inventory or deferred charges in the contractor’s accounts.

**Claims of subcontractors**

24. The term *subcontractor’s claims* as used in connection with terminated contracts refers to those obligations of a contractor to a subcontractor which arise from the subcontractor’s costs incurred through transactions which were related to the contract terminated but did not result in the transfer of billable materials or services to the contractor before termination. Other obligations of a contractor to a subcontractor, arising through transaction by which materials or services of the subcontractor are furnished or supplied to the contractor, are considered to be liabilities incurred in the ordinary course of business and are not included in the term *claims of subcontractors*.

25. The termination articles provide that, following the termination of a contract, the contractor shall settle, with the approval or ratification of the contracting officer when necessary, all claims of subcontractors arising out of the termination; and that the contractor shall be paid, as part of this settlement, the cost of settling and paying claims arising out of the stoppage of work under subcontracts affected by the termination. While a contractor ordinarily is liable to his subcontractors or suppliers for such obligations, the amounts due them are an element in his termination claim and often are not paid to them until after his claim has been settled. He often has no control over the filing of subcontractors’ claims and may not know their amount until some time after the termination date or even until some time after he has filed and received payment for his own claim.

26. The possibility that a contractor may suffer loss through failure to recover the amount of his liability on subcontractors’ claims arises principally from overcommitments, errors in ordering, and similar causes. Provision should be made in his accounts for losses of this character which are known or believed to be probable.

27. Although the principle that liabilities may not be offset against assets in the financial statements is generally approved by account-
ants, there is no general agreement as to the accounting treatment to be accorded subcontractors' claims which are expected to be fully recoverable. To the extent that a subcontractor's claim is considered to be unrecoverable no difference of opinion exists; the liability should be recorded and provision made for any contemplated loss. The difference of opinion relates to those subcontractors' claims which are deemed to be fully recoverable.

28. Some accountants believe that the effect of the various acts and regulations is to establish a relationship between the claims of subcontractors and the resulting right of the contractor under his own termination claim which differs from an ordinary commercial relationship and justifies their omission from the accounts. Recoverable subcontractors' claims are thus said to be in the nature of contingent liabilities, which are customarily omitted from the accounts except where a loss is expected. Contingent liabilities may be disclosed in the financial statements without recording them as assets and liabilities, and even when they are recorded it is customary accounting practice to show them on the balance sheet as deductions from the related contingent assets so that no effect upon financial ratio and relationships results.

29. Other accountants believe that the nature of an obligation to a subcontractor is that of an ordinary liability, even though it may arise through the termination of a war or defense contract, and that the contractor's termination claim receivable, although related to the subcontractor's claim, is to be accounted for independently as an asset. This group believes that all subcontractors' claims, to the extent that they are reasonably ascertainable, should be recorded in the accounts and displayed in the contractor's balance sheet as current liabilities, and that the amounts recoverable by the contractor should be included in his termination claim receivable. To the extent that the amounts of subcontractors' claims are not reasonably determinable, disclosure by footnote or otherwise in the financial statements is believed to be adequate.

30. Because of the merits and prevalence of these alternative views, the committee expresses no preference for either treatment and considers either to be acceptable.

Disposal credits

31. Disposal credits are amounts deducted from the contractor's termination claim receivable by reason of his retention, or sale to
outsiders, of some or all of the termination inventory for which claim was made. In the case of items retained, either as scrap or for use by the contractor, the amount of the credit is determined by agreement between the contractor and a representative of the government. The sale of inventory items by the contractor is likewise subject to approval by the government, except as permitted by regulation. Since the amount of the contractor's termination claim, as already indicated, is properly recorded as a sale, any elements included in that claim for items of inventory retained by the contractor are, in effect, reacquired by him and should be treated as purchases at the agreed value. Amounts received for items sold to others with the approval of the government are collections for the account of the government and should be applied in reduction of the claim receivable. Obviously inventories or other items that are retained by the contractor after termination without claim for loss should not be included as an element of the termination claim.

No-cost settlements

32. A contractor whose contract is terminated may prefer to retain the termination inventory for use in other production or for disposal at his own risk. For these or other reasons the contractor may prefer to make no claim against the government or a higher-tier contractor. In the case of such no-cost settlements there is no sale of inventory or other items to the government and therefore no occasion to accrue any profit arising out of the termination. The costs otherwise applicable to the contract should be given their usual treatment in the accounts. Items of inventory or other property retained, having been previously recorded, will, of course, require no charge to purchases but should be treated in accordance with the usual procedures applicable to such assets.

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1 See chapter 11(a), paragraph 22.

ARB No. 45 | LONG-TERM CONSTRUCTION-TYPE CONTRACTS

1. This bulletin is directed to the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. It does not deal with cost-plus-fixed-fee contracts, which are discussed in Chap-
ter 11, Section A, of Accounting Research Bulletin No. 43, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, the bulletin would also be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. The problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

2. Considerations other than those acceptable as a basis for the recognition of income frequently enter into the determination of the timing and amounts of interim billings on construction-type contracts. For this reason, income to be recognized on such contracts at the various stages of performance ordinarily should not be measured by interim billings.

**GENERALLY ACCEPTED METHODS**

3. Two accounting methods commonly followed by contractors are the percentage-of-completion method and the completed-contract method.

*Percentage of completion method*

4. The percentage-of-completion method recognizes income as work on a contract progresses. The committee recommends that the recognized income be that percentage of estimated total income, either:

(a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

*Costs* as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

5. Under this method current assets may include costs and recognized income not yet billed, with respect to certain contracts; and
liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

6. When the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

7. The principal advantages of the percentage-of-completion method are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimates of costs to complete or of progress toward completion.

8. The principal disadvantage of the percentage-of-completion method is that it is necessarily dependent upon estimates of ultimate costs and consequently of currently accruing income, which are subject to the uncertainties frequently inherent in long-term contracts.

*Completed contract method*

9. The completed-contract method recognizes income only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provisions for losses. A contract may be regarded as substantially completed if remaining costs are not significant in amount.

10. When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

11. Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses. If there is a close
relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

12. When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs. It is suggested that the asset item be described as “costs of uncompleted contracts in excess of related billings” rather than as “inventory” or “work in process,” and that the item on the liability side be described as “billings on uncompleted contracts in excess of related costs.”

13. The principal advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses.

14. The principal disadvantage of the completed-contract method is that it does not reflect current performance when the period of any contract extends into more than one accounting period and under such circumstances it may result in irregular recognition of income.

Selection of method

15. The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Disclosure of the method followed should be made.

COMMITMENTS

16. In special cases disclosures of extraordinary commitments may be required, but generally commitments to complete contracts in process are in the ordinary course of a contractor’s business and are not required to be disclosed in a statement of financial position. They partake of the nature of a contractor’s business, and generally do not
represent a prospective drain on his cash resources since they will be financed by current billings.

The statement entitled "Long-term Construction-type Contracts" was adopted unanimously by the twenty-one members of the committee, of whom two, Mr. Coleman and Mr. Dixon, assented with qualification.

Mr. Coleman and Mr. Dixon do not approve the statements in paragraphs 6 and 11 as to provisions for expected losses on contracts. They believe that such provisions should be made in the form of footnote disclosure or as a reservation of retained earnings, rather than by a charge against revenues of the current period.

Mr. Coleman also questions the usefulness of the refinement of segregating the offset costs and billings by character of excess as set forth in the second sentence of paragraph 12. He suggests that a more useful alternative would be to show in any event total costs and total billings on all uncompleted contracts (a) with the excess shown either as a current asset or a current liability, and (b) with a supporting schedule indicating individual contract costs, billings, and explanatory comment.

* Restatement and Revision of Accounting Research Bulletins, American Institute of Accountants, 1953.

----------------------------------Principle A-2----------------------------------

Costs of sales and expenses should be appropriately matched against the periodic sales and revenues. It follows that there must be proper cutoff accounting for inventories and liabilities for costs and expenses at the beginning and end of the period or periods.

Operating Expenses

Expenses are costs which have expired in the process of producing revenue or with the passage of time. The term “cost” here means the sum of applicable expenditures and charges, directly or indirectly incurred, in acquiring a good or service in the condition and location in which it is used or sold. Initially, cost incurrence produces an asset or provides a service, the benefits of which are expected to produce present or future revenue. As the benefits are used up or
expire, the portion of the cost applicable to the revenues realized is charged against revenue. The identification and measurement of costs which have expired and matching them against applicable periodic revenues is a primary consideration in accounting.

... it is deemed desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.

[ARB No. 43, Ch. 6, par. 4]

A great deal of the essence of accrual accounting is to be found in the proper matching of revenues realized with their related costs, and the pattern of assignment of costs and expenses to periods must be coordinated with policies and circumstances controlling the realization of revenues. This point may be illustrated by the three basic stages in the flow of cost factors for an item such as fuel used in the production of another product: (1) coal is acquired; at this stage it is a supply inventory, (2) coal is burned; at this stage the cost becomes part of the work in progress of the product, (3) the cost of fuel is charged against revenue, as a component of the total cost of the product, as the product is sold, which may extend over periods considerably after the actual burning or utilization.

Expired costs (expenses) to be charged against the current period's revenue, therefore, must be distinguished from unexpired costs (inventories, prepaid and deferred costs, and fixed assets) to be charged against the revenue of future periods in order to present net income fairly. When more than one accounting period is affected, however, the cost must be allocated between the fiscal periods that benefit from the use or sale of the good or service.

... when a cost is incurred the benefits of which may reasonably be expected to be realized over a period in the future, it should be charged against income over such period.

[ARB No. 43, Ch. 15, par. 9]

The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness.

[ARB No. 43, Ch. 5, par. 5]

The benefits derived from some assets expire in comparatively uniform installments over a period of time that is predictable with a high degree of certainty (e.g., prepaid rent, interest, and insurance). In these cases the allocation of cost between expenses and assets is based
on the ratios of the time elapsed and the remaining useful life to the total time span expected to be benefited from the cost incurrence. As the degree of certainty concerning the total life span decreases, the degree of reliability with which cost can be allocated decreases accordingly.

To the extent that the rate of asset expiration is either erratic or unpredictable, reliable measurement is tempered or replaced by judgment as the basis by which cost is allocated between expenses and assets. Substantial uncertainty as to whether benefits may reasonably be expected to be realized in the future are resolved by charging the costs against current revenue. Only those prepaid expenses and deferred costs that properly apply to future periods are not shown as expenses of the current period.

The original estimates of the useful life of assets are re-examined regularly and adjustments are made where appropriate. A statement of the accounting procedures committee in reference to intangible assets is equally applicable to other assets having an uncertain useful life:

\[ \text{\ldots If it becomes evident that the period benefited will be longer or shorter than originally estimated, recognition thereof may take the form of an appropriate decrease or increase in the rate of amortization or, if such increased charges would result in distortion of income, a partial write-down may be made by a charge to earned surplus.} \]

\[ \text{[ARB No. 43, Ch. 5, par. 5]} \]

All expenses are related directly or indirectly to the production of revenue. When costs are directly identifiable with specific revenues, they are expensed in the same accounting period in which the revenue is recognized in the accounts in order to effect a proper matching of revenue and expense. Costs that are common to more than one activity are allocated between those activities on cost incurrence bases such as time or use factors.

When a sale of merchandise is accompanied by a warranty or service guarantee, a cost or expense is incurred at the time of the sale. The amount of the expense and accompanying liability are unknown at the time of sale and are therefore estimated on the basis of past experience. When the liability is subsequently paid, it may be paid in labor and materials rather than in cash. The estimated costs incurred in relation to warranties are sometimes shown as a revenue offset instead of as an expense.

The cost of salable output and components thereof (usually called
inventories), pensions, taxes, stock options and the cost of long-lived assets held for the production of other goods and services (usually referred to as fixed assets), present important problems in the allocation of costs between expenses and assets. A separate section is provided for the discussion of each of these classes of costs.

Cost of Goods Sold

Statement 2

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

Discussion

4. An inventory has financial significance because revenues may be obtained from its sale, or from the sale of the goods or services in whose production it is used. Normally such revenues arise in a continuous repetitive process or cycle of operations by which goods are acquired and sold, and further goods are acquired for additional sales. In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

[ARB No. 43, Ch. 4]

The valuation of inventories is discussed in Chapter 6. The amount assigned to the inventory at the end of a period is the balance with which the next period begins. The beginning balance in inventory plus the cost of merchandise purchased for resale by a retailer less the amount assigned to the ending inventory is the merchandise cost to be matched against revenue for the period. In a manufacturing situation, cost of goods sold includes all direct labor and material cost plus all factory overhead amounts adjusted for the change in amounts assigned to the beginning and closing inventories. When standard cost methods of inventory valuation are used, the balances in variance accounts may be used to adjust cost of goods sold if the amounts are immaterial; otherwise they may be allocated between inventories and cost of goods sold.
Expense of Pension Plans and Voluntary Payments to Retired Employees

It is accepted practice to account for voluntary payments to retired employees, not covered by a formal plan, on a cash basis, in which case the expense will be exactly equal to the payment. It is preferable, however, to account for the payments on the same basis as payments under a formal pension plan, i.e., an accrual basis, when the costs can be estimated in advance with reasonable accuracy.

The committee on accounting procedure of the Institute has dealt with accounting for costs of pension plans in ARB No. 43, Chapter 13A and in ARB No. 47, which are reproduced below. An accounting research study on the treatment of pension costs is expected to be published in 1965. After consideration of the recommendations in this study, the APB probably will issue an opinion supplanting these earlier Accounting Research Bulletins.

ARB No. 43
Chapter 13
Section A

1. This section deals with the accounting treatment of costs arising out of past service which are incurred under pension plans involving payments to outside agencies such as insurance companies and trustees. Self-administered and informal plans which do not require payments to outside agencies are not dealt with because of their special features and lack of uniformity. The principles set forth herein, however, are generally applicable to those plans as well.

2. Charges with respect to pension costs based on past service have sometimes been made to surplus on the ground that such payments are indirectly compensation for services and that since the services upon which computation of the payments is based were performed in the past, the compensation should not be permitted to affect any period or periods other than those in which the services involved were performed. In other cases all annuity costs based on past service have been charged to income in the period of the plan's inauguration as a current cost of originating the plan. In still other cases the position has been taken that a pension plan cannot bring the hoped-for benefits in the future unless past as well as future services are given recognition and, accordingly, annuity costs based on past service have
been spread over a period of present and future years. The last method is the one permitted under provisions of the Internal Revenue Code.¹

3. The committee believes that, even though the calculation is based on past service, costs of annuities based on such service are incurred in contemplation of present and future services, not necessarily of the individual affected but of the organization as a whole, and therefore should be charged to the present and future periods benefited. This belief is based on the assumption that although the benefits to a company flowing from pension plans are intangible, they are nevertheless real. The element of past service is one of the important considerations in establishing pension plans, and annuity costs measured by such past service contribute to the benefits gained by the adoption of a plan. It is usually expected that such benefits will include better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel, all of which should result in improved operations.

4. The committee, accordingly, is of the opinion that:
   (a) Costs of annuities based on past service should be allocated to current and future periods; however, if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year;
   (b) Costs of annuities based on past service should not be charged to surplus.

5. This opinion is not to be interpreted as requiring that charges be made to income rather than to reserves previously provided, or that recognition be given in the accounts of current or future periods to pension costs written off prior to the issuance of an opinion on this subject.

¹ See IRC Sec. 23(p)(1)(A).
upon their adoption, have resulted in substantial differences in accounting for pension costs. This bulletin indicates guides which, in the opinion of the committee, are acceptable for dealing with costs of pension plans in the accounts and reports of companies having such plans. It is not concerned with funding as such.

2. The term pension plan is here intended to mean a formal arrangement for employee retirement benefits, whether established unilaterally or through negotiation, by which commitments, specific or implied, have been made which can be used as the basis for estimating costs. It does not include profit-sharing plans or deferred-compensation contracts with individuals. It does not apply to informal arrangements by which voluntary payments are made to retired employees, usually in amounts fixed at or about the time of an employee’s retirement and in the light of his then situation but subject to change or discontinuance at the employer’s will; where such informal arrangements exist, the pay-as-you-go method of accounting for pension costs generally is appropriate, although the accrual method is equally appropriate in cases where costs can be estimated with reasonable accuracy.

3. When a pension plan is first adopted, it is customary to provide that pensions for covered employees will give recognition not only to services which are to be rendered by them in the future, but also to services which have been rendered by them prior to the adoption of the plan. The costs of the pensions to the employer, therefore, usually are based in part on past services and in part on current and future services of the employees. The committee considers that all of such costs are costs of doing business, incurred in contemplation of present and future benefits, as are other employment costs such as wages, salaries, and social security taxes. It, therefore, is of the opinion that past service benefit costs should be charged to operations during the current and future periods benefited, and should not be charged to earned surplus at the inception of the plan. The committee believes that, in the case of an existing plan under which inadequate charges or no charges for past services have been made thus far and the company has decided to conform its accounting to the preferred procedure expressed in this bulletin, it may be appropriate to charge to earned surplus the amount that should have been accumulated by charges to income since inception of the plan.

4. In addition to the basic features of a pension plan relating to employee eligibility and the level of pension payments, other factors enter into the determination of the ultimate costs of pensions. Some of these are:
(a) other benefits (such as social security) where amounts of pension payments are integrated therewith;
(b) length of life of employees both before and after retirement;
(c) employee turnover;
(d) in some cases, alternatives as to age at which employees may retire;
(e) future compensation levels; and
(f) in a funded plan, future rates of earnings on the fund and the status of fund investments.

Because of these factors, the total cost of the pensions that will be paid ultimately to the present participants in a plan cannot be determined precisely in advance, but, by the use of actuarial techniques, reasonably accurate estimates can be made. There are other business costs for which it is necessary to make periodic provisions in the accounts based upon assumptions and estimates. The committee believes that the uncertainties relating to the determination of pension costs are not so pronounced as to preclude similar treatment.

5. In the view of many, the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or governed by a strict legal interpretation of the obligations under the plan. They feel that because of the widespread adoption of pension plans and their importance as part of compensation structures, a provision for cancellation or the existence of a terminal date for a plan should not be the controlling factor in accounting for pension costs, and that for accounting purposes it is reasonable to assume in most cases that a plan, though modified or renewed (because of terminal dates) from time to time, will continue for an indefinite period. According to this view, costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations. Such calculations may be made as to each employee, or as to categories of employees (by age, length of service, or rate of pay, for example), or they may be based upon an average of the expected service lives of all covered employees. These calculations, although made primarily for funding purposes, may be used also for accounting purposes. They should, of course, be revised at intervals. Also according to this view, costs based on past services should be charged off over some reasonable period, provided the allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any
one year. The length of the period benefited by costs based on past services is subject to considerable difference of opinion. Some think that the benefits accrue principally during the early years of a plan; others feel that the period primarily benefited approximates the remaining service life of the employees covered by a plan at the time of its adoption; still others believe that the benefits of such costs extend over an indefinite period, possibly the entire life of a plan and its successors, if any. In practice, costs based on past services have in many instances been charged off over a ten- to twelve-year period, or over a fixed longer period such as twenty or thirty years. (The minimum period presently permitted for tax purposes is ten years if the initial past-service cost is immediately paid in full, or about twelve years if one-tenth of the initial past-service cost plus interest is paid each year.)

6. In the view of others, the full accrual of pension costs may be unnecessary. They point out that in some cases accounting for such costs in the manner indicated in paragraph 5 would result, as to a given year or cumulatively or both, in the accrual of costs under a pension plan in amounts differing materially from the payments made under the plan into a pension fund or to retired employees, and in other cases it would require the employer to record pension costs in amounts varying widely from his legal liabilities. They say that a company would in all probability never be called upon to utilize the entire amount of an actuarially calculated full accrual, and that, in the event of liquidation of the business, any amounts accrued with respect to employees who have not at the time acquired vested rights would, except for a voluntary act of grace, revert to the surplus of the company. They also believe that in the case of an unfunded or partially funded plan the accumulation of a substantial accrual would lead to pressure for full funding, possibly to the detriment of the company and its security holders, and that fear of this might deter management from entering into pension arrangements beneficial to employees. They also feel that the method of accounting envisioned in paragraph 5 disregards the probability that future unfavorable changes in a company’s economic position undoubtedly would lead to changes in the pension arrangements it would make for its employees. According to this view, management should have wider discretion in accounting for pension costs, provided there is adequate disclosure as to the method followed.

7. The committee regards the method outlined in paragraph 5
as being the method most likely to effect a reasonable matching of costs and revenues, and therefore considers it to be preferable. However, the committee believes that opinion as to the accounting for pension costs has not yet crystallized sufficiently to make it possible at this time to assure agreement on any one method, and that differences in accounting for pension costs are likely to continue for a time. Accordingly, for the present, the committee believes that, as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trustee funds or annuity contracts purchased.

8. The committee believes that the costs of many pension plans are so material that the fact of adoption of a plan or an important amendment to it constitutes significant information in financial statements. When a plan involving material costs is adopted, there should be a footnote to the financial statements for the year in which this occurs, stating the important features of the plan, the proposed method of funding or paying, the estimated annual charge to operations, and the basis on which such annual charge is determined. When an existing plan is amended to a material extent, there should be similar disclosure of the pertinent features of the amendment. When there is a change in the accounting procedure which materially affects the results of operations, there should be appropriate indication thereof. If there are costs of material amount based on past or current services for which reasonable provision has not been, or is not being, made in the accounts, appropriate disclosure should be made in a footnote to the financial statements as long as this situation exists.

The statement entitled “Accounting for Costs of Pension Plans” was adopted unanimously by the twenty-one members of the committee, of whom six, Messrs. Flatley, Jennings, Lindquist, Luther, Powell and Staub, assented with qualification.

The six members assenting with qualification object to that part of paragraph 3 which appears to sanction the charging to earned surplus in some circumstances of pension costs based on past service. They believe this to be in conflict with section A of chapter 13 of Accounting Research Bulletin No. 43, in which the committee expresses the opinion that costs of annuities based on past service should
not be charged to surplus. They consider the conclusion expressed in chapter 13 to be sound for the reasons therein stated.

Real and Personal Property Tax Expense

There are many technical aspects in determining the fiscal period to which property taxes are assignable. The systematic accrual on the taxpayer's books over the fiscal year of the taxing authority is preferred, but the accrual over various other periods is accepted practice. The variety of acceptable periods makes it essential to apply the method selected in a consistent manner as between years. The views of the committee on accounting procedure are presented in Chapter 10A of ARB No. 43, which is reproduced below.
various dates on which certain property taxes are said to accrue legally. Among them are the following:

(a) Assessment date,
(b) Beginning of taxing authority's fiscal year,
(c) End of taxing authority's fiscal year,
(d) Date on which tax becomes a lien on the property,
(e) Date tax is levied,
(f) Date or dates tax is payable,
(g) Date tax becomes delinquent,
(h) Tax period appearing on tax bill.

3. Most of the foregoing dates are mentioned in tax laws. In a given case several of these dates may coincide.

4. The date to be applied in a particular case necessarily requires reference to the law and court decisions of the state concerned. Where the matter has been litigated, it has often been held that property taxes become a liability at the point of time when they become a lien. The general rule, however, is that such taxes accrue as of the date on which they are assessed. The position of the Bureau of Internal Revenue is that generally property taxes accrue on the assessment date, even if the amount of the tax is not determined until later.

5. A practical aspect of the legal liability for property taxes must be considered when title to property is transferred during the taxable year. As stated above, the assessment date generally determines accrual. But as between vendor and vendee, the Supreme Court\(^1\) has laid down the rule that the lien date, or the date of personal obligation, controls and that where a transfer occurs after either of those dates, the purchaser is not entitled to deduct the taxes for income-tax purposes.

6. Adjustments on account of property taxes paid or accrued are frequently incorporated in agreements covering the sale of real estate, which determine the question for the individual case as between the buyer and seller, though they are not necessarily controlling for income-tax purposes.

7. Although pro-rata accrual of property taxes has been permitted by some courts, the generally accepted rule seems to be that such taxes accrue in a lump sum on one date and not ratably over the year.
ACCOUNTING FOR PROPERTY TAXES

Accrual accounting

8. Accounting questions arise as to (1) when the liability for real and personal property taxes should be recorded on the books of a taxpayer keeping his accounts on the accrual basis and (2) the amounts to be charged against the income of respective periods. Here again, the decision is influenced by the particular circumstances of each tax. Such terms as assessment date and levy date vary in meaning in the different jurisdictions; and while there is sufficient agreement about assessment date to furnish a basis for the general legal rule already mentioned, it does not necessarily follow that the legal rule should determine the accounting treatment.

9. Determination of the liability for the tax often proceeds by degrees, the several steps being taken at appreciable intervals of time. For example, while it is known that the owner of real property is liable, with respect to each tax period, for a tax on property owned on the assessment date, the amount of the tax may not be fixed until much later. There is sometimes reluctance toward recording liabilities of indeterminate amount, especially such items as property taxes, and a preference for recording them when the amount can be computed with certainty. While this consideration is one which occasionally leads to the mention of taxes in footnotes as contingent liabilities, the inability to determine the exact amount of taxes is in itself no justification for failure to recognize an existing tax liability.

10. In practice, real and personal property taxes have been charged against the income of various periods, as indicated below:

(a) Year in which paid (cash basis),
(b) Year ending on assessment (or lien) date,
(c) Year beginning on assessment (or lien) date,
(d) Calendar or fiscal year of taxpayer prior to assessment (or lien) date,
(e) Calendar or fiscal year of taxpayer including assessment (or lien) date,
(f) Calendar or fiscal year of taxpayer prior to payment date,
(g) Fiscal year of governing body levying the tax,
(h) Year appearing on tax bill.

11. Some of these periods may coincide, as when the fiscal year of the taxing body and that of the taxpayer are the same. The charge to income is sometimes made in full at one time, sometimes ratably
on a monthly basis, sometimes on the basis of prior estimates, adjusted during or after the period.

12. The various periods mentioned represent varying degrees of conservatism in accrual accounting. Some justification may be found for each usage, but all the circumstances relating to a particular tax must be considered before a satisfactory conclusion is reached.

13. Consistency of application from year to year is the important consideration and selection of any of the periods mentioned is a matter for individual judgment.

*Basis considered most acceptable*

14. Generally, the most acceptable basis of providing for property taxes is monthly accrual on the taxpayer's books during the fiscal period of the taxing authority for which the taxes are levied. The books will then show, at any closing date, the appropriate accrual or prepayment.

15. It may be argued that the entire amount of tax should logically be accrued by the lien date. Advocates of this procedure vary from those who would accrue the tax by charges to income during the year ending on the lien date, to those who urge setting up the full tax liability on the lien date and charging the amount thereof to income during the subsequent year. However, the basis described in the preceding paragraph is held by the majority of accountants to be practical and satisfactory so long as it is consistently followed.

**TREATMENT IN FINANCIAL STATEMENTS**

*Balance sheet*

16. An accrued liability for real and personal property taxes, whether estimated or definitely known, should be included among the current liabilities. Where estimates are subject to a substantial measure of uncertainty the liability should be described as estimated.

*Income statement*

17. While it is sometimes proper to capitalize in property accounts the amount of real estate taxes applicable to property which is being developed for use or sale, these taxes are generally regarded as an expense of doing business. They may be (a) charged to operating expenses; (b) shown as a separate deduction from income; or
(c) distributed among the several accounts to which they are deemed to apply, such as factory overhead, rent income, and selling or general expenses.

18. In condensed income statements appearing in published reports, the amounts of real and personal property taxes, however charged in the accounts, are rarely shown separately. They are frequently combined with other taxes but not with taxes on income.

19. Since the liability for property taxes must frequently be estimated at the balance-sheet date, it is often necessary to adjust the provision for taxes of a prior year when their amount has been ascertained. These adjustments should ordinarily be made through the income statement, either in combination with the current year's provision or as a separate item in the income statement. Such adjustments should not be made in the surplus account, except under the conditions set forth in chapter 8, paragraphs 11, 12, and 13.

One member of the committee, Mr. Wellington, assented with qualification to adoption of section (a) of chapter 10.

Mr. Wellington objects to the statement in paragraph 15 that the basis described in paragraph 14 is held by the majority of accountants to be practical and satisfactory as long as it is consistently followed. In his opinion, the most logical practice is to accrue the entire amount of tax at the lien date, with a corresponding charge to an account such as taxes unexpired which will then be reduced pro rata, as outlined in the latter part of the second sentence of paragraph 15.

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* * *

Income Taxes

The amount of income tax expense that is properly deducted in an income statement to arrive at net income has become a debatable issue in the accounting profession. One school of thought believes in accruing income taxes on the basis of the revenue and expense that are reported in the income statement, exclusive of items that are never taxable or deductible in any period. The other school believes that the income taxes assessable for the period under the tax code should be accrued. The latter group would accept alloca-
CHAPTER 4: INCOME AND EXPENSE (SECTION A OF SUMMARY)

tion of income taxes for intra-period items recorded in retained earnings or other accounts and would provide for taxes where substantial revenues (such as installment sales) are reported in advance of their taxability, but they would not otherwise extend tax allocation to differences between the tax return and the income statement which will recur regularly over a long period of time.

The subject of tax effect accounting, particularly as to the impact of changes in tax rates, was discussed by the author in the April 1964 Journal of Accountancy. This discussion is reproduced in the following paragraphs.


“Questions have been raised as to the impact of changes in Federal income tax rates under the 1964 Revenue Act upon “tax effect accounting” arising out of certain major differences between taxable income and net income reported by business entities as determined from their accounting records. Under the 1964 Act the basic corporate tax rate is reduced from 52 per cent to 50 per cent for 1964 and 48 per cent thereafter.

REVIEW OF THE PROBLEM

“The reduction in the basic tax rate raises these questions: (1) On what tax rate should current provisions for tax effect accounting be based? (2) Should accumulated amounts carried as debits and credits in balance sheets be adjusted to give effect to the rate change? (3) On what basis should those amounts be taken into income in future years?

“There are two broad theories as to the nature and objectives of tax effect accounting. Using as an example the common situation of tax depreciation exceeding recorded depreciation, one theory holds that tax effect accounting recognizes the estimated income tax to be paid in the future in excess of that which would be payable if extra depreciation were not being claimed currently for tax purposes. Under this theory the balance sheet account is regarded as an estimated liability, and the current tax rate or the rate that can be reasonably anticipated
at the time the estimate is made is used to compute the current year provision, to adjust the balance sheet account to current estimated requirements, and to take amounts back into income when recorded depreciation exceeds tax depreciation. This theory, then, tends to emphasize the balance sheet rather than the income statement.

"The other broad theory holds that tax effect accounting defers to a future period the amount of actual tax reduction in the current period by reason of tax depreciation exceeding recorded depreciation. Under this theory the balance sheet account is regarded as a deferred credit, to be carried unadjusted until released to income when recorded depreciation exceeds tax depreciation. This approach contemplates that the release of amounts deferred is to be at the rate at which amounts previously entered the account, so that the effect of any difference in tax rates as between the year of provision and the year of release will be reflected in the latter year. This theory, then, emphasizes the income statement rather than the balance sheet, by removing from income the actual tax reduction realized in the current period by reason of tax depreciation exceeding book depreciation.

"Existing AICPA bulletins which touch on the problem (paragraph 11 of Chapter 9C and paragraph 8 of Chapter 10B of ARB No. 43) suggest the "estimated liability" approach in giving recognition to anticipated rate changes. However, there is no indication that the committee on accounting procedure of the AICPA went into this aspect of the tax accounting problem in depth. The estimated liability approach is supported by a number of academicians (including Professor Homer A. Black in his most recent draft of the AICPA research project on accounting for income taxes), and that line of reasoning is also followed in the English bulletin on income tax accounting.

"The "deferred credit" approach is supported by the Securities and Exchange Commission (see footnote 3 of Accounting Series Release No. 85) and the Canadian profession's bulletin on income tax accounting. It should be noted, also, that while no formal "polling" has been done, many individual members of the APB and of the Project Advisory Committee on Accounting for Income Taxes favor the deferred credit approach.

DIFFERENT TYPES OF TAX EFFECT ACCOUNTING

"While it is unlikely that all of the several different situations giving rise to tax effect accounting will be encountered in any one company, it may be helpful to an understanding of the problem to examine briefly some of these situations and their characteristics. The more
commonly encountered situations involving tax effect accounting between periods of time are summarized below:

"1. Accelerated depreciation methods and depreciation guideline rates used for tax purposes which are in excess of rates used in the accounts.

"2. Amounts capitalized or deferred on the books expensed for tax purposes. Examples — Research and development expenses, interest and taxes during construction.

"3. Income recognized on the books in advance of recognition for tax purposes. Examples — Installment sales of merchandise, contract income recorded on percentage of completion method for book purposes and completed contract basis for tax purposes, installment sales of assets.

"4. Income reported for tax purposes before being recorded as income in the accounts. Examples — Intercompany profit in inventory, advance rentals and royalties, carved out oil or ore payments.

"5. Expenses or losses provided for in the accounts in advance of their deductibility for tax purposes. Examples — Anticipated losses on disposition of facilities, pension costs, vacation pay, deferred compensation, severance pay, self-insurance, warranties.

"Of the foregoing situations, those most frequently encountered and involving the largest amounts of money (Example — Accelerated depreciation methods in a company having constant or increasing annual capital additions) have a long-term tax effect, involve repetitive as distinguished from isolated transactions, and are of such a nature that it is possible to establish a known amount by which taxes for the year were reduced or increased because of accounting for the item one way on the books and another way in the tax return. Situations described in Nos. 1 to 4 above are generally of that kind. For these, the "deferred credit" approach seems appropriate.

"Of a somewhat different nature are tax effect accounting situations involving an estimated loss or liability (No. 5 above), which may not cover long periods, do not necessarily involve repetitive transactions, may be susceptible of fairly accurate estimates and the tax effect represents an estimate of future effect rather than being currently determinable. For situations of this type, the "estimated liability" approach appears to be appropriate both for the estimated tax effect and for the account to which the tax effect relates.

"Inasmuch as it will require several months to complete the research study on accounting for Federal income taxes and subsequent consideration of the study by the APB, the Director of Accounting Research was requested to make recommendations on tax effect accounting for
the guidance of the members of the AICPA until such time as the APB issues an opinion on the subject. Such recommendations follow:

RECOMMENDATIONS

"1. The principal objective should be a fair presentation of net income; it follows that any distortions of that figure in comparison with earlier or later years, resulting from adjustments in tax effect accounting, should not be acceptable.

"2. As a general rule, the accumulated amounts carried as debits and credits in balance sheets should be regarded as deferred items. Under this interpretation, current year provisions should be made at the tax rate applicable for the year (52 per cent for 1963 and, prospectively, 50 per cent for 1964 and 48 per cent thereafter). The accumulation at any point in time of the amounts of current tax reduction provided for previously should be allocated to future periods at the same rate that the amounts were accumulated in the account, or at the average rate of accumulation. As explained earlier, this interpretation is supported by the SEC.

"3. If the management of a company, having been informed of these recommendations and the SEC position as stated in paragraph 2, nevertheless decides to adopt the liability approach and clearly discloses that this has been done, a qualification in the CPA’s opinion cannot be justified in view of the previously mentioned existing AICPA bulletins and other support for this interpretation. Of course, if paragraph 1 were not observed, with the result that income was not “fairly presented,” a qualified opinion would be required. If it were to be adopted, the liability theory might take a form somewhat as follows:

"Current year provision at 48 per cent, the rate which can be reasonably anticipated at this time,

"Prior year balances left unadjusted on grounds of conservatism, or

"Prior year balances adjusted to the 48 per cent rate and (a) amount of the adjustment excluded from income if material, or (b) amount spread to future income over a period of years sufficiently long to avoid distortion of income.

"Managements expressing a preference for the liability approach should be reminded that:

"The permanence of the reduction in rates has not been established and might be regarded as uncertain from a political standpoint.

"An adjustment downward now for the rate reduction would call for an adjustment upward in the event that rates should be increased in the future.

"There may have been recorded less than a full deferral in the past,
which would make it difficult to now justify the liability concept (Example — Companies that adopted accelerated methods for tax purposes but did not initiate tax effect accounting until ARB No. 44 (Revised), was issued in 1958).

"4. The liability approach should be regarded as generally applicable to tax effect accounting situations involving an estimated loss or liability, particularly where the items are susceptible of fairly accurate estimates and are short term in nature. Current provisions would normally be made at the rate which can be reasonably anticipated at this time (48 per cent), and the balances accumulated in prior years adjusted to that rate. Such adjustments would be excludable from income if material.

"5. The recommendations described in broad terms in paragraphs 1 to 4 should be applied to the particular circumstances of each company. Such application would contemplate looking at the company's tax effect accounting situation as a whole as well as reviewing the several individual accounts as suggested previously.

"6. Accounting changes and adjustments of the kind described herein would arise from "altered conditions" (revision of the law) rather than a "choice by management." Thus a consistency exception would not be required, but full disclosure in the notes would be desirable (Chapter 8 of Statements on Auditing Procedure No. 33).

"7. Where an adjustment for the tax rate change has been made and the accounts of more than one period are presented, the advisability of restatement of prior year financial statements should be considered.

"8. This statement is not intended to apply to regulated industries, where the effect of the rate-making process ordinarily requires consideration in each case."

* * *

The committee on accounting procedure dealt with income tax allocation in ARB No. 43, Chapter 10B, with differences arising from Emergency Facilities in ARB No. 43, Chapter 9C, with differences arising from Declining-balance Depreciation in ARB No. 44 (Revised). The Accounting Principles Board dealt with "New Depreciation Guidelines and Rules" in its Opinion No. 1 and with "Accounting for the 'Investment Credit' " in Opinions Nos. 2 and 4. These bulletins and Opinions are reproduced below, in the order previously given. An accounting research study on income taxes is expected to be
published in the near future. After considering the recommendations in this study, the APB may revise and supplant some or all of the presently outstanding ARBs and Opinions relating to income taxes.

ARB No. 43
Chapter 10
Section B

TAXES

Income Taxes

1. This section deals with a number of accounting problems which arise in the reporting of income and excess-profits taxes (hereinafter referred to as income taxes) in financial statements. The problems arise largely where (a) material items entering into the computation of taxable income are not included in the income statement and where (b) material items included in the income statement do not enter into the computation of taxable income. The section does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time.

2. Basic difficulties arise in connection with the accounting for income taxes where there are material and extraordinary differences between the taxable income upon which they are computed and the income for the period determined in accordance with generally accepted accounting principles. For example, provisions may be made in the income statement for possible losses not yet realized but requiring recognition under generally accepted accounting principles, such losses, however, being deductible for tax purposes only when they occur. On the other hand, deductions may be taken in the tax return which are not included in the income statement, such as charges against an estimated liability account created in a prior period. Likewise, gains subject to income tax may not be included in the income statement, as, for instance, a gain on the sale of property credited to surplus. Also, credits in the income statement may not be includable in taxable income, as when an unneeded past provision for an estimated liability is restored to income.

3. In some cases the transactions result in gains; in others they result in losses or net costs. If all the effects of the transactions (including their effect on income tax) were reflected in the income statement the income would, of course, be increased where the
transactions result in a gain and reduced where they result in a loss 
or net cost. But where the effects are not all reflected in the income 
statement, and that statement indicates only the income tax actually 
payable, exactly the opposite effect is produced — where the special 
transactions result in a gain the net income is reduced; and where 
they result in a loss, or net cost, the net income is increased. Such 
results ordinarily detract from the significance or usefulness of the 
financial statements.

4. Financial statements are based on allocations of receipts, pay­
ments, accruals, and various other items. Many of the allocations 
are necessarily based on assumptions, but no one suggests that allo­
cations based on imperfect criteria should be abandoned in respect 
of expenses other than income taxes, or even that the method of 
allocation should always be indicated. Income taxes are an expense 
that should be allocated, when necessary and practicable, to income 
and other accounts, as other expenses are allocated. What the income 
statement should reflect under this head, as under any other head, 
is the expense properly allocable to the income included in the income 
statement for the year.

5. In cases in which transactions included in the surplus state­
ment but not in the income statement increase the income tax pay­
able by an amount that is substantial and is determinable without 
difficulty, as in the case of a gain credited to surplus, an allocation of 
income tax between the two statements would ordinarily be made. 
Objection to allocation in other cases, as where a loss is charged to 
surplus, has been made on the ground that the amount shown for 
income taxes in the income statement would be increased beyond 
the amount of the tax estimated to be actually payable. Further 
objection has been made on the ground that the amount attributable 
to accounts other than income is not reasonably determinable.

6. The committee sees no objection to an allocation which re­
results in the division of a given item into two parts one of which is 
larger than the item itself and is offset by the smaller. The argument 
that the effect of the special transactions on the amount of tax is not 
identifiable is usually without substantial merit. The difficulties en­
countered in allocation of the tax are not greater than those met with 
in many other allocations of expenses. The allocation procedure 
recommended here does not, of course, contemplate a determina­
tion of the tax effect attributable to every separate transaction. In 
the committee’s view, all that is necessary in making an allocation
is to consider the effect on taxes of those special transactions which are not included in the income statement.

7. The cases that are likely to call for allocation are those in which transactions affecting the income tax in a manner which would have a distorting effect on net income are included in (a) surplus accounts, (b) deferred-charge accounts, or (c) estimated liability and similar accounts. Methods of applying the allocation principle in these instances are set forth below.

METHODS OF APPLYING THE ALLOCATION PRINCIPLE

Computation of tax effect

8. In most cases, it is appropriate to consider the tax effect as the difference between the tax payable with and without including the item in the amount of taxable income. In certain cases the tax effect attributable to a particular transaction for the purposes indicated above may be computed directly as in the case of transactions subject to the capital gains tax. There may also be cases in which it will be appropriate to use a current over-all effective rate or, as in the case of deferred income, an estimated future tax rate. The estimated rate should be based upon normal and surtax rates in effect during the period covered by the income statement with such charges therein as can be reasonably anticipated at the time the estimate is made.

Credits to surplus

9. Where an item resulting in a material increase in income taxes is credited to surplus, the portion of the provision for income taxes which is attributable to such item should, under the principle of allocation, be charged thereto. The committee suggests, however, that the provision for income taxes estimated as due be shown in the income statement in full and that the portion thereof charged to surplus be shown on the income statement either (a) as a separate deduction from the actual tax or (b) as a separate credit, clearly described.

Charges to surplus

10. Where an item resulting in a material reduction in income taxes is charged to surplus, the principle of allocation may be applied in the income statement in either of two ways: (a) the provision for income taxes may be shown as if the item in question were not
deductible (the total amount of tax estimated to be due for the year being indicated) or (b) a special charge representing the portion of such item equal to the tax reduction resulting therefrom may be separately shown. In either case the amount charged to surplus is reduced accordingly.

Deferred-charge and estimated liability accounts

11. The principle of allocation applies also where an item resulting in a material reduction in income taxes is charged to or carried forward in a deferred-charge account or charged to an estimated liability account.

12. The deduction for tax purposes in a given year of an item which is carried to or remains in a deferred-charge account will involve a series of charges in future income statements for amortization of the deferred charge, and these charges will not be deductible for tax purposes. In the period in which the item is taken as a deduction for tax purposes a charge should be made in the income statement of an amount equal to the tax reduction, in the manner set forth above with respect to charges to surplus, with a corresponding credit in the deferred-charge account. Thereafter amortization of the deferred charge should be based on the amount as adjusted by such tax reduction.

13. Where an item resulting in a material reduction in income taxes is charged to an estimated liability account the principle of allocation may be applied in the income statement in any of three ways: (a) the current provision for income taxes may be shown as if the item in question were not deductible (the total amount of tax estimated to be due for the year being indicated), or (b) a charge may be included for a portion of such item equal to the tax reduction resulting therefrom, or (c) the item in question may be charged in the income statement and a credit made in the income statement representing a portion of the estimated liability account equal to the excess of such item over the related tax reduction.

Special treatment

14. Where the treatments recommended above are considered to be not practicable, the amount of taxes estimated to be actually payable for the year may be shown in the income statement, provided that the pertinent facts, including the amount of the increase or decrease attributable to other accounts, are clearly disclosed either in a footnote or in the body of the income statement.
ADDITIONAL TAXES AND REFUNDS

15. Adjustments of provisions for income taxes of prior periods, as well as any refunds and any assessments of additional amounts, should be included in the income statement unless they are so material as to have a distorting effect on net income;¹ in such event they may be charged or credited to surplus with indication as to the period to which they relate.

CARRY-BACK OF LOSSES AND UNUSED EXCESS-PROFITS CREDITS

16. While claims for refund of income taxes ordinarily should not be included in the accounts prior to approval by the taxing authorities, a claim based on the carry-back provisions of the Internal Revenue Code presumably has as definite a basis as has the computation of income taxes for the year. Therefore, amounts of income taxes paid in prior years which are refundable to the taxpayer as the result of the carry-back of losses or unused excess-profits credits ordinarily should be included in the income statement of the year in which the loss occurs or the unused excess-profits credit arises. Either of two treatments is acceptable: (a) the amount of taxes estimated to be actually payable for such year may be shown in the income statement, with the amount of the tax reduction attributable to the amounts carried back indicated either in a footnote or parenthetically in the body of the income statement; or (b) the income statement may indicate the results of operations without inclusion of such reduction, which reduction should be shown as a final item before the amount of net income for the period.

CARRY-FORWARD OF LOSSES AND UNUSED EXCESS-PROFITS CREDITS

17. Where taxpayers are permitted to carry forward losses or unused excess-profits credits, the committee believes that, as a practical matter, in the preparation of annual income statements the resulting tax reduction should be reflected in the year to which such losses or unused credits are carried. Either of two treatments is acceptable: (a) the amount of taxes estimated to be actually payable for such year may be shown in the income statement, with the amount of the tax reduction attributable to the amounts carried forward indicated either in a footnote or parenthetically in the body of the income statement; or (b) the income statement may indicate the results of operations without inclusion of such reduction,
which reduction should be shown as a final item before the amount of net income for the period. However, where it is believed that misleading inferences would be drawn from such inclusion, the tax reduction should be credited to surplus.

DISCLOSURE OF CERTAIN DIFFERENCES BETWEEN TAXABLE AND ORDINARY INCOME

18. If, because of differences between accounting for tax and accounting for financial purposes, no income tax has been paid or provided as to certain significant amounts credited to surplus or to income, disclosure should be made. However, if a tax is likely to be paid thereon, provision should be made on the basis of an estimate of the amount of such tax. This rule applies, for instance, to profits on installment sales or long-term contracts which are deferred for tax purposes, and to cases where unrealized appreciation of securities is taken into the accounts by certain types of investment companies.

Two members of the committee, Messrs. Wellington and Werntz, assented with qualification to adoption of section (b) of chapter 10.

Mr. Wellington objects to paragraph 17, as he believes that the amount of the reduction in tax of the later year is due to the operations of the prior year, is in effect an adjustment of the net income or net loss previously reported, and, unless it is relatively not significant, should not be included in the income of the current year but should be credited to surplus. In an income statement for several years, he would show this credit to surplus as an addition to the income previously reported for the prior year, with suitable explanation.

Mr. Werntz does not agree with some of the reasoning, particularly paragraph 6, and certain of the conclusions contained in this section. While he believes that in many cases a difference in treatment of items for tax and financial purposes preferably requires a specialized charge or credit in the income account, so that neither a double benefit nor a double deduction results, he believes that the charge or credit may not always be mandatory and should ordinarily be described in terms of the item involved rather than as taxes.

1 See chapter 8, paragraphs 11, 12, and 13.
CERTIFICATES OF NECESSITY

1. Section 124A of the Internal Revenue Code, which was added by the Revenue Act of 1950, provides for the issuance of certificates of necessity under which all or part of the cost of so-called emergency facilities may be amortized over a period of 60 months for income-tax purposes. In many cases, the amounts involved are material, and companies are faced with the problem of deciding whether to adopt the 60-month period over which the portions of the cost of the facilities covered by certificates of necessity may be amortized for income-tax purposes as the period over which they are to be depreciated in the accounts.

2. Thinking on this question apparently has become confused because many so-called percentage certificates have been issued covering less than the entire cost of the facility. This fact, together with the fact that the probable economic usefulness of the facility after the close of the five-year amortization period is considered by the certifying authority in determining the percentage covered by these certificates, has led many to believe that the percentage used represents the government's conclusion as to the proportion of the cost of the facility that is not expected to have usefulness at the end of five years.

3. In some cases, it is apparent that the probable lack of economic usefulness of the facility after the close of the amortization period must constitute the principal if not the sole basis for determining the percentage to be included in the certificate. However, it must be recognized that the certifying authority has acted under orders to give consideration also to a variety of other factors to the end that the amount certified may be the minimum amount necessary to secure expansion of industrial capacity in the interest of national defense during the emergency period. Among the factors required to be considered in the issuance of these certificates, in addition to loss of useful value, are (a) character of business, (b) extent of risk assumed (including the amount and source of capital employed, and the potentiality of recovering capital or retiring debt through tax savings or pricing), (c) assistance to small business and promotion of competition, (d) compliance with government policies (e.g., dispersal for
security), and (e) other types of incentives provided by government, such as direct government loans, guaranties, and contractual arrangements.

DEPRECIATION CONSIDERATIONS

4. The argument has been advanced from time to time that, since the portion of the cost of properties covered by certificates of necessity is amortized over a five-year period for income-tax purposes, it is necessary to follow the same procedure in the accounts. Sound financial accounting procedures do not necessarily coincide with the rules as to what shall be included in "gross income," or allowed as a deduction therefrom, in arriving at taxable net income. It is well recognized that such rules should not be followed for financial accounting purposes if they do not conform to generally accepted accounting principles. However, where the results obtained from following income-tax procedures do not materially differ from those obtained where generally accepted accounting principles are followed, there are practical advantages in keeping the accounts in agreement with the income-tax returns.

5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

6. The committee is of the opinion that from an accounting standpoint there is nothing inherent in the nature of emergency facilities which requires the depreciation or amortization of their cost for financial accounting purposes over either a shorter or a longer period than would be proper if no certificate of necessity had been issued. Estimates of the probable useful life of a facility by those best informed in the matter may indicate either a shorter or a longer life than the statutory 60-month period over which the certified portion of its cost is deductible for income-tax purposes.

7. In determining the proper amount of annual depreciation with
respect to emergency facilities for financial accounting purposes, it must be recognized that a great many of these facilities are being acquired primarily for what they can produce during the emergency period. To whatever extent it is reasonable to expect the useful economic life of a facility to end with the close of the amortization period, the cost of the facility is a proper cost of operation during that period.

8. In determining the prospective usefulness of such facilities it will be necessary to consider their adaptability to post-emergency use, the effect of their use upon economic utilization of other facilities, the possibility of excessive costs due to expedited construction or emergency conditions, and the fact that no deductions for depreciation of the certified portion will be allowable for income-tax purposes in the post-amortization years if the company elects to claim the amortization deduction. The purposes for which emergency facilities are acquired in a great many cases are such as to leave major uncertainties as to the extent of their use during the amortization period and as to their subsequent usefulness—uncertainties which are not normally encountered in the acquisition and use of operating facilities.

9. Consideration of these factors, the committee believes, will in many cases result in the determination of depreciation charges during the amortization period in excess of the depreciation that would be appropriate if these factors were not involved. Frequently they will be so compelling as to indicate the need for recording depreciation of the cost of emergency facilities in the accounts in conformity with the amortization deductions allowable for income-tax purposes. However, the committee believes that when the amount allowed as amortization for income-tax purposes is materially different from the amount of the estimated depreciation, the latter should be used for financial accounting purposes.

10. In some cases, certificates of necessity cover facilities which the owner expects to use after the emergency period in lieu of old facilities. As a result the older facilities may become unproductive and obsolete before they are fully depreciated on the basis of their previously expected life. In such situations, the committee believes depreciation charges to income should be determined in relation to the total properties, to the end that sound depreciation accounting may be applied to the property accounts as a whole.

RECOGNITION OF INCOME TAX EFFECTS

11. In those cases in which the amount of depreciation charged in the accounts on that portion of the cost of the facilities for which
certificates of necessity have been obtained is materially less than the amount of amortization deducted for income-tax purposes, the amount of income taxes payable annually during the amortization period may be significantly less than it would be on the basis of the income reflected in the financial statements. In such cases, after the close of the amortization period the income taxes will exceed the amount that would be appropriate on the basis of the income reported in the statements. Accordingly, the committee believes that during the amortization period, where this difference is material, a charge should be made in the income statement to recognize the income tax to be paid in the future on the amount by which amortization for income-tax purposes exceeds the depreciation that would be allowable if certificates of necessity had not been issued. The amount of the charge should be equal to the estimated amount by which the income tax expected to be payable after the amortization period exceeds what would be so expected if amortization had not been claimed for income-tax purposes in the amortization period. The estimated amount should be based upon normal and surtax rates in effect during the period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.

12. In accounting for this deferment of income taxes, the committee believes it desirable to treat the charge as being for additional income taxes. The related credit in such cases would properly be made to an account for deferred income taxes. Under this method, during the life of the facility following the amortization period the annual charges for income taxes will be reduced by charging to the account for deferred income taxes that part of the income tax in excess of what would have been payable had the amortization deduction not been claimed for income-tax purposes in the amortization period. By this procedure the net income will more nearly reflect the results of a proper matching of costs and revenues.

13. There are those who similarly recognize the necessity for giving effect to the amount of the deferred income taxes but who believe this should be accomplished by making a charge in the income account for additional amortization or depreciation. They would carry the related credit to an accumulated amortization or depreciation account as a practical means of recognizing the loss of future deductibility of the cost of the facility for income-tax purposes. If this procedure is followed, the annual charges for depreciation will be correspondingly reduced throughout the useful life of the facility following the amortization period. Although this procedure will
result in the same amount of net income as the procedure outlined in paragraph 12, and therefore may be considered as acceptable, the committee regards the paragraph 12 procedure as preferable. In any circumstances, there should be disclosure of the procedures followed.

ARB No. 44 (Revised)

DECLINING-BALANCE DEPRECIATION

1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.

2. The declining-balance method is one of those which meets the requirements of being “systematic and rational.” In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this bulletin also apply to other methods, including the “sum-of-the-years-digits” method, which produce substantially similar results.

3. When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in the year in which the change is made.

4. There may be situations in which the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes. In such cases, accounting recognition should be given to deferred income taxes if the amounts thereof are material, except in those rare cases, such as are mentioned in paragraph 8, where there are special circumstances which may make such procedure inappropriate. The foregoing provision as to accounting recognition of deferred income taxes applies to a single asset, or to a group of assets which are expected to be retired from service at about the same time; in this case an excess of depreciation
taken for income-tax purposes during the earlier years would be fol-
lowed by the opposite condition in later years, and there would be a
tax deferment for a definite period. It applies also to a group of assets
consisting of numerous units which may be of differing lengths of life
and which are expected to be continually replaced; in this case an
excess of depreciation taken for income-tax purposes during the
earlier years would be followed in later years by substantial equality
between the annual depreciation for income-tax purposes and that for
accounting purposes, and a tax deferment would be built up during
the earlier years which would tend to remain relatively constant there-
after. It applies further to a gradually expanding plant; in this case an
excess of depreciation taken for income-tax purposes may exist each
year during the period of expansion in which event there would be a
tax deferment which might increase as long as the period of expansion
continued.

5. Where it may reasonably be presumed that the accumulative
difference between taxable income and financial income will continue
for a long or indefinite period, it is alternatively appropriate, instead of
crediting a deferred tax account, to recognize the related tax effect as
additional amortization or depreciation applicable to such assets in
recognition of the loss of future deductibility for income-tax purposes.

DISCUSSION

6. Following the passage of the Internal Revenue Act of 1954 in
August of that year, permitting the use of declining-balance and simi-
lar accelerated depreciation methods for Federal income-tax purposes,
the committee anticipated that many companies would be consider-
ing whether such methods should be adopted for general accounting
purposes. In October of that year, Accounting Research Bulletin No.
44 was issued in which the committee stated that such accelerated
methods met the requirement of being “systematic and rational.” The
committee also stated that when such methods were adopted for gen-
eral accounting purposes, appropriate disclosure of the change should
be made whenever depreciation was a significant factor in the deter-
mination of net income.

7. Since the issuance of Accounting Research Bulletin No. 44, the
committee has been observing and studying cases involving the appli-
cation of the bulletin. Studies of published reports and other source
material have indicated that, where material amounts are involved,
recognition of deferred income taxes in the general accounts is needed
to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes or, alternatively, recognize the loss of future deductibility for income-tax purposes of the cost of fixed assets by an appropriate credit to an accumulated amortization or depreciation account applicable to such assets.

8. Many regulatory authorities permit recognition of deferred income taxes for accounting and/or rate-making purposes, whereas some do not. The committee believes that they should permit the recognition of deferred income taxes for both purposes. However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations.

9. In those rare situations in which accounting for deferred income taxes is not appropriate, full disclosure should be made of the amount of deferred income taxes arising out of the difference between the financial statements and the tax returns when the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes.

10. The committee believes that, in applying the provisions of this bulletin to cases where there was no accounting recognition of deferred income taxes for the years since 1953, the entries made for periods subsequent to the issuance of this bulletin should be based upon all assets acquired after 1953 as to which the declining-balance method has been elected for tax purposes. As is indicated in the "Notes" to each Accounting Research Bulletin, opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. If a retroactive adjustment is made for prior periods, the adjustment may be made in a lump sum, or the deficiency may be systematically accumulated over a reasonable future period of time.

The statement entitled "Declining-balance Depreciation" (July 1958) was adopted unanimously by the twenty-one members of
the committee, of whom five, Messrs. Burns, Graham, Halvorson, Jennings, and Powell, assented with qualification.

Mr. Burns objects to the exceptions mentioned in paragraph 4 and discussed in paragraphs 8 and 9. He believes that accounting principles apply equally to all companies operated for profit and that the exceptions referred to are wholly inconsistent with the basic principles stated in paragraph 4; further, that the last sentence of paragraph 8 is based upon an untenable concept, namely, that accounting resulting from the application of an accounting rule prescribed by a regulatory commission may properly be approved by public accountants notwithstanding the fact that the rule is clearly contrary to generally accepted accounting principles.

Mr. Graham objects to the exceptions mentioned in the second sentence of paragraph 4 and discussed in the last sentence of paragraph 8 and in paragraph 9. He believes that accepted accounting principles should be applied uniformly to all corporations, including regulated companies. He does not believe that rate-making rules which are in conflict with these accepted principles constitute a sound basis for sanctioning a departure from these principles in financial reporting. Furthermore, he disagrees with the validity of the assumption which, by implication, forms the basis for this exception; he does not believe that public utility rates will always be adjusted automatically to compensate fully, or even substantially, for increases in future income taxes; he believes that this assumption is not in accord with the known realities of rate regulation and is not, therefore, a proper basis for the anticipation of future revenues.

Mr. Halvorson dissents from the recommendations of paragraph 4 because he believes its requirements for accounting recognition of deferred income taxes should be limited to a requirement for compliance with the recommendations of chapter 10(b) of Accounting Research Bulletin No. 43; he believes that paragraph 4 is effectively a revision of chapter 10(b) and that it is improper thus to make a substantive change in the committee's existing recommendations for tax allocation in the guise of a revision of a bulletin on depreciation.

Messrs. Jennings and Powell dissent from the conclusion (expressed in paragraph 4 and implied in the related discussion) that where the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes, there should be accounting recognition of deferred income taxes, except for certain rare cases. They believe this calls for more extensive allocation of income taxes among periods of time than is necessary or desirable, especially where the situation is such that the
so-called tax deferment is in effect a permanent tax reduction. Further, they object to the use of a bulletin on depreciation incidentally as a vehicle for making an important change in the committee’s views, as set forth in previous bulletins, on accounting for income taxes.

April 15, 1959

To the members of the American Institute of Certified Public Accountants

Gentlemen:

Question has been raised with respect to the intent of the committee on accounting procedure in using the phrase “a deferred tax account” in Accounting Research Bulletin No. 44 (revised), Declining-balance Depreciation, to indicate the account to be credited for the amount of the deferred income tax (see paragraphs 4 and 5).

The committee used the phrase in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit. A provision in recognition of the deferral of income taxes, being required for the proper determination of net income, should not at the same time result in a credit to earned surplus or to any other account included in the stockholders’ equity section of the balance sheet.

Three of the twenty-one members of the committee, Messrs. Jennings, Powell and Staub, dissented to the issuance at this time of any letter interpreting Accounting Research Bulletin No. 44 (revised).

Committee on Accounting Procedure

1 Accounting Terminology Bulletin No. 1, par. 56.

APB Opinion No. 1 | NEW DEPRECIATION GUIDELINES AND RULES

1. This Interpretive Opinion is an extension of Chapter 10(b) of Accounting Research Bulletin No. 43, “Income Taxes.” It concerns accounting problems which may arise in connection with the new Depreciation Guidelines and Rules issued by the United States Treasury Department Internal Revenue Service as Revenue Procedure 62-21, effective July 12, 1962.

2. The service lives suggested in the Guidelines for broad classes of depreciable assets are, in general, appreciably shorter than the indi-
individual lives given in Bulletin “F,” which was previously used as a guide in the determination of deductible depreciation for income-tax purposes. The Guidelines purport to bring the lives used for income-tax purposes into line with the actual experience of taxpayers, and thereby reduce the areas of controversy as to the amount of deductible depreciation, but not to provide another type of accelerated depreciation.

3. For the first three years, either the new Guideline lives, or lives longer than the Guideline lives, may be used for income-tax purposes without challenge. Lives shorter than those found in the Guidelines may be used if they have previously been established or are justifiable as reflecting the taxpayer’s existing or intended retirement and replacement practices. If the “reserve ratio” tests provided in the Procedure subsequently indicate that the lives used for income-tax purposes are not in accordance with actual retirement and replacement practices, the lives may be lengthened in accordance with the “life adjustment” tables provided in the Procedure. If the adjustment is not sufficient to bring tax and actual lives into line, the adjusted lives will then be replaced by lives determined in accordance with all of the facts and circumstances.

4. A taxpayer should carefully review the estimates of useful life of depreciable property adopted for financial accounting purposes, with the objective of conforming them with Guideline lives to the extent that the latter fall within a reasonable range of estimated useful lives applicable in his business.

5. With exceptions such as those discussed in paragraphs 6 and 7, net income for the period should not be increased as the result of the adoption of Guideline lives for income-tax purposes only. Accordingly, where Guideline lives shorter than the lives used for financial accounting purposes are adopted for income-tax purposes, and there is an excess of tax-return depreciation over book depreciation, provision for deferred income taxes should be made with respect to the part of the excess that is attributable to the adoption of Guideline lives, in the same manner as provided by Accounting Research Bulletin No. 44 (Revised), “Declining-balance Depreciation,” for liberalized depreciation under the Internal Revenue Code of 1954.¹

6. It may happen that a company has used shorter lives for accounting purposes than for tax purposes in the past, and now finds that these lives are longer than the new Guideline lives. If the lives previously used for accounting purposes are still considered reason-
able, they presumably will be continued, but Guideline lives might be adopted for tax purposes. Tax-effect accounting should be introduced in this type of case only when the accumulated depreciation for tax purposes exceeds that on the books. In other words, not recording a prepaid income tax while the tax-return lives were longer than the book lives makes it unnecessary to provide for deferred income taxes until depreciation accumulated for tax purposes exceeds that for accounting purposes.¹

7. It may develop that some regulatory authorities having jurisdiction over regulated businesses will prescribe the manner in which the tax effect of the adoption of Guideline lives for income-tax purposes only is to be dealt with for rate-making purposes. Where this is done, the principles set forth in paragraphs 8 and 9 of Accounting Research Bulletin No. 44 (Revised) are applicable.

The Interpretive Opinion entitled “New Depreciation Guidelines and Rules” was unanimously adopted by the twenty members of the Accounting Principles Board, of whom five, Messrs. Bevis, Cannon, Moyer, Powell, and Spacek, assented with qualification.

Messrs. Bevis and Powell assent to the Interpretive Opinion as a logical extension of Accounting Research Bulletin No. 44 (Revised), “Declining-balance Depreciation,” which was adopted by the required majority of the former committee on accounting procedure. However, they do not wish their assents in this case to imply concurrence with those aspects of Accounting Research Bulletin No. 44 (Revised) from which Messrs. Donald R. Jennings and Weldon Powell dissented at the time. They believe the grounds for those dissents are still valid. They also believe that subsequent events have shown the disclosure requirements of paragraph 9 of Accounting Research Bulletin No. 44 (Revised) to be questionable.

Mr. Moyer assents to the Interpretive Opinion except for those sections which relate to deferred income taxes. He believes that the new Guideline lives permitted should not provide another type of accelerated depreciation but instead should permit a taxpayer to use the same estimated lives for income-tax purposes as are used for financial accounting purposes.

Mr. Cannon does not agree with paragraph 7 of the Interpretive Opinion because he does not believe a present declaration of the regulatory body on future rate-making policy is effective, nor should it be controlling as to the current reporting of current income in accordance with generally accepted accounting principles.
Mr. Spacek concurs in the Interpretive Opinion, but dissents with respect to the inclusion of paragraph 7 thereof, since it incorporates by reference paragraph 8 of Accounting Research Bulletin 44 (Revised), with which he does not agree. Paragraph 8 of ARB 44 states that regulated companies need not provide for the income taxes which, under the tax laws, are deferred but not eliminated "if it may reasonably be expected that increased future income taxes . . . will be allowed in future rate determinations." Thus, the independent public accountants, in expressing opinions on the financial statements of regulated companies, are placed in the position of having to predict not only the future action of Congress and the state legislatures, but of the regulatory commissions and courts as well. Where provisions for deferred income taxes are omitted as a result of the expectation that the increased future income taxes will be allowed in future rate determinations merely because of present regulatory practices, such practices are not sufficient evidence to support unqualified opinions by independent public accountants, particularly in view of the decision on September 27, 1962, of the second highest court of the land (United States Court of Appeals for the District of Columbia, No. 16,479, in Panhandle Eastern Pipe Line Company v. Federal Power Commission), which stated in part as follows:

We cannot change the plain purpose of these statutory sections merely because the Commission thinks they have had a 'basically dynamic and fluid effect.' Congress has not provided that, with respect to utilities, ratepayers are entitled to share in the temporary benefits resulting from the use of liberalized depreciation in computing income taxes. Such a provision, which would put utilities and unregulated companies in different categories, may be within the competence of Congress, but neither the Commission nor this court is authorized to legislate in that fashion. Moreover, if it should hereafter provide that utilities must share with their ratepayers the temporary reduction of income taxes produced by liberalized depreciation during the early years of useful life, Congress probably would also provide that ratepayers should proportionately bear the higher income taxes during the later years of the anticipated life of the facilities, when the depreciation deduction for tax purposes is relatively small.

1 It is assumed here that the cost or other book value of the property is the same as its tax basis. If it is not, the part of the difference between tax-return depreciation and book depreciation that results from the difference in basis ordinarily should be disregarded in making provision for deferred income taxes.
1. The Revenue Act of 1962 provides for an "investment credit" which, in general, is equal to a specified percentage of the cost of certain depreciable assets acquired and placed in service after 1961. It is subject to certain statutory limitations and the amount available in any one year is used to reduce the amount of income tax payable for that year. The full amount of the investment credit is treated for income tax purposes as a reduction in the basis of the property. An investment credit once allowed is subject to recapture under certain circumstances set forth in the statute.

2. Some decision as to the nature of the investment credit, i.e., as to the substance of its essential characteristics, if not indispensable, is of great significance in a determination of its accounting treatment. We believe there can be but one useful conclusion as to the nature of the investment credit and that it must be determined by the weight of the pertinent factors.

3. Three concepts as to the substance of the investment credit have been considered by the Board: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount to future accounting periods.

4. There is no significant disagreement with the view that the investment credit is a factor which influences the determination of net income. The basic accounting issue before us therefore is not whether the investment credit increases net income but, rather, the accounting period(s) during which it should be reflected in the operating statement. Resolution of the accounting issue, in large part, rests upon the accounting principles relative to the realization of income. This is true for both regulated and nonregulated companies. (See paragraph 17 of this Opinion.)

5. Subsidy by way of a contribution to capital. This concept, in our opinion, is the least rational because it runs counter to the conclusion that the investment credit increases the net income of some accounting period(s).

6. Tax reduction. The argument for this concept essentially is
that since the investment credit is made available by the Revenue Act of 1962 it is in substance a selective reduction in taxes related to the taxable income of the year in which the credit arises.

7. A refinement of the tax reduction concept advocates that 48% of the investment credit (the maximum extent to which the credit normally can increase net income, assuming that the income tax rate is 52%) should be recorded as a reduction of tax expense of the year in which the credit arises; the balance of 52% should be deferred to subsequent accounting periods, as provided in Chapter 10(b) of Accounting Research Bulletin No. 43, because of the statutory requirement that the basis of the property be reduced for tax purposes by the amount of the investment credit.

8. The General Rule of section 38 of the Revenue Act of 1962 provides that

There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under sub-part B of this part.

The tax code has traditionally distinguished between exclusions from taxable income (which affect the computation of taxes payable on taxable income of the period) and credits to be applied to reduce taxes otherwise applicable to such taxable income (which do not enter into such computation). In our view the relevant materials support the interpretation that the investment credit is an administrative procedure to permit the taxpayer to withhold the cash equivalent of the credit from taxes otherwise payable and that it is not an element entering into the computation of taxes related to income of the period.

9. Cost reduction. We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles.

10. In reaching this conclusion we have evaluated the pertinent portions of the legislative history of the investment credit, which we regard as significant but not decisive. We also evaluated the pertinent provisions of the Revenue Act of 1962 which, as earlier stated, require that the investment credit be treated as a reduction in the basis of the property which gives rise to the credit and which contain recapture and other provisions the effect of which is to make realization of the credit dependent to some degree on future events.
11. The investment credit under certain circumstances is transferable to the lessee of qualified property. We regard it as significant that in such cases the rules and regulations of the Treasury require the lessee to reduce his taxable deduction for rent over a four, six, or eight year period, depending upon the useful life category of the property.

12. In concluding that the cost reduction concept is based upon existing accounting principles we attach substantial weight to two points in particular. First, in our opinion, earnings arise from the use of facilities, not from their acquisition. Second, the ultimate realization of the credit is contingent to some degree on future developments. Where the incidence of realization of income is uncertain, as in the present circumstances, we believe the record does not support the treatment of the investment credit as income at the earliest possible point of time. In our opinion the alternative choice of spreading the income in some rational manner over a series of future accounting periods is more logical and supportable.

CONCLUSIONS

13. We conclude that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service.

14. A number of alternative choices for recording the credit on the balance sheet have been considered. While we believe the reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases, we recognize as equally appropriate the treatment of the credit as deferred income, provided it is amortized over the productive life of the acquired property.

15. We believe it preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth in paragraph 13. Nevertheless, reflection of income tax provisions, in the income statement, in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption.
16. An investment credit should be reflected in the financial statements only to the extent that it has been used as an offset against income tax liability. Under the statute, unused investment credits may be carried back or forward to other years. The accounting for these carrybacks and carryforwards should be consistent with the provisions of Accounting Research Bulletin No. 43, Chapter 10(b), “Income Taxes,” paragraphs 16 and 17. The amount of a carryback of unused investment credit may be set up as an asset (a claim for refund of income taxes) and be added to the allowable investment credit in accounting for the effect of the credit in the year in which the property is placed in service. A carryforward of unused investment credit should ordinarily be reflected only in the year in which the amount becomes “allowable,” in which case the unused amount would not appear as an asset. Material amounts of unused investment credits should be disclosed.

17. Authorities having jurisdiction over regulated business may require that the investment credit be accounted for in some manner not consistent with the conclusions expressed in this Opinion. We have previously stated our position on the issues involved in such a case (The Journal of Accountancy, December 1962, page 67—reprinted as an Addendum to this Opinion). The position there taken is intended to permit the so-called “flow through” treatment only in those circumstances where the standards described in that statement are met.

The Opinion entitled “Accounting for the ‘Investment Credit’” adopted by the assenting votes of fourteen members of the Board, of whom one, Mr. McEachren, assented with qualification. Messrs. Bevis, Black, Cannon, Powell, Tippit, and Walker dissented.

Mr. McEachren agrees with the conclusion that the investment credit should be reflected in net income over the productive life of acquired property but disagrees with the inclusion of paragraphs 9, 10, and 12 to the extent that they argue that the investment credit is a reduction of cost. Whether or not it is a reduction of cost is a question with many ramifications and subject to different interpretations under differing circumstances and in any event is not relevant to the matter here involved. He believes that the fundamental basis for the conclusion in paragraph 13 is that “earnings arise from the use of facilities; not from their acquisition.”

Messrs. Bevis, Powell, and Tippit believe that the pertinent factors preponderantly support the view that the investment credit is in substance a reduction in income taxes. They consider that the generally
accepted accounting principles applicable (including the pronouncements of the former Committee on Accounting Procedure, especially those relating to the accounting for income taxes and to the reporting of income, which are still in effect) preponderantly support the treatment of the investment credit as a reduction of the provision for current income taxes in the year in which the credit arises. They believe specifically, that the generation of taxable income for the year in and by itself, rather than the future productive use of the related property, effects the realization of the credit. They point out that opinions received by the Board of practitioners and businessmen make it clear that the "48-52" method discussed in paragraph 7 of the Opinion has at least as wide acceptance among these groups as the method sponsored by the majority of the Board. They believe that, in the circumstances, the "48-52" method must also be considered to have substantial authoritative support and, therefore, to be generally acceptable.

Messrs. Black and Cannon dissent from the conclusion that there is only one acceptable accounting treatment of the investment credit. While not objecting to reflecting the investment credit over the productive life of the acquired property, they believe that it would be preferable to defer only that part of the credit (52%) equivalent to the increased taxes in future years arising from the reduction in the tax base of the property acquired.

Mr. Walker concurs with the method set forth in the Opinion as the preferred basis for treatment of the investment credit, but it is his opinion that, with adequate disclosure, it should be considered an acceptable alternative to reduce the taxes of the year in which the credit arises by an appropriate portion of such credit.

ADDENDUM

Accounting principles for regulated industries

The following statement, referred to in paragraph 17 of the Opinion and approved by the Board, originally appeared in The Journal of Accountancy, December 1962, p. 67:

1. The basic postulates and the broad principles of accounting comprehended in the term "generally accepted accounting principles" pertain to business enterprises in general. These include public utilities, common carriers, insurance companies, financial institutions, and the like that are subject to regulation by government, usually through commissions or other similar agencies.
2. However, differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. For example, if a cost incurred by a regulated business during a given period is treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently. However, this is appropriate only when it is clear that the cost will be recoverable out of future revenues, and it is not appropriate when there is doubt, because of economic conditions or for other reasons, that the cost will be so recoverable.

3. Accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses by orders of regulatory authorities, and occasionally by court decisions or statutes. The fact that such accounting requirements are imposed by the government does not necessarily mean that they conform with generally accepted accounting principles. For example, if a cost, of a kind which in a nonregulated business would be charged to income, is charged directly to surplus pursuant to the applicable accounting requirements of the regulatory authority, such cost nevertheless should be included in operating expenses or charged to income, as appropriate in financial statements intended for use by the public.

4. The financial statements of regulated businesses other than those prepared for filing with the government for regulatory purposes preferably should be based on generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2) rather than on systems of accounts or other accounting requirements of the government.

5. Generally Accepted Auditing Standards lists four standards of reporting, the first of which says that “The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.” In reporting on the financial statements of regulated businesses, the independent auditor should observe this standard and should deal with material variances from generally
accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2), if the financial statements reflect any such variances, in the same manner as in his reports on nonregulated businesses.

1 The first $25,000 of income tax payable plus 25% of the remainder. See paragraph 16 for treatment of unused investment credits.

APB Opinion No. 4 (Amending No. 2)
ACCOUNTING FOR THE 'INVESTMENT CREDIT'

1. In December 1962 this Board issued Opinion No. 2 "Accounting for the 'Investment Credit.'" In this Opinion we said:

Some decision as to the nature of the investment credit, i.e., as to the substance of its essential characteristics, if not indispensable, is of great significance in a determination of its accounting treatment. We believe there can be but one useful conclusion as to the nature of the investment credit and that it must be determined by the weight of the pertinent factors. (paragraph 2)

2. The Opinion listed the possible interpretations which the Board had considered:

Three concepts as to the substance of the investment credit have been considered by the Board: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount to future accounting periods. (paragraph 3)

3. After noting the arguments in favor of each, the Board said:

We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles. (paragraph 9)

4. The Board concluded (paragraph 13) that the investment credit "should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service."
5. In January 1963 the Securities and Exchange Commission issued Accounting Series Release No. 96 in which it reported that in recognition of the substantial diversity of opinion among responsible persons in the matter of accounting for the investment credit the Commission would accept statements in which the credit was accounted for either as this Board concluded in Opinion No. 2 or as a reduction in taxes otherwise applicable to the year in which the credit arises. The Commission has recently reconsidered and reaffirmed that position.

6. The Board’s review of experience since the issuance of Opinion No. 2 shows that the investment credit has been treated by a significant number of companies as an increase in net income of the year in which the credit arose.

7. The Revenue Act of 1964 eliminates the requirement imposed by the Revenue Act of 1962 that the investment credit be treated for income tax purposes as a reduction in the basis of the property to which the credit relates.

CONCLUSIONS

8. It is the conclusion of this Board that the Revenue Act of 1964 does not change the essential nature of the investment credit and, hence, of itself affords no basis for revising our Opinion as to the method of accounting for the investment credit.

9. However, the authority of Opinions of this Board rests upon their general acceptability. The Board, in the light of events and developments occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the Opinion effective.

10. In the circumstances the Board believes that, while the method of accounting for the investment credit recommended in paragraph 13 of Opinion No. 2 should be considered to be preferable, the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises is also acceptable.

11. The Board emphasizes that whichever method of accounting for the investment credit is adopted, it is essential that full disclosure be made of the method followed and amounts involved, when material.

The Opinion entitled “Accounting for the ‘Investment Credit’” was adopted by the assenting votes of fifteen members of the

Messrs. Crichley and Trueblood believe that, under the Revenue Act of 1964, there is considerable theoretical support for regarding the investment credit as a selective reduction in taxes. Accordingly, they do not necessarily regard amortization of the investment credit over the life of acquired properties as the “preferable method.” They believe that the alternative method is preferable, but agree that recognition of both methods is necessary and desirable under existing conditions.

Mr. Frese assents to the conclusions in this Opinion, and to its publication, because he believes developments and circumstances summarized in paragraphs 5, 6, and 9 leave the Board no other practical choice. He desires, however, to express his strong preference for the conclusion of the Board in Opinion No. 2 because he believes it conforms with the basic concept, which has long been generally accepted, that income should be recognized as it is earned through the use of assets and not as an immediate result of their acquisition.

Messrs. Higgins and Jennings assent to Opinion No. 4 and its publication only because they believe the action of the SEC, reported in paragraph 5, and the consequences recited in paragraph 6, leave no other practicable choice. They believe that the Revenue Act of 1964 does not alter the soundness of the conclusion stated in Opinion No. 2 that the investment credit should be reflected in net income over the productive life of acquired property and not in the year in which such property is placed in service. They believe further that the present action recognizing the alternative treatment as acceptable is illogical (for the reasons given in the first sentence of Mr. Moonitz’s dissent) and is tantamount to taking no position. They observe that paragraph 17 of Opinion No. 2 is still effective and, accordingly, that the alternative method of treating the credit as a reduction of Federal income tax of the year in which the credit arises is improper and should be unacceptable in those instances where Section 203(e) of the Revenue Act of 1964 effectively requires the credit to be reflected in net income over the productive life of the property.

Mr. Queenan, joined by Messrs. Bevis and Tippit, assents to the Opinion because he continues to believe that the investment credit constitutes a reduction in income tax expense in the year in which the credit arises. In view of the substantial support of the cost-reduction
concept, he does not object to inclusion of the credit in net income over the life of the acquired property, but believes that the order of preference expressed in paragraph 10 should be reversed.

Mr. Armstrong dissents from Opinion No. 4. He agrees that the Revenue Act of 1964 does not change the essential nature of the investment credit and agrees with the conclusions expressed in Opinion No. 2. He disagrees with paragraph 10 of Opinion No. 4 wherein an alternative method of treating the credit is recognized as being acceptable, thereby adding one more to the list of principles for which there are a variety of acceptable methods yielding substantially different results in comparable situations.

Mr. Blough dissents from this opinion because he believes the conclusion reached in Opinion No. 2 “that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service” was and is sound. The fact that there is substantial support for treating the investment credit as an increase in net income of the year in which the credit arose is not a sound reason, in his opinion, for this Board to retreat from a position which it still considers to be “preferable.” He does not believe the Board can carry out its major responsibility “to determine appropriate practice and to narrow the areas of difference and inconsistency in practice” if it withdraws its influence from the support of its considered opinion whenever that opinion is not immediately accepted by all influential persons.

Mr. Moonitz dissents to paragraph 10 of Opinion No. 4 because while it is conceivable that the tax reduction method may be right, or that cost reduction may be right, or that both are wrong and some other unspecified possibility right, the investment credit cannot be two different things at one and the same time. As between the two methods set forth in paragraph 10, he believes that accounting principles compel the treatment of the investment credit as a selective reduction in tax available to those who meet the conditions laid down in the statute. The method preferred by the majority of the Board permits identical items bought from the same supplier at identical prices to be recorded at different “costs” depending upon the tax status of the purchaser and not upon the conditions prevailing in the transaction between buyer and seller. Alternatively the method preferred by the majority of the Board permits the balance sheet to include a “deferred credit to income” that cannot be classified as part of the interest of owners, creditors, government, employees, or any other recognizable group. He concludes that the effect of Opinion No.
CHAPTER 4: APB OPINION NO. 4 (AMENDING NO. 2)

4 can only be the direct opposite of the Board’s ultimate objective of narrowing the areas of difference in practice.

Mr. Moyer believes that Opinion No. 4 should not have been issued, as it carries the strong implication that Opinions of the Board always should follow existing practices. He believes that progress cannot be made under such a policy.

Mr. Spacek dissents from the conclusion in paragraph 10. He believes this Opinion illustrates the accounting profession’s complete failure in its responsibility to establish accounting principles that will provide reliable financial statements that are comparable among companies and industries, for use of the public in making personal investment decisions. He states there is no justification for sanctioning two contradictory practices to accommodate SEC and other regulatory bodies and some CPAs who have approved reporting the investment credit as, in effect, profit from acquisition rather than from use of property. This flouts Congress’ clear intent in granting the investment credit, “to reduce the net cost of acquiring depreciable property.” Alternative procedures under this Opinion can increase by up to 25 per cent the earnings otherwise reported. In this Opinion and in SEC’s stated position, Mr. Spacek finds no word of concern for the investor, to whose protection both CPAs and SEC supposedly are dedicated. He believes this Opinion approves accounting of the type that precipitated the 1929 financial crisis, and that history is being repeated by actions of the very authorities created to prevent such catastrophes. He feels this breakdown in safeguards created to protect investors has resulted from fragmentation of responsibility for establishing accounting principles, and the only remedy is to create a Federally established Court of Accounting Principles with a prescribed basis for its decisions; this court would be independent of the profession and regulatory commissions, and its decisions would be binding on all, thus rescuing investors from their present abandonment.

* * *

Compensation by Stock Option and Stock Purchase Plans

Stock options and purchase rights given to officers and employees include an element of compensation to be included in the calculation
of net income when the restricted right to purchase shares is granted at a price below the fair value of the shares at the date selected for recognition in the accounts. The cost to the company granting the right or option is the difference between the option price and the fair value of the shares.

In estimating the fair value of the shares, the range of market quotations over a reasonable period and the expenses that would otherwise be incurred in selling the shares are taken into consideration. The point on which opinion diverges is the date at which the measurement should be made and the transaction recognized in the accounts.

The committee on accounting procedures (ARB No. 43, Chapter 13, Sec. B, par. 10) recommended the date on which the option is granted. This pronouncement is reproduced in the equity section, chapter 5, of the Inventory.

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**Principle A-3**

*Appropriate charges should be made for depreciation and depletion of fixed assets and for amortization of other deferred costs.*

**Fixed Asset Expiration**

Depreciation, depletion, and amortization designate the portion of cost or other carrying value of fixed assets that expires and is charged to expense or overhead accounts during the accounting period. Depreciation refers to tangible, man-made facilities, depletion to natural resources, and amortization to intangibles. All three represent an expiration of usefulness; the purpose of all three is the orderly charging of fixed asset costs to operations.

The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. [ARB No. 43, Ch. 9C, par. 5]
The amount of expense from fixed asset expiration is dependent upon two variables: (1) the carrying value of the asset, and (2) the method used to estimate the portion of the carrying value that has expired. For a discussion of the carrying value of the asset see Principle C-2 of Chapter 6.

Methods used to estimate expired cost or other carrying value. The purpose of estimating the portion of the carrying value of fixed assets that has expired is to match the cost of long-term assets against the revenues of the periods in which they render service which, in turn, results in carrying forward to future periods the part of acquisition cost (or in some cases, appraised value) that is allocated to expected future benefits. The process is basically the same whether the expired portion is termed depreciation, depletion, or amortization.

Depreciation is not wholly a physical deterioration. The incidence of depreciation is a combination of the wearing out of the facilities coupled with obsolescence and inadequacy due to technological developments and changing business conditions. All of these factors must be considered in estimating the future service lives of the facilities which, in turn, serve as the basis for allocating the cost or other carrying value between current and future periods in a systematic and rational manner.

Depletion is the allocation of cost or other carrying value of a natural resource to current and future periods based on the physical exhaustion of the resource in the process of production. A distinction is made between the residual value of the land, which remains after the resource is exhausted, and the cost or other value of the resource which is extracted from the land.

Although amortization is a generic term that is used to describe any gradual extinguishment of asset or liability amounts, its use here is limited to the expiration of fixed asset costs that are not described by the more specific terms, depreciation and depletion. Depreciation and depletion describe the expiration of the cost of tangible fixed assets; amortization, as used here, describes the expiration of the cost of intangible fixed assets.

Depreciation methods. Methods of computing depreciation which meet the requirement of being systematic and rational can be roughly divided into three groups: straight-line, decreasing charge and increasing charge. Straight-line methods charge amounts to depreciation in proportion to the number of service units consumed which may be measured in years, machine hours, units produced, or other
applicable measure. The cost or other carrying value less estimated salvage value is divided by the number of units of estimated service potential to determine the amount per unit.

When the unit is a time period (e.g., month, year, etc.), the amount of the depreciation charge for the accounting period is the same whether the facility is in use or idle. When the unit is directly related to use (e.g., units produced, machine hours, etc.), no charge is made to depreciation for idle time; depreciation varies directly with production.

A hybrid straight-line and production method is sometimes used in connection with budget programs and standard cost systems to compute costs at different levels of productive activity. A charge for depreciation is included in both fixed and variable costs so that the cost of having idle facilities available and variations due to different operating levels will both have an effect on expense where applicable.

Since the adoption of the Internal Revenue Code of 1954, decreasing charge methods have increased in importance. Of these methods, the sum-of-the-years digits and the double-declining-balance methods are most widely used. These methods meet the requirements of being "systematic and rational." [ARB No. 44 (Revised), par. 2.] Decreasing charge methods allocate the largest periodic charges to the early years of the asset's useful life with smaller amounts charged in each succeeding year than in the preceding one. The "double-declining-balance" method applies a fixed rate, which is double the straight-line rate, to the declining book value. The "sum-of-the-years digits" method, on the other hand, applies a declining rate to the cost or other carrying value before deducting accumulated depreciation. The rate for each year is calculated by dividing the remaining number of years (or other time period) of estimated useful life from the beginning of the current period by the sum of the digits representing the total estimated useful life from date of acquisition. Another declining-balance method that applies a fixed rate to a diminishing amount calculates the rate by use of a geometric progression formula. Although this latter method has some theoretical support, it is seldom used in practice.

When a declining-balance method is used for income tax purposes, but other methods are used for financial accounting purposes; recognition should be given to deferred income taxes, except in the case of regulated utilities in jurisdictions which allow, for rate-making purposes, only the actual taxes.

Two increasing charge methods that meet the requirements of
being “systematic and rational” are the sinking fund and the annuity methods. The sinking-fund method, which is used primarily by public utilities, in certain western states, treats depreciation as if it were, in fact, a replacement fund. Each period’s depreciation charge is composed of (1) an amount that would accumulate to the total amount invested in depreciating assets by the end of their estimated useful life if that amount were invested each period at the interest rate implicit in the situation, and (2) interest on the accumulated depreciation at the beginning of the period.

The annuity method has some theoretical support but is seldom used for expensing fixed assets except in the case of some leaseholds. This method treats the amount paid for an asset as the present value of anticipated benefits from the use of the asset. It results in an increasing charge to depreciation each period because it includes an interest charge on the net book value at the beginning of the period.

One group method of depreciation accounting consists of applying a composite rate to the whole heterogeneous group of fixed assets. Relatively short-lived assets are grouped with long-lived assets and depreciated at a rate that represents a rough estimate of the “average” life of the plant.

Another method makes use of grouping homogeneous items and applying a class rate of depreciation. When the items in the group are similar with only minor differences in the estimated service lives of the components, this method saves clerical labor while retaining the advantages of unit depreciation methods as long as retirements and replacements are handled on a unit basis.

Whichever depreciation method is used, the computation should be based on the carrying value of the assets whether the carrying value is cost or an appraised value. This position is supported in ARB No. 43, Chapter 9B which is reproduced below.

ARB No. 43
Chapter 9
Section B

DEPRECIATION
Depreciation on Appreciation

1. Historically, fixed assets have been accounted for on the basis of cost. However, fixed assets in the past have occasionally been written up to appraised values because of rapid rises in price levels, to adjust
costs in the case of bargain purchases, etc. In some of these instances companies have continued to compute depreciation on the basis of cost.

2. When appreciation has been entered on the books income should be charged with depreciation\(^1\) computed on the written-up amounts. A company should not at the same time claim larger property valuations in its statement of assets and provide for the amortization of only smaller amounts in its statement of income. When a company has made representations as to an increased valuation of plant, depreciation accounting and periodic income determination thereafter should be based on such higher amounts.

Three members of the committee, Messrs. Calkins, Lindquist, and Mason, assented with qualification to adoption of section (b) of chapter 9.

Messrs. Calkins, Lindquist, and Mason believe that, as a matter of consistency, where increased property valuations have been entered on the books the credit item should be treated as permanent capital and would therefore not be available for subsequent transfer to earned surplus as realized through depreciation or sale.

\(^{13}\)The word depreciation is here used in its ordinary accounting sense and not as the converse of appreciation.

**Depletion methods.** Depreciation and depletion are usually discussed in contradistinction to each other because, although they both apply to the allocation of cost or other valuation basis of long-lived tangible assets over their estimated useful lives, there are important differences in the nature of the assets involved.

The term depreciation applies to productive facilities that are used over and over again and never become a physical part of the salable merchandise produced. Depletion on the other hand refers to the physical exhaustion of a natural resource which, when extracted from its natural habitat, becomes salable merchandise either in the state and condition in which it is extracted or after further processing. Depletable assets are not used over and over in the sense that depreciable assets are. When the supply of a natural resource is gone, a new supply must be found if operations are to continue. Depreciable assets are man-made and therefore reproducible by man. Depletable assets, i.e., natural resources, are not reproducible except by nature and over
long periods of time. The useful lives of depreciable assets are extinguished by the wearing out and obsolescence of the facilities. Natural resources are used up rather than worn out and obsolescence is rarely a factor. In other words, depreciation refers primarily to economic exhaustion, depletion to physical exhaustion.

Depletion is usually computed by a unit of production method. The cost or other value assigned to the asset is divided by an estimate of the number of recoverable units to determine the unit charge. The unit charge multiplied by the number of units extracted or otherwise produced is the amount charged to depletion for the period. The marketing unit is the preferred unit of depletion in most cases, e.g., ton of salable coal, board feet of lumber, etc.; but the extracting unit is used in some cases, e.g., ton of ore. The extracting unit may be the marketing unit in cases where the natural resource is sold in the condition extracted without further processing, e.g., barrels of crude oil, cubic feet of natural gas.

There is considerable uniformity in some industries in the grouping of assets for unit depletion rate computations. For example, depletion is usually computed separately for each lease or property unit by oil and gas producers. In other industries, there is considerable variety in grouping schemes. For example, in the forestry industry the following schemes are in common use: (1) a single composite rate may be used for all timber owned, adjustments to the rate being computed with each acquisition. (2) Separate composite rates may be used for each block of timber making up an operating unit, with adjustments to the rates for additions to the block. (3) Separate rates for each tract acquired. (4) Allocation of purchase price of the tract over quarter sections of the tract based on accessibility and terrain with separate depletion rates for each quarter section. Under any of these methods there may be a single rate for all species or separate rates for each species.

Depletion rates are adjusted as it becomes apparent that the recoverable deposit or growth is more or less than previously estimated. The rates are based on the best available current information concerning the amount of recoverable resource. The reliability of the information often varies directly with the extent to which the mine or other resource has been developed; depletion estimates are therefore extremely tentative and may require frequent adjustment.

It is accepted practice in nonferrous metal mining either to omit depletion charges altogether or to record them based on the best information available. The trend is toward the latter method.
Computation of depletion as a fixed percentage of gross income limited to 50 per cent of net income from the property, although permitted for Federal income tax computations, is not accepted practice for financial reporting.

**Amortization of intangibles.** Intangible assets are classified in *ARB No. 43*, Chapter 5, par. 2 as follows:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration);

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

Guidelines to amortization and to write-offs of intangibles are also included in the following paragraphs from Chapter 5 of *ARB No. 43*.

*  *  *

**Type (a)**

"The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness. If it becomes evident that the period benefited will be longer or shorter than originally estimated, recognition thereof may take the form of an appropriate decrease or increase in the rate of amortization or, if such increased charges would result in distortion of income, a partial write-down may be made by a charge to earned surplus.

**Type (b)**

"When it becomes reasonably evident that the term of existence of a type (b) intangible has become limited and that it has therefore become a type (a) intangible, its cost should be amortized by systematic charges in the income statement over the estimated remaining period of usefulness. If, however, the period of amortization is relatively short so that misleading inferences might be drawn as a result of inclusion of substantial charges in the income statement a partial write-down may be made by a charge to earned surplus, and the rest of the cost may be amortized over the remaining period of usefulness."
 CHAPTER 4: AMORTIZATION OF INTANGIBLES

“When a corporation decides that a type (b) intangible may not continue to have value during the entire life of the enterprise it may amortize the cost of such intangible by systematic charges against income despite the fact that there are no present indications of limited existence or loss of value which would indicate that it has become type (a), and despite the fact that expenditures are being made to maintain its value. Such amortization is within the discretion of the company and is not to be regarded as obligatory. The plan of amortization should be reasonable; it should be based on all the surrounding circumstances, including the basic nature of the intangible and the expenditures currently being made for development, experimentation, and sales promotion. Where the intangible is an important income-producing factor and is currently being maintained by advertising or otherwise, the period of amortization should be reasonably long. The procedure should be formally approved and the reason for amortization, the rate used, and the shareholders’ or directors’ approval thereof should be disclosed in the financial statements.

Write-off of intangibles

“The cost of type (b) intangibles should be written off when it becomes reasonably evident that they have become worthless. Under such circumstances the amount at which they are carried on the books should be charged off in the income statement or, if the amount is so large that its effect on income may give rise to misleading inferences, it should be charged to earned surplus. In determining whether an investment in type (b) intangibles has become or is likely to become worthless, consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value.

Limitation on write-off of intangibles

“Lump sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus. If not amortized systematically, intangibles should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles.”
Other Fixed Asset Related Expenses

Depreciation, depletion, and amortization are the means by which costs and other amounts are removed from asset accounts and charged to expense over their estimated productive lives. Many expenditures for or related to fixed assets are charged to expense when incurred and therefore never become a part of the asset-account balance. Expenditures that are charged to the asset account are called "capital expenditures"; those charged directly to expense are called "revenue expenditures."

The distinction between capital and revenue expenditures may be an arbitrary distinction based on the materiality of the amounts involved, or the distinction may be based on whether future periods will benefit from the expenditure or only the period in which incurred.

As a general rule, expenditures for ordinary repairs necessary to put assets back into good operating condition and for maintenance aimed at keeping them that way are expensed as incurred. This general rule sometimes is modified to permit the distribution of total estimated repair costs over the life of the asset through use of a reserve. Total repairs, both ordinary and extraordinary, may be estimated for the life of the asset and a proportionate amount charged to expense and credited to the reserve each period. Actual expenditures are then charged against the reserve. Minor improvements and additions are usually included with ordinary repairs and expensed currently.

After equipment has been installed and placed in operation, expenditures for tests, correction, and improvement in installation are chargeable to expense. When machines are purchased subject to an agreement that provides for payment of royalties on units produced, the royalty payments are expensed.

Although the initial cost of accessories are capitalized, subsequent replacements are expensed. Alterations which merely modernize, rather than improve, buildings or equipment are also expensed as incurred, unless the program is so extensive as to warrant reconsideration of the estimated life of the asset.

Substantial uncertainty as to whether an expenditure may reasonably be expected to benefit future periods is usually resolved by charging the amounts in question against current income. Expenditures to acquire natural resources and intangible assets are frequently subject to substantial uncertainty. The degree of uncertainty varies
with each case so that considerable leeway is necessary in deciding whether a particular expenditure is to be expensed or capitalized. It seems to be a fairly common policy to expense regular recurring costs, e.g., land staff and geophysical staff expenses, and to capitalize costs that are directly attributable to specific successful projects.

Regular recurring assessments by municipalities for services that are incident to owning property, but of temporary benefit; e.g., lighting, sprinkling, street cleaning, snow removal, are charged to expense.

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**Principle A-4**

Proper distribution of costs should be made as between fixed assets, inventories, maintenance and expense. Direct costs are usually identifiable and common costs applicable to more than one activity should be distributed on appropriate cost incurrence bases such as time or use factors.

The computation of net income requires the matching of revenues with the expense incurred to produce the revenue as far as it is possible to do so. The distribution of costs between various asset and expense accounts may affect the computation of net income for a sequence of many years. For example, if an expenditure for a fixed asset betterment used in the production of finished goods inventory is incorrectly charged to maintenance expense, (1) the current year's income is understated because expense is overstated, (2) the fixed asset account, and the work in process and finished goods inventories will be understated in both current and subsequent balance sheets, and (3) the cost of goods sold will be understated and net income overstated in subsequent years to the extent that the cost of the betterment should normally affect the cost of goods sold through depreciation. If costs are not properly allocated between fixed assets, maintenance, inventories and expense, it will not be possible to achieve a proper matching of revenues and expenses.

A chart of accounts can aid proper allocation if it is in enough detail to cover all expected cases and, in addition, provides the guidelines for handling the unexpected items. To be an effective aid, the chart of accounts must, of course, be integrated into an adequate system of internal control.
"The characteristics of a satisfactory system of internal control would include:

a. A plan of organization which provides appropriate segregation of functional responsibilities,

b. A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues and expenses,

c. Sound practices to be followed in performance of duties and functions of each of the organizational departments, and

d. Personnel of a quality commensurate with responsibilities.

"These elements, as important as each is in its own right, are all so basic to adequate internal control that serious deficiencies in any one normally would preclude successful operation of the system. For example, no system of authorization and record procedures for accounting control may be considered adequate without personnel capable of performing the procedures designed to make such a system work. While each element is discussed separately in the following sections, the interrelationship of all elements must be borne in mind. . . .

"A satisfactory system must include media: first, for the records control of the operations and transactions (source data and its flow) and, second, for the classification of data within a formal structure of accounts (a chart of accounts). A carefully prepared chart of accounts facilitates preparation of financial statements. If the chart of accounts is supplemented by an account manual which clearly defines the accounts and the entries to be made therein, greater uniformity can be achieved in recording accounting transactions.

"Media for the original records control of the operations and transactions are created through the designing of appropriate records and forms and through planning the logical flow of the recordkeeping and approval procedures. Such forms, and the instructions regarding the flow of recording and approval procedures, are often incorporated in procedure manuals."†

In large corporate enterprises the account manual, of which the chart of accounts is an integral part, is almost indispensable. Such manuals contain complete instructions on the accounting policies of the corporation and are specific in defining the boundary lines of the items chargeable to fixed assets, inventory and other assets, on the one hand, and those chargeable to maintenance and operating expenses, on the other. In the case of fixed assets and related maintenance accounts, for example, the accounting manual should set forth the elements of direct costs and overhead costs to be capitalized, including methods of allocation of overhead costs, a catalogue of property retirement units, which establish the physical dividing line between property and maintenance, and a description of the usual work functions which are chargeable to maintenance accounts. In most cases a work-order system is used to facilitate compliance with the instructions contained in the manual in the accumulation of charges related to construction in progress and to substantial maintenance projects. In the absence of this type of organized instructions, it is much more difficult for either management or the certified public accountant to be assured that the accounting policies used by the corporation have substantial authoritative support and that they are being consistently applied from year to year.

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**Principle A-5**

*Contingency provisions and reserves should not be misused as a means of arbitrarily reducing income or shifting income from one period to another.*

Net income for a single year in the life of a continuing enterprise is always tentative, and future profitability is uncertain. The increasing use of "earnings per share" statistics has, however, given an exaggerated and unwarranted significance to the single figure which makes it important that charges and credits to income be based on objective evidence and not mere speculative guesses or management's desire to level reported income. Fluctuation in net income is normal and any device used to remove fluctuations is misleading.

An important objective of income presentation should be the avoidance of any practice that leads to income equalization. [ARB No. 43, Ch. 8, par. 2]
The possible misuse of contingency type provisions and reserves referred to in Principle A-5 was dealt with in Chapter 6 of *ARB No. 43*, which is reproduced below.

ARB No. 43
Chapter 6  
CONTINGENCY RESERVES

1. The purpose of this chapter is to consider problems which arise in the accounting treatment of two types of reserves whose misuse may be the means of either arbitrarily reducing income or shifting income from one period to another:

   (a) General contingency reserves whose purposes are not specific;

   (b) Reserves designed to set aside a part of current profits to absorb losses feared or expected in connection with inventories on hand or future purchases of inventory.

2. Charges to provide, either directly or by use of a reserve, for losses due to obsolescence or deterioration of inventory or for reducing an inventory to a recognized basis such as last-in first-out or its equivalent in accordance with an announced change in policy to be consistently followed thereafter, are not under consideration here.

3. If a provision for a reserve, made against income, is not properly chargeable to current revenues, net income for the period is understated by the amount of the provision. If a reserve so created is used to relieve the income of subsequent periods of charges that would otherwise be made against it, the income of such subsequent periods is thereby overstated. By use of the reserve in this manner, profit for a given period may be significantly increased or decreased by mere whim. As a result of this practice the integrity of financial statements is impaired, and the statements tend to be misleading.

4. The committee recognizes the character of the income statement as a tentative installment in the record of long-time financial results, and is aware of the tendency to exaggerate the significance of the net income for a single year. Nevertheless, there still exists the responsibility for determining net income as fairly as possible by
sound methods consistently applied and the duty to show it clearly. In accomplishing these objectives, it is deemed desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.

5. Accordingly, inventories on hand or contracted for should be priced in accordance with principles stated elsewhere by the committee. When inventories which have been priced in accordance with those principles are further written down by a charge to income, either directly or through the use of a reserve, current revenues are not properly matched with applicable costs, and charges to future operations are correspondingly reduced. This process results in the shifting of profits from one period to another in violation of the principle that reserves should not be used for the purpose of equalizing reported income.

6. It has been argued with respect to inventories that losses which will have to be taken in periods of receding price levels have their origins in periods of rising prices, and that therefore reserves to provide for future price declines should be created in periods of rising prices by charges against the operations of those periods. Reserves of this kind involve assumptions as to what future price levels will be, what inventory quantities will be on hand if and when a major price decline takes place, and finally whether loss to the business will be measured by the amount of the decline in prices. The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guesses rather than informed judgments. When estimates of this character are included in current costs, amounts representing mere conjecture are combined with others representing reasonable approximations.

7. The committee is therefore of the opinion that reserves such as those created:

(a) for general undetermined contingencies, or
(b) for any indefinite possible future losses, such as, for example, losses on inventories not on hand or contracted for, or
(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles,
(d) without regard to any specific loss reasonably related to the operations of the current period, or
(e) in amounts not determined on the basis of any reasonable estimates of costs or losses

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income.

8. Accordingly, it is the opinion of the committee that if a reserve of the type described in paragraph 7 is set up:

(a) it should be created by a segregation or appropriation of earned surplus,
(b) no costs or losses should be charged to it and no part of it should be transferred to income or in any way used to affect the determination of net income for any year,4
(c) it should be restored to earned surplus directly when such a reserve or any part thereof is no longer considered necessary,4 and
(d) it should preferably be classified in the balance sheet as a part of shareholders' equity.

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1 See chapter 2 (b); also chapter 8, paragraphs 11, 12, and 13.
2 See chapter 4.
3 See particularly chapter 4.
4 Items (b) and (c) of paragraph 8 also apply to contingency reserves set up in prior years.

Principle A-6

Nonrecurring and extraordinary gains and losses should be recognized in the period they occur, but should be shown separately from the ordinary and usual operations.
The income statement includes many items of gain or loss, of which net income is the residual. Some of these items are recurrent features of business operation, more or less normal and dependable in their incidence from year to year. Others may be irregular and unpredictable, more or less fortuitous and incidental.

Only the recurring items may be meaningfully compared over time. If the trends shown by past income statements are to serve useful analytical purposes, therefore, fair presentation requires that the nonrecurring gains and losses should be shown separately from the ordinary and usual operations. The preferable form of presentation is discussed in Chapter 8 of this Inventory.

The Securities and Exchange Commission’s Regulation S-X provides in rule 5-03 that operating revenues and expenses be shown prior to including other income and expense items, a position that is in accord with this principle.

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**Principle A-7**

*There is a strong presumption that all gains and losses will be included in periodic income statements unless they are of such magnitude in relation to revenues and expenses from regular operations as to cause the statements to be misleading.*

The views of the committee on accounting procedure supporting this principle and a discussion of exclusion of extraordinary items of gains and loss of large magnitude from the income statement was covered in Chapter 8 of *ARB No. 43*, which is reproduced below.

In order to minimize the danger that extraordinary items might be overlooked, if excluded from the income statement, the committee on accounting procedure recommended in Chapter 2B of *ARB No. 43* that the statements of income and retained earnings be combined. Chapter 2B of *ARB No. 43* is reproduced under Principle E-1 of Chapter 8 of this Inventory.

The Securities and Exchange Commission requires in Rule 5-03-17 of Reg. S-X that these items be included in the “profit and loss or income statements” following “net income or loss.” Significantly, the following and last caption on the statement is labeled “Net income or loss and special items.”
The treatment of "special items" is a subject of current study by the accounting research division and the Accounting Principles Board.

1. The purpose of this chapter is to recommend criteria for use in identifying material extraordinary charges and credits which may in some cases and should in other cases be excluded from the determination of net income and to recommend methods of presenting these charges and credits.

2. In dealing with the problem of selecting the most useful form of income statement, the danger of understatement or overstatement of income must be recognized. An important objective of income presentation should be the avoidance of any practice that leads to income equalization.

3. Attention is directed to certain facts which serve to emphasize that the word income is used to describe a general concept, not a specific and precise thing, and that the income statement is based on the concept of the going concern. It is at best an interim report. Profits are not fundamentally the result of operations during any short period of time. Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement.

4. It must also be recognized that the ultimate distinction between operating income and charges and non-operating gains and losses, terms having considerable currency in the accounting profession, has not been established. The former are generally defined as recurrent features of business operation, more or less normal and dependable in their incidence from year to year; the latter are generally considered to be irregular and unpredictable, more or less fortuitous and incidental. The committee is also mindful that the term net income has
been used indiscriminately and often without precise, and most cer­
tainly without uniform, definition in the financial press, investment
services, annual reports, prospectuses, contracts relating to compen­sation of management, bond indentures, preferred stock dividend provi­sions, and many other places.

5. In the committee's view, the above facts with respect to the
income statement and the income which it displays make it incumbent
upon readers of financial statements to exercise great care at all times
in drawing conclusions from them.

6. The question of what constitutes the most practically useful
concept of income for the year is one on which there is much difference
of opinion. On the one hand, net income is defined according to a
strict proprietary concept by which it is presumed to be determined
by the inclusion of all items affecting the net increase in proprietorship
during the period except dividend distributions and capital trans­
actions. The form of presentation which gives effect to this broad
concept of net income has sometimes been designated the all-inclusive
income statement. On the other hand, a different concept places its
principal emphasis upon relationship of items to the operations, and to
the year, excluding from the determination of net income any material
extraordinary items which are not so related or which, if included,
would impair the significance of net income so that misleading infer­ences might be drawn therefrom. This latter concept would require
the income statement to be designed on what might be called a current
operating performance basis, because its chief purpose is to aid those
primarily interested in what a company was able to earn under the
operating conditions of the period covered by the statement.

7. Proponents of the all-inclusive type of income statement insist
that annual income statements taken for the life of an enterprise
should, when added together, represent total net income. They em­
phasize the dangers of possible manipulation of the annual earnings
figure if material extraordinary items may be omitted in the determina­
tion of income. They also assert that, over a period of years, charges
resulting from extraordinary events tend to exceed the credits, and the
omission of such items has the effect of indicating a greater earning
performance than the corporation actually has exhibited. They insist
that an income statement which includes all income charges or credits
arising during the year is simple to prepare, is easy to understand, and
is not subject to variations resulting from the different judgments that
may be applied in the treatment of individual items. They argue that
when judgment is allowed to enter the picture with respect to the inclusion or exclusion of special items, material differences in the treatment of borderline cases develop and that there is danger that the use of distortion as a criterion may be a means of accomplishing the equalization of income. With full disclosure of the nature of any special or extraordinary items, this group believes the user of the financial statements can make his own additions or deductions more effectively than can the management or the independent accountant.

8. Those who favor the *all-inclusive* income statement largely assume that those supporting the *current operating performance* concept are mainly concerned with establishing a figure of net income for the year which will carry an implication as to future earning capacity. Having made this assumption, they contend that income statements should not be prepared on the *current operating performance* basis because income statements of the past are of only limited help in the forecasting of the earning power of an enterprise. This group also argues that items reflecting the results of unusual or extraordinary events are part of the earnings history of the company, and accordingly should be given weight in any effort to make financial judgments with respect to the company. Since a judgment as to the financial affairs of an enterprise should involve a study of the results of a period of prior years, rather than of a single year, this group believes that the omission of material extraordinary items from annual income statements is undesirable since there would be a greater tendency for those items to be overlooked in such a study.

9. On the other hand, those who advocate the *current operating performance* type of income statement generally do so because they are mindful of the particular business significance which a substantial number of the users of financial reports attach to the income statement. They point out that, while some users of financial reports are able to analyze a statement and eliminate from it those unusual and extraordinary items that tend to distort it for their purposes, many users are not trained to do so. Furthermore, they contend, it is difficult at best to report in any financial statement sufficient data to afford a sound basis upon which the reader who does not have an intimate knowledge of the facts can make a well-considered classification. They consider it self-evident that management and the independent auditors are in a better position than outsiders to determine whether there are unusual and extraordinary items which, if included in the determination of net income, may give rise to misleading inferences as to current
operating performance. Relying on the proper exercise of professional judgment, they discount the contention that neither managements nor the independent auditors, because of the absence of objective standards to guide them, have been able to decide consistently which extraordinary charges and credits should be excluded in determining earning performance. They agree it is hazardous to place too great a reliance on the net income as shown in a single annual statement and insist that a realistic presentation of current performance must be taken for what it is and should not be construed as conveying an implication as to future accomplishments. The net income of a single year is only one of scores of factors involved in analyzing the future earnings prospects or potentialities of a business. It is well recognized that future earnings are dependent to a large extent upon such factors as market trends, product developments, political events, labor relationships, and numerous other factors not ascertainable from the financial statements. However, this group insists that the net income for the year should show as clearly as possible what happened in that year under that year’s conditions, in order that sound comparisons may be made with prior years and with the performance of other companies.

10. The advocates of this current operating performance type of statement join fully with the so-called all-inclusive group in asserting that there should be full disclosure of all material charges or credits of an unusual character, including those attributable to a prior year, but they insist that disclosure should be made in such manner as not to distort the figure which represents what the company was able to earn from its usual or typical business operations under the conditions existing during the year. They point out that many companies, in order to give more useful information concerning their earning performance, make a practice of restating the earnings of a number of prior years after adjusting them to reflect the proper allocation of items not related to the years in which they were first reported. They believe that material extraordinary charges or credits may often best be disclosed as direct adjustments of surplus. They point out that a charge or credit in a material amount representing an unusual item not likely to recur, if included in the computation of annual net income, may be so distorting in its results as to lead to unsound judgments with respect to the current earning performance of the company.

11. The committee has indicated elsewhere¹ that in its opinion it is plainly desirable that over the years all profits and losses of a business be reflected in net income, but at the same time has recog-
nized that, under appropriate circumstances, it is proper to exclude certain material charges and credits from the determination of the net income of a single year, even though they clearly affect the cumulative total of income for a series of years. In harmony with this view, it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption relates to items which in the aggregate are material in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;
(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;
(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes, and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;
(d) The write-off of a material amount of intangibles; and
(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debt before maturity.

12. The following, however, should be excluded from the determination of net income under all circumstances:

(a) Adjustments resulting from transactions in the company's own capital stock;
(b) Amounts transferred to and from accounts properly designated as surplus appropriations, such as charges and credits with respect to general purpose contingency reserves;
(c) Amounts deemed to represent excessive costs of fixed assets, and annual appropriations in contemplation of replace-
ment of productive facilities at higher price levels; and 
(d) Adjustments made pursuant to a quasi-reorganization.

13. Consideration has been given to the methods of presentation of the extraordinary items excluded in the determination of net income under the criteria set forth in paragraph 11. One method is to carry all such charges and credits directly to the surplus account with complete disclosure as to their nature and amount. A second method is to show them in the income statement after the amount designated as net income. Where the second method is used, misconceptions are likely to arise as to whether earnings for the period are represented by the amount actually designated as net income or by the final, and often more prominent, amount shown on the income statement after deduction or addition of material extraordinary items excluded from the determination of net income. Having in mind the possibility of such misconceptions where the second method is employed, the committee believes that the first method more clearly portrays net income. It should be noted that the Securities and Exchange Commission, in its revised Regulation S-X issued in December, 1950, made provision in item 17 of Rule 5-03 for the addition to or deduction from net income or loss, at the bottom of income statements filed with the Commission, of items of profit and loss given recognition in the accounts during the period and not included in the determination of net income or loss. The change in Rule 5-03 does not affect the determination of the amount to be reported as net income or earnings for the year. Furthermore, the additions or deductions at the foot of the income statement after determination of net income are equivalent to direct credits or charges to earned surplus. In view of the foregoing, and although the committee strongly prefers the first method, it considers the second method of presentation described above to be acceptable provided care is taken that the figure of net income is clearly and unequivocally designated so as not to be confused with the final figure in the income statement. Thus it is imperative that the caption of the final figure should precisely describe what it represents, e.g., net income and special items, net income and refund of 1945 excess profits taxes, net loss and special items, or profit on sale of subsidiary less net loss. A company may use the first method of presentation in one statement and the second method in another like statement covering the same fiscal period. The committee wishes to make clear that neither of the above-described methods of presentation precludes the use of the combined statement of income and earned surplus. However, where such combined statement is utilized, the committee’s preference is
that the figure of net income be followed immediately by the surplus balance at the beginning of the period. It is also the committee's opinion that deduction of the single item of dividends from net income on the income statement would not be subject to misconception.

14. In its deliberations concerning the nature and purpose of the income statement, the committee has been mindful of the disposition of even well-informed persons to attach undue importance to a single net income figure and to earnings per share shown for a particular year. The committee directs attention to the undesirability in many cases of the dissemination of information in which major prominence is given to a single figure of net income or net income per share. However, if such income data are reported (as in newspapers, investors' services, and annual corporate reports), the committee strongly urges that any determination of income per share be related to the amount designated in the income statement as net income and that where material extraordinary charges or credits have been excluded from the determination of net income, the corresponding total or per-share amount of such charges and credits also be reported separately and simultaneously. In this connection the committee earnestly solicits the cooperation of all organizations, both governmental and private, engaged in the compilation of business earnings statistics from annual reports.

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1 See chapter 2 (b), paragraph 3.
2 See Chapter 10 (b) with respect to the allocation of income taxes.
3 See chapter 5, paragraphs 8 and 9, for conditions under which a material portion or the entire amount of intangibles described therein as type (b) may be written off.
4 See chapter 9 (a) and dissents thereto.
5 See chapter 2 (b).

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**Principle A-8**

*Disclose rental charges under material leases and capitalize those which are in effect installment purchases of fixed assets.*
Accounting for leases was dealt with in *Accounting Research Study No. 4*. After considering the recommendations in the study, the APB reaffirmed the position previously stated by the committee on accounting procedure in *ARB No. 43*, Chapter 14, which supports Principle A-8 as stated above. The Opinion, however, extends the disclosure requirements and clarifies criteria for the identification of installment purchases in the legal form of leases. *Opinion No. 5* by the Accounting Principles Board is reproduced below.

**APB Opinion No. 5**

**REPORTING OF LEASES IN FINANCIAL STATEMENTS OF LESSEE**

**INTRODUCTION**

1. This Opinion sets forth the Board’s views as to proper procedures or methods for implementing generally accepted accounting principles governing accounting for assets and liabilities and income and expense with respect to leases and sale and leasebacks. It supersedes Chapter 14 of *Accounting Research Bulletin No. 43*, “Disclosure of Long-Term Leases in Financial Statements of Lessees.” This Opinion makes no distinction between leases of real property and leases of personal property. Because of the highly specialized problems involved, this Opinion does not apply to agreements concerning natural resources such as oil, gas, timber and mineral rights.

2. The two principal recommendations of Chapter 14 of *Accounting Research Bulletin No. 43* were:

   (1) ...where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

   (a) disclosure should be made in financial statements or in notes thereto of:

   (1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and

   (2) any other important obligation assumed or guarantee made in connection therewith;
(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.

(2) . . . the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

3. In the period since the issuance of the Bulletin, the practice of obtaining by lease the right to use property has continued on an important scale. Although relatively more information about leases has been disclosed in financial statements of lessees in recent years, no consistent pattern has emerged, and the extent of disclosure of pertinent information has often been inadequate. In addition, there have been relatively few instances of capitalization of leased property and recognition of the related obligation, which suggests that the criteria for determining when a lease is in substance a purchase require clarification.

4. The situation described in the preceding paragraph caused the accounting research division of the American Institute of Certified Public Accountants to undertake a research study on reporting of leases in financial statements. This study recommended, in part:

... To the extent then that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet.

The major question then is what leases, or parts of leases, give rise to property rights. . . . (p. 4)

To the extent, then, that the rental payments represent a means of financing the acquisition of property rights which the lessee has in his possession and under his control, the transaction constitutes the acquisition of an asset with a related obligation to pay for it. To the extent, however, that the rental payments are for services such as maintenance, insurance, prop-
property taxes, heat, light, and elevator service, no asset has been acquired, and none should be recorded.

The measurement of the asset value and the related liability involves two steps: (1) the determination of the part of the rentals which constitutes payment for property rights, and (2) the discounting of those rentals at an appropriate rate of interest.

On the balance sheet the property rights acquired under lease should be grouped with the other property accounts, but probably separately classified in order to disclose the existence of the lease arrangement. The liability should be divided into its current and long-term portions and shown in the appropriate classification.

In effect, the proposed balance-sheet treatment removes the charge for "rent" in the [income statement] accounts as an occupancy cost and instead treats it simply as a payment of an obligation and interest thereon. In its place is put "amortization of property right acquired under lease" (an occupancy cost) and "interest" (a financial expense). In the case of manufacturing concerns there probably would be a related effect on the valuation of work in process and of finished goods.

5. The Accounting Principles Board has considered the recommendations and the supporting argument presented in Accounting Research Study No. 4. The Board agrees that the nature of some lease agreements is such that an asset and a related liability should be shown in the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. The Board believes that the disclosure requirements regarding leases contained in Accounting Research Bulletin No. 43, Chapter 14, should be extended, and the criteria for identification of lease agreements which are in effect installment purchases of property should be clarified. The Board also believes that accounting for gains and losses on sale-and-leaseback transactions should be specifically dealt with in this Opinion.

DISCUSSION

6. The central question is whether assets and liabilities are created by leases which convey the right to use property if no equity is
accumulated in the property by the lessee. Chapter 14 of Accounting Research Bulletin No. 43 and Accounting Research Study No. 4 agree that leases which are clearly in substance purchases result in assets and liabilities which should be recorded, and that to the extent rental payments are for services, such as property taxes, utilities, maintenance, and so forth, they should be charged to current operations. They disagree with regard to leases which convey merely the right to use property in consideration of specified rental payments over a definite future period.

7. It seems clear that leases covering merely the right to use property in exchange for future rental payments do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee for the full period covered by the leases. The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.

8. The rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. Generally accepted accounting principles require the disclosure of the rights and obligations under executory contracts in separate schedules or notes to the financial statements if the omission of this information would tend to make the financial statements misleading. The rights and obligations under leases which convey merely the right to use property, without an equity in the property accruing to the lessee, fall into the category of pertinent information which should be disclosed in schedules or notes rather than by recording assets and liabilities in the financial statements.

9. On the other hand, some lease agreements are essentially equivalent to installment purchases of property. In such cases, the substance of the arrangement, rather than its legal form, should determine the accounting treatment. The property and the related obligation should be included in the balance sheet as an asset and a liability, respectively, at the discounted amount of the future lease rental payments, exclusive of payments to cover taxes and operating expenses other than depreciation. Further, in such cases, it is appropriate to depreciate the capitalized amount for property over its estimated useful life rather than over the initial period of the lease.
10. The property and the related obligation should be included as an asset and a liability in the balance sheet if the terms of the lease result in the creation of a material equity in the property. It is unlikely that such an equity can be created under a lease which either party may cancel unilaterally for reasons other than the occurrence of some remote contingency. The presence, in a noncancelable lease or in a lease cancelable only upon the occurrence of some remote contingency, of either of the two following conditions will usually establish that a lease should be considered to be in substance a purchase:

a. The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or

b. The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.

In these cases, the fact that the rental payments usually run well ahead of any reasonable measure of the expiration of the service value of the property, coupled with the options which permit either a bargain purchase by the lessee or the renewal of the lease during the anticipated useful life at bargain rentals, constitutes convincing evidence that an equity in the property is being built up as rental payments are made and that the transaction is essentially equivalent to a purchase.

11. The determination that lease payments result in the creation of an equity in the property obviously requires a careful evaluation of the facts and probabilities surrounding a given case. Unless it is clear that no material equity in the property will result from the lease, the existence, in connection with a noncancelable lease or a lease cancelable only upon the occurrence of some remote contingency, of one or more circumstances such as those shown below tend to indicate that the lease arrangement is in substance a purchase and should be accounted for as such.

a. The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.

b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay
costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.

c. The lessee has guaranteed the obligations of the lessor with respect to the property leased.

d. The lessee has treated the lease as a purchase for tax purposes.

12. In cases in which the lessee and the lessor are related, leases should often be treated as purchases even though they do not meet the criteria set forth in paragraphs 10 and 11, i.e., even though no direct equity is being built up by the lessee. In these cases, a lease should be recorded as a purchase if a primary purpose of ownership of the property by the lessor is to lease it to the lessee and (1) the lease payments are pledged to secure the debts of the lessor or (2) the lessee is able, directly or indirectly, to control or influence significantly the actions of the lessor with respect to the lease. The following illustrate situations in which these conditions are frequently present:

a. The lessor is an unconsolidated subsidiary of the lessee, or the lessee and the lessor are subsidiaries of the same parent and either is unconsolidated.

b. The lessee and the lessor have common officers, directors, or shareholders to a significant degree.

c. The lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations.

d. The lessee (or its parent) has the right, through options or otherwise, to acquire control of the lessor.

OPINION

Application of opinion

13. This Opinion is concerned with accounting for noncancelable leases (or leases cancelable only upon the occurrence of some remote contingency) which are material, either individually or as a group for similar types of property, or in the aggregate. The presumption is that if the rights and obligations under such leases are either material in relation to the lessee's net assets or reasonably expected to affect materially the results of operations of future periods, the leases are covered by the provisions of this Opinion.

Capitalization

14. Except in cases of leases which come under paragraphs 9, 10, 11, and 12 of this Opinion, the right to use property and a related obliga-
CHAPTER 4: APB OPINION NO. 5

Leases of this type involve future rights and obligations, however, and pertinent information should be disclosed as described in paragraphs 16, 17, and 18. In the opinion of the Board, disclosure rather than capitalization is the correct accounting treatment of these leases.

15. Leases which are clearly in substance installment purchases of property (see paragraphs 9, 10, 11, and 12) should be recorded as purchases. The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. A note or schedule may be required to disclose significant provisions of the transaction. The method of amortizing the amount of the asset to income should be appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged.

Disclosure

16. The Board believes that financial statements should disclose sufficient information regarding material, noncancelable leases which are not recorded as assets and liabilities (see paragraphs 13 and 14) to enable the reader to assess the effect of lease commitments upon the financial position and results of operations, both present and prospective, of the lessee. Consequently, the financial statements or the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.

17. In many cases, additional disclosure will be required. The Board believes that rentals for the current year on leases covered by this Opinion should be disclosed if they differ significantly from the minimum rentals under the leases. Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also usually be disclosed.

18. The specific details to be disclosed and the method of disclosure will vary from one situation to another depending upon the circumstances. In many cases, a simple statement will suffice. In more complicated situations, more detailed disclosure will be appropriate. For example, it may be useful to provide a schedule of rentals by years or by three- or five-year periods if annual rentals will fluctuate signifi-
ficantly; or it may be desirable to provide a brief description of the
basis for calculating the rental if the amount of rent is dependent upon
some factor other than the lapse of time; or it may be necessary to
indicate the effect of lease renewals in order to avoid misleading
implications.

**Sale and leaseback**

19. The principal details of any material sale-and-leaseback ar-
range ment should be disclosed in the year in which the transaction
originates.

20. The conclusions in paragraphs 14, 15, 16, 17, and 18 apply to
the agreement covering the leaseback as though no concurrent sale
were involved.

21. The Board is of the opinion that the sale and the leaseback
usually cannot be accounted for as independent transactions. Neither
the sale price nor the annual rental can be objectively evaluated inde-
dependently of the other. Consequently, material gains or losses resulting
from the sale of properties which are the subject of sale-and-leaseback
transactions, together with the related tax effect, should be amortized
over the life of the lease as an adjustment of the rental cost (or, if the
leased property is capitalized, as an adjustment of depreciation).

22. Exceptions to the rule in paragraph 21 are expected to be rare.
If, however, the fair value of the property at the time of the sale and
leaseback is less than the undepreciated cost, the loss should be
reflected in income at the time of the sale to the extent that a write-
down to recognize fair value could properly have been recorded in the
absence of a sale. In other instances in which the use of the leased
property changes with the sale and leaseback and in which the sale
price falls within the limits which would reasonably be set by inde-
pendent transactions (for example, companies engaged in both con-
structing and operating office buildings or other commercial investment
properties may sell a property after construction and lease it back for
operation), the exceptional circumstances surrounding a particular
sale-and-leaseback transaction may clearly justify recognition of all or
part of the gain or loss at the time of the sale.

**Prior lease agreements**

23. Unless otherwise stated, Opinions of the Board are not intended
to be retroactive. However, the Board encourages the revision of past
accounts in individual cases where the effect on current financial state-
ments is material. In any event, the Board believes the conclusions as to disclosure stated in paragraphs 16, 17, and 18 should apply to lease agreements made prior to the issuance of this Opinion.

The Opinion entitled "Reporting of Leases in Financial Statements of Lessee" was adopted by the assenting votes of twenty members of the Board, of whom two, Messrs. Moonitz and Walker, assented with qualification. Mr. Spacek dissented.

Mr. Moonitz assents to the publication of this Opinion because he believes that it will increase the disclosure of pertinent information regarding leases in published financial statements. He does not believe that this Opinion resolves the underlying issue of the nature of assets and of liabilities. He dissents to paragraph 21, which evidences the confusion concerning assets and liabilities. Paragraph 21 recommends that gains or losses from sale-and-leaseback transactions be amortized over the life of the lease. The adoption of this recommendation in practice will result in the introduction into the balance sheet of "deferred credits to income" for gains and "deferred charges to income" for losses. In a sale-and-leaseback transaction, neither of these deferred items qualifies as a liability or as an asset. Their effect is to permit a smoothing of reported net income over a number of years. This result stems from the attempt to treat the transaction as though no sale has been made, insofar as the effect on net income is concerned, while treating the property as sold in the balance sheet. If the property has in fact been sold, it should be so reported in consistent fashion in all the financial statements. If it has not, the balance sheet should not be made to report that it has.

Mr. Walker assents to the conclusions of this Opinion. He believes, however, that adequate disclosure with respect to leases which are considered to be essentially equivalent to installment purchases can be made as well by notes to the financial statements as by inclusion in the figures. Such disclosure is more appropriate because of the legal status and avoids inflating the balance sheet with questionable assets and liabilities.

Mr. Spacek dissents from the principal conclusion that a lease liability should be shown on the balance sheet only when the lease, because of an element of prepaid rent (referred to in this Opinion as "equity") arising from the early lease payments, is interpreted to be an agreement to purchase. In his view, a liability (discounted to present value) should be recorded for all material amounts payable under non-cancelable leases, which in fact are "take or pay" contracts, representing a present liability payable in the future. The payment of this
obligation has a call on other corporate assets, ahead of corporate equity applicable to investors; and, thus, a liability should be shown on the face of the balance sheet, rather than being relegated to inadequate footnote disclosure. He considers this “equity” to be prepaid rent which should be deferred to the periods to which it applies. It is incorrect to assume that only when rental charges are thus determined to be excessive in early periods does a recordable obligation for future payments result, since this leads to the unsupportable conclusion that the payment of prepaid rent creates a liability and the nonexistence of prepaid rent eliminates the liability. He further believes this Opinion (a) does not explain why its major conclusions disagree with those in Research Study No. 4, and (b) establishes criteria for recording lease obligations on an unrealistic and impracticable basis which compounds the ineffective provisions of ARB 43 that have not met the needs of investors and other users of financial statements.

1 Accounting Research Study No. 4, “Reporting of Leases in Financial Statements,” by John H. Myers, published for its accounting research division by the American Institute of Certified Public Accountants in May, 1962. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on important accounting issues.)

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**Principle A-9**

*If accounting principles in the determination of periodic results have not been consistently maintained, the effect of the change should be stated.*

Consistency in the application of accounting principles between periods for the same entity has been set forth as one of the basic concepts in chapter 2 of this Inventory. This concept resulted from the correspondence in the early 1930’s between an Institute committee and the New York Stock Exchange. The profession decided against prescribing a set of fixed principles or practices of accounting and adopted the following alternative, as expressed in the letter of September 22, 1932 to the Committee on Stock List of the New York Stock Exchange:
CHAPTER 4: PRINCIPLE A-9

The more practicable alternative would be to leave every corporation free to choose its own methods of accounting within the very broad limits to which reference has been made, but require disclosure of the methods employed and consistency in their application from year to year.

Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year.

The usefulness of accounting statements under these conditions is dependent upon the consistent application of the principles and procedures adopted. When a company wants to change a procedure that it has followed to an alternative procedure that has substantial authoritative support, the effect of the change should be disclosed so that its effect can be adequately assessed.

The importance of consistency in accounting is recognized in the standards of auditing generally accepted by the profession.

1. The second standard of reporting reads:

The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

2. The term “current period” means the most recent year or period of less than one year upon which the independent auditor is reporting. It is implicit in the standard that such principles have been consistently observed within each period. . . . the term “principles of accounting” as used in the reporting standards is construed to include not only accounting principles and practices, but also the methods of applying them.

3. The objective of the consistency standard is: (1) to give assurance that the comparability of financial statements as between periods has not been materially affected by changes in the accounting principles employed or in the method of their application; or (2) if comparability has been materially affected by such changes, to require a statement of the nature of the changes and their effects on the financial statements.

Comparability of financial statements.

4. Proper application of the consistency standard requires a clear understanding by the independent auditor of the relationship of consistency to comparability. The consistency standard involves the consistent application of accounting principles; lack of consistency produces lack of comparability. However, lack of com-
parability may be caused by other factors unrelated to consistency and even unrelated to accounting.

5. In general, comparability of financial statements as between years is affected by changes arising from: (a) a change in accounting principles employed, (b) changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed, and (c) changed conditions unrelated to accounting.

6. Only the first of these three classes involves the consistency standard and therefore only changes of this class having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Changes of the second and third classes having a material effect on the financial statements will not ordinarily be commented upon in the independent auditor's report. However, fair presentation may require their disclosure in the notes to the financial statements. [Statements on Auditing Procedure No. 33, pp. 42-43]

The objective in requiring disclosure of the effect upon income of changes in accounting principles is to provide users of financial statements with the means of measuring the remaining changes in operations arising from changed conditions, i.e., events or transactions, as referred to in 5(b) and (c) in the above quotation.
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*ARB No. 43, Ch. 13B, “Compensation Involved in Stock Option and Stock Purchase Plans”*
Account for the equity capital invested by stockholders through contribution of assets or retained earnings in a meaningful manner on a cumulative basis and as to changes during the period or periods covered. The account structure and presentation in financial statements of a business entity are designed to meet statutory and corporate charter requirements and to portray significant financial relationships.

The foregoing constitutes a broad statement of the fiduciary accountability or objective to be met in handling the equity capital of stockholders. The means by which the general objective is attained are briefly described in the numbered principles. It is believed that the later discussion of these principles will be facilitated by the incorporation at this point of the committee on terminology’s comments on the —

Use of the term “surplus.”

65. In 1941 the committee suggested a general discontinuance of the use of the term surplus in corporate accounting, and a substitution therefor in the proprietorship section of the balance sheet of designations which would emphasize the distinction be-
between (a) legal capital, (b) capital in excess of legal capital, and (c) undivided profits. Extensive discussions of the proposal followed, and in 1949 it was approved "as an objective" by the committee on accounting procedure.

66. A factor of primary importance in the balance-sheet presentation of the stockholders' equity is the status of ownership at the balance-sheet date. Where two or more classes of stockholders are involved, the interests of each must be presented as clearly as possible. These interests include the entire proprietary capital of the enterprise, frequently divided further, largely on the basis of source, as follows:

(1) Capital stock, representing the par or stated value of the shares.

(2) Capital surplus, representing (a) capital contributed for shares in excess of their par or stated value, or (b) capital contributed other than for shares.

(3) Earned surplus, representing accumulated income or the remainder thereof at the balance-sheet date.

67. While the terms capital surplus and earned surplus have been widely used, they are open to serious objection.

(1) The term surplus has a connotation of excess, overplus, residue, or "that which remains when use or need is satisfied" (Webster), whereas no such meaning is intended where the term is used in accounting.

(2) The terms capital and surplus have established meanings in other fields, such as economics and law, which are not in accordance with the concepts the accountant seeks to express in using those terms.

(3) The use of the term capital surplus (or, as it is sometimes called, paid-in surplus) gives rise to confusion. If the word surplus is intended to indicate capital accumulated by the retention of earnings, i.e. retained income, it is not properly used in the term capital surplus; and if it is intended to indicate a portion of the capital, there is an element of redundancy in the term capital surplus.

(4) If the term capital stock (and in some states the term capital surplus) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms surplus or earned surplus of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as
a practical matter, or as a matter of prudent management, available for dividends.

68. In seeking terms more nearly connotative of the ideas sought to be expressed, consideration should be given primarily to the sources from which the proprietary capital was derived.

In addition, regard should be had for certain types of events which may have occurred in the history of the corporation. Thus, a quasi-reorganization in which a “new start” has been made may be said to have put the entire net assets, as restated at the time, into the status of contributed capital, so that in subsequent balance-sheet presentations that part of proprietary capital sometimes described as earned surplus would include only income retained after the quasi-reorganization and would be “dated” accordingly. Likewise a stock dividend, or a transfer by resolution of the board of directors, must for purposes of subsequent balance-sheet presentation be dealt with as a transfer of capital accumulated by retention of income to the category of restricted capital. Finally, the classification of proprietary capital involves a consideration of present status in such matters as contractual commitments, dividend restrictions and appropriations of various kinds.

69. In view of the foregoing the committee in 1949 particularized the proposal which had been so long under consideration by recommending that, in the balance-sheet presentation of stockholders’ equity:

(1) The use of the term surplus (whether standing alone or in such combinations as capital surplus, paid-in surplus, earned surplus, appraisal surplus, etc.) be discontinued.

(2) The contributed portion of proprietary capital be shown as:

(a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.

(b)(i) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value, or of a reduction in par or stated value of shares after issuance, or of transactions by the corporation in its own shares); and

(b)(ii) Capital received other than for shares whether from shareholders or from others.
(3) The term *earned surplus* be replaced by terms which will indicate source, such as *retained income, retained earnings, accumulated earnings, or earnings retained for use in the business*. In the case of a deficit, the amount should be shown as a deduction from contributed capital with appropriate description.

(4) In connection with 2(b) and 3 there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal. Retained income appropriated to some specific purpose nevertheless remains part of retained income, and any so-called “reserves” which are clearly appropriations or segregations of retained income, such as those for general contingencies, possible future inventory losses, sinking fund, etc., should be included as part of the stockholders’ equity.

(5) Where there has been a quasi-reorganization, retained income should be “dated” for a reasonable time thereafter; and where the amount of retained income has been reduced as a result of a stock dividend or a transfer by resolution of the board of directors from unrestricted to restricted capital, the presentation should, until the fact loses significance, indicate that the amount shown as retained income is the remainder after such transfers.

(6) Any appreciation included in the stockholders’ equity other than as a result of a quasi-reorganization should be designated by such terms as *excess of appraised or fair value of fixed assets over cost or appreciation of fixed assets*.

70. As already noted, this proposal was approved “as an objective” by the committee on accounting procedure although it has subsequently used the term *surplus* in certain of its pronouncements where it felt that the avoidance of such usage might seem to border on pedantry. The cogency of the reasons adduced for discontinuing the use of the term in balance-sheet presentations of the stockholders’ equity seems obvious, and that the proposal is winning general acceptance appears from analyses made by the Institute’s research department of numerous published corporate financial statements: the proportion of such statements in which the term *surplus* was not used was 10 per cent for 1947 and 18 per cent for 1948, but for 1949, 1950, and 1951, after the recommendation was published, it was 32 per cent, 41 per cent, and 44 per cent, respectively.

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8 This classification includes such items as capital transferred from cap-
CHAPTER 5: PRINCIPLE B-1

ital stock account as a result of the reduction of par or stated value, and
credits resulting from transactions in the corporation's own stock.

* * *

It may be noted that the foregoing trend has continued and, in 1962,
54 per cent of the 600 companies included in the survey had replaced
the term *surplus* for "capital" type accounts and 75 per cent had
replaced the term *surplus* in reference to retained earnings account.

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**Principle B-1**

*In case there are two or more classes of stock, account for the equity capital invested for each and disclose the rights and preferences to dividends and to principal in liquidation.*

As has been stated in Objective B, the account structure and presenta-
tion in financial statements are designed to meet statutory and
corporate charter requirements and to portray significant financial
relationships. The two are not mutually exclusive. The charter provi-
sions provide proper names of the various classes of stock, their prefer-
ences as to dividends and to assets in liquidation, whether par or no-par
value stock, shares authorized, voting rights, etc. In the accounting for
capital invested, the emphasis is placed on source and nature of the
stockholders' contributions, but separate accounts are provided for the
capital contributed to the extent of par or stated values and for capital
contributed in excess of such par or stated values for the shares that
have been issued.

Inasmuch as this Inventory is prepared primarily for experienced
financial executives and CPAs and since there is little controversy
regarding accounting for equity capital, there is no need for lengthy
comments. The following summary of a detailed type of presentation
will illustrate the nature of disclosures and accounting distinctions
regarding the source and nature of equity-invested capital of a corpo-
rate enterprise.
Stockholders’ Equity in Capital Invested:

Capital Stock:
- Preferred stock — 5% cumulative; par value $100; authorized ______ shares; issued ______ shares
- Class A preferred stock — $2.00 cumulative; no par value, redeemable value $30; authorized and issued ______ shares
- Common stock — no par value; stated value $10; authorized ______ shares; issued ______ shares of which ______ are in treasury

Capital Paid-in in Excess of Par, Redemption and Stated Values of Capital Stocks:
- Premium on preferred stock
- Arising from treasury stock transactions
- Paid-in on common stock
- Retained earnings capitalized on stock dividends

Retained Earnings:
- Appropriated in amount equal to restriction under bank loan as to payment of dividends
- Unappropriated

Total
Deduct Cost of ______ Shares of Treasury Common Stock

Stockholder Equity

It should be noted that the detail breakdown of capital paid in in excess of par, etc., is not ordinarily shown in financial statements. The participating restrictive and preference provisions of some corporate charters may be so complex that further footnote explanations are required in financial statements. The objective, of course, is to present sufficient information so that the owners of each class of stock may ascertain the existence of prior claims in dividend distributions, redemptions and liquidation. When cumulative dividends are in arrears, the amount per share and in the aggregate should be disclosed. When redemption or liquidation values of preference stocks are above their par or stated values, these facts are to be clearly set forth. It is good practice to indicate in dollars the aggregate excess of
involuntary liquidation price of preference stock over par or stated value.

The Securities and Exchange Commission’s Regulation S-X, Rule 3.19, requires that, if “the excess involved is material there shall be shown (i) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value; (ii) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital shares and the surplus, if such is the case; and (iii) a statement as to the existence, or absence, of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value.” As administrative policy the Commission has also required, when the excess involved is significant, an opinion of counsel as to whether there are any restrictions upon surplus by reason of these differences and also as to any remedies available to stockholders before or after the payment of any dividend that reduces surplus to an amount less than that by which the aggregate preference of such stock on involuntary liquidation exceeds its aggregate par or stated value.

Accounting Separately for the Invested Capital of Each Class of Stock

Equitable treatment of stockholders requires that accountants establish a cleavage of invested capital among the different classes of stock. In ASR No. 45 the SEC held that this cleavage between classes is considered of comparable importance to the distinction between total invested capital and retained earnings. When invested capital in excess of par or stated value of a particular class is unavailable, therefore, costs which would ordinarily be absorbed by that account are charged to retained earnings rather than to invested capital of another class of stock still outstanding. If there is any invested capital applicable to stock no longer outstanding, this invested capital may be used to absorb charges from other classes that may have exhausted their own invested capital in excess of par value.

This principle is applied, as an example, in accounting for retirement of treasury stock.† As a general rule, the applicable par, stated,

† While the following may be stated as the general rule, it is advisable to consult legal counsel when stock is retired so that book entries and financial statements may be prepared in conformity with counsel’s interpretation of applicable state laws.
or assigned value is deducted from the appropriate capital stock account. Any excess of cost over the amount so deducted is charged first to any related invested capital in excess of par value applicable to the retired shares on a pro rata basis, then to any other invested capital in excess of par value from shares no longer outstanding, and the remainder to retained earnings. It would be inadvisable to debit the invested capital applicable to shares still outstanding. If there is an excess of amount deducted from capital stock over the cost of the shares, this excess is credited to an invested capital account.

Accounting for resale of treasury stock was dealt with in ARB No. 43, Chapter 1B, reproduced below:

ARB No. 43  Chapter 1  Section B:  

PART OPINIONS  

Opinion Issued by Predecessor Committee

1. Following an inquiry made by the New York Stock Exchange, a predecessor committee on accounting procedure in 1938 issued the following report:

PROFITS OR LOSSES ON TREASURY STOCK

2. The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:

TO THE EXECUTIVE COMMITTEE,  
AMERICAN INSTITUTE OF ACCOUNTANTS:

3. This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on cooperation with stock exchanges.

4. As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was
furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

5. "Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?"

6. The opinion of the special committee on cooperation with stock exchanges reads in part as follows:

7. "Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock."

8. This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

9. The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:

10. "Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account)."

11. This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.

12. This committee recommends that the views expressed be circulated for the information of members of the Institute.
The procedure set forth in the Bulletin is followed, also, when preferred stock is redeemed. If a premium over the par or stated value was received at time of issue and was credited to invested capital, premium and call expense on retirement may be debited to invested capital to the extent of the pro rata premium received on issue of these shares; any remaining premium or call expense should be debited first to any invested capital applicable to preferred issues previously redeemed in their entirety, and second, to retained earnings.

Similarly, underwriting discounts, professional fees, and other expenses of stock issues should be debited to the related invested capital account to the extent that it exceeds par value. Any excess over this amount should be debited first to any available invested capital on issues no longer outstanding, and the balance to retained earnings.

When preferred stock is converted into common, the invested capital of the preferred becomes the invested capital of the common. Specifically, the excess of the par or stated value of the preferred stock over the par or stated value of the common stock issued in exchange, less expenses, should be credited to an invested capital account.

**Capital Stock Issued for Properties and Services**

In addition to cash, the invested capital of a corporation may result from contributions of tangible property, intangibles, or services. All forms of contributions should be properly valued and recorded as invested capital.

As a general rule, cost of tangible fixed assets, inventories and supplies so acquired should be determined either by the fair market value of the stock given or by the fair market of the property acquired, whichever is more clearly evident. The par or stated value of the stock usually cannot be relied upon as a reasonable basis for recording the cost of the property acquired. If the fair value of the stock is not readily determinable, some appraisal of the property must be made, either by the management or by outside parties, taking into consideration all pertinent factors.

The acquisition of limited-term intangibles, such as patents, copyrights and prepayments, and of unlimited-term intangibles, such as trademarks and goodwill, must be valued in the same general way as described for tangibles. Often they are acquired together in the transfer of ownership of the entire assets of a business enterprise. The problem of valuation and amortization of intangible assets is dealt with in *ARB No. 43*, Chapter 5, which is presented in the asset section of this Inventory, Chapter 6, to which reference is made.
Invested capital may arise from performance of services, and this likewise requires determining the fair market value of the stock or of the services. Services rendered by employees in connection with stock option plans are dealt with in ARB No. 43, Chapter 13B, presented later in this section under the disclosures required for stock options.

The foregoing comments on valuation of tangible properties, intangibles and services are predicated upon the existence of arms-length transactions between the corporation and other persons. Where there is evidence of domination by promoters or others on the corporation or its directors, the burden of proof on the validity of valuations of assets and services received is considerably stronger.

In the early days, approval of valuations by directors was deemed to be conclusive and it was rather common to donate to the corporation a part of the shares issued. In order to remove such donations as a source of paid-in capital, the Council and membership of the Institute adopted the following rule in 1934 (ARB No. 43 — Chapter 1A):

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

Where the consideration received for capital stock has been properly priced, the above rule would not apply.

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**Principle B-2**

*From a financial viewpoint, the capital invested by stockholders is the corpus of the enterprise and its identity should be fully maintained. Any impairment of invested capital resulting from operating deficits, losses of any nature, dividend distributions in excess of earnings, and treasury stock purchases is accounted for both currently and cumulatively.*

The importance of this principle flows from the concept of capital as a fund for the protection of creditors and from the business and economic stewardship accountability for funds invested by stock-
holders. Invested capital may arise from contributions to the enterprise attributable to stock outstanding, and to retired or redeemed stock. The financial statements should ideally show the invested capital of each class as shown in the earlier summary. This is always done to the extent of the par or assigned value of the stock outstanding for each class, but the amount of invested capital in excess of that par value is generally shown in total; the accounting records, of course, preserve the distinctions.

**Invested Capital Attributable to Stock Outstanding**

Stock outstanding may consist of preference and common stocks. Debentures subordinate to the claims of creditors are also sometimes classified as invested capital. The accountant should not ordinarily object to this, if full disclosure is made. The debentures should be listed first, and the capital section should be headed "capital and subordinated debentures."

When subscriptions to capital stock have been taken, and the stock is to be issued only when the subscription price has been fully paid by the subscriber, the obligation to issue this stock should be included as invested capital. If a subscriber has the right to cancel his subscription and to have refunded the amounts paid in, it is preferable to state the subscription at the amounts paid in, described as common (or preferred) stock installments. Rule 5-02 of Regulation S-X requires that subscriptions receivable be shown as a deduction from capital stock or total equity, as appropriate.

When a subscriber to capital stock remits a portion of the subscription price and fails to pay the balance, the corporation must act in accordance with the laws of the state of incorporation. In some states the subscriber, after a certain period has elapsed, forfeits his payment, and the corporation may resell the stock. The forfeited payment should be considered as part of the invested capital applicable to the resold stock.

If treasury stock is purchased and resold, the difference between its cost and resale price results in an addition or reduction to invested capital applicable to the shares resold. If no invested capital is available, a loss would be chargeable to retained earnings. Subsequent accounting entries affecting these shares should reflect both the original invested capital and the invested capital resulting from their purchase and resale. If the stock was reacquired by donation (issued fully paid and nonassessable) and subsequently sold, the entire proceeds of the sale become invested capital attributable to the resold shares.
When specific amounts equal to accrued dividends per share are included in the prices at which shares of capital stock are sold by the issuer, with the intention that these amounts are to be returned to the stockholders as part of the first dividends to be distributed to them, such amounts should be shown as a liability and not included in the proceeds of the sale of the stock. Similarly, some preferred issues require periodic redemption of amounts based on excess earnings determined in accordance with a prescribed formula based on other terms of the charter. Amounts equal to the redemption amount of preferred stock which must be redeemed within the next fiscal year should be shown among the current liabilities, rather than as a part of equity.

Invested Capital Attributable to Retired or Redeemed Stock

If a corporation retires treasury stock or redeems preferred stock, any resulting increase or decrease in invested capital may be included in this category. Since this invested capital is no longer specifically attributable to any shares outstanding, it constitutes a pool that may be available to absorb charges related to stock outstanding that has exhausted its own available invested capital in excess of par or stated values.

Accounting for Impairment of Invested Capital

Invested capital may be diminished through a deficit of retained earnings, treasury stock purchases, and dividends debited to invested capital accounts. Each should be reported separately on the balance sheet and not offset against the invested capital. The changes in each for the current period as well as the cumulative status should also be reported in the financial statements.

Treasury stock purchases. The laws of most states allow corporations to retire outstanding stock under certain conditions. The formality of retirement and cancellation of stock certificates legally ends the corporation’s accountability for the retired stock. The financial statements should show the decrease in invested capital for the current period; the new amount of invested capital should be maintained in subsequent balance sheets.

Treasury stock is stock that has been purchased but not formally retired, and the corporation is still accountable for it in the financial statements. The balance sheet should indicate the number of shares
CHAPTER 5: EQUITY (SECTION B OF SUMMARY)

held and describe the issue. Treasury stock is usually deducted from total stockholders' equity at cost; but if it has been acquired for the specific purpose of resale to employees or others, it is permissible to show it separately on the asset side of the balance sheet, at cost, provided the reason for the treatment is disclosed in the balance sheet or in a note thereto. In this connection Rule 4, adopted by the membership of the Institute in 1934, reads as follows:

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

State corporation codes provide that treasury stock may be purchased only when the purchase does not impair legal capital. In some states, this provision results in a reduction in retained earnings; in others it results in a restriction on retained earnings available for dividends as long as the treasury shares are held. If retained earnings are legally reduced by the purchase of treasury stock, the financial statements must, of course, reflect the reduction. If the acquisition of treasury stock restricts retained earnings available for dividends, the common practice of showing the cost of treasury stock as a deduction from total capital in the financial statements is acceptable as long as the restriction is disclosed in the retained earnings caption or in a note.

Generally, treasury stock which has been retired or cancelled is restored to authorized shares. This results in a reduction of issued shares with no change in authorized shares.

Legal considerations have substantial weight in determining the proper display of treasury stock in financial statements. The accountant should have some familiarity with the state laws concerning the accounting for and presentation of treasury stock and consult with legal counsel when necessary.

Dividends debited to invested capital accounts. Since there are many variations in the requirements of corporate agreements and state legislation, a company may in some states legally declare dividends out of a source other than earnings. The accountant should fully disclose in the financial statements, both currently and cumulatively, any repayments made to stockholders of their invested capital in the form of dividends.

Dividends paid with the express intent of reducing the capital of the corporation, and with a view toward partial or complete dissolution,
are known as liquidating dividends or distributions of capital. Accounting for these dividends should follow the intent expressed in resolutions of the directors or stockholders. When a liquidating dividend has been declared and all the legal steps taken requisite to the reduction of the stock, but the payments to stockholders have not been made, the balance sheet should show the outstanding stock at its reduced amount and the liquidating dividend as a current liability, adequately described.

Principle B-3

Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. There should be no commingling of retained earnings with invested capital in excess of par or stated values.

The first sentence in this principle is taken verbatim from the second of the six rules adopted by the membership of the Institute in 1934. The rule, as adopted, contains a further sentence providing possible exceptions under conditions of reorganization or quasi-reorganization procedures, which are dealt with later in this equity section. The second sentence of the above caption is a logical extension or clarification of the first.

The accountant should make evident the extent of compliance with this principle by disclosing all charges and credits to retained earnings and to any invested capital in excess of par value accounts for the period or periods covered, as well as maintaining the identity of the cumulative balances.

The common use of the terms “earned surplus” and “capital surplus,” now fortunately in the waning stage, has helped to obscure the fundamental differences between these categories and to increase the likelihood of erroneous classification of items between them. If there are several classes of capital surplus and several appropriations of earned surplus, the problem is somewhat confusing to a reader of the statements. Under such conditions, simplification may be in order as long as the basic distinction between invested capital and retained earnings is maintained. Financial statements should contain adequate descriptions
of changes in capital surplus and earned surplus, including surplus reserves.

**Principle B-4**

*Retained earnings should represent the cumulative balance of periodic earnings less dividend distributions in cash, property or stock, plus or minus gains and losses of such magnitude as not to be properly included in periodic earnings. The entire amount may be presumed to be unrestricted as to dividend distributions unless restrictions are indicated in the financial statements.*

This Principle is closely parallel to the definition of earned surplus in *Accounting Terminology Bulletin No. 1*, paragraph 34, which follows:

The balance of net profits, income, gains and losses of a corporation\(^1\) from the date of incorporation (or from the latest date when a deficit was eliminated in a quasi-reorganization) after deducting distributions therefrom to shareholders and transfers therefrom to capital stock or capital surplus accounts.

\(^1\) Other than gains from transactions in its own shares, and losses therefrom chargeable to capital surplus; see chapter 1(b) of *Accounting Research Bulletin No. 43*, paragraphs 7 and 8.

When a dividend payable in cash or property has been declared and public notice of it has been given to the stockholders, the dividend is a legal obligation and may not be rescinded without the consent of stockholders entitled to receive the dividend. Therefore, retained earnings is charged with the appropriate amount at the time of declaration, and the amount is included among the current liabilities. Dividends paid or declared are shown in the analysis of retained earnings. It is customary to indicate the total dividend for each class of stock and the medium of payment if other than cash.

Ordinarily, cash dividends are not paid on treasury stock. When dividends are paid through a dividend-paying agent, they may be paid on treasury stock, but upon receipt these dividends should be applied as a reduction of the amount of dividend distribution and not taken into income.
When dividends are paid in property, there are two alternatives as to the amount to be charged to retained earnings. One is that retained earnings be charged with the cost of the property to the disbursing corporation; the other, with the market value of the property at the date the dividend is declared, any difference between market value and cost being reflected as a charge or credit to income or retained earnings for the period. Generally, the first alternative is used, although problems arise under either treatment, and it is not always feasible to determine fair market value. Income tax considerations may have an important bearing on the accounting treatment selected. When dividends are paid in property, the value of which may be subject to differences in opinion, it is good procedure to indicate in the financial statements the basis used by the board of directors in determining the dollar amount of the property distributed.

If dividends are paid in property having a readily determinable market value appreciably in excess of the amount at which the property is carried on the books and these dividends are charged to surplus at book amount, the amount of this difference should be clearly indicated in the current financial statements. This is particularly important if there is more than one class of stock and the property is being distributed to a class other than the common stock.

Disclose of Restrictions of Retained Earnings as to Dividend Distributions

Restrictions may be indicated by footnote or parenthetical notation. Restrictions imposed by bond indentures, bank loan agreements, state laws, or charter provisions are examples of those which should be disclosed. The restriction may be based upon the retention of the balance of retained earnings as of a specified date, upon the corporation's ability to observe certain working capital requirements, or upon other considerations. When there is more than one type of restriction, disclosure of the amount of retained earnings, so restricted, may be based on the most restrictive covenants likely to be effective in the immediate future. In other words, restrictions seldom, if ever, pyramid in amount.

Terms of bond indentures, preferred stock agreements, or other contractual obligations may make mandatory appropriations from retained earnings for particular purposes. Occasionally, amounts of retained earnings covered by restrictions are voluntarily segregated by action of a corporation's board of directors. The appropriation, whether mandatory or voluntary, serves to measure the restricted retained earnings,
but it remains necessary either in the caption or in a note to describe the nature of the restriction.

The only purposes served by retained earnings appropriations are to conform with the provisions of agreements with respect to bonds, notes, preferred stocks, etc., and to give some indication to stockholders of the amount of possible unusual losses which may occur in the future. There should, therefore, be no effect on the income statement; the only accounts affected should be appropriated retained earnings and unappropriated retained earnings. *ARB No. 43*, Chapter 6, takes this position and is reproduced in the income and expense section, Chapter 4, of this Inventory.

**Stock Dividends and Stock Split-Ups**

Although they appear to be similar, stock dividends and stock split-ups are substantially different and must receive different accounting treatment. This remains the case, even though the legal form of the transactions might be the same. The subject of stock dividends and split-ups is treated in Chapter 7B, *ARB No. 43*, which is reproduced below:

1. The term *stock dividend* as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term *stock split-up* as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their
unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This chapter is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

AS TO THE RECIPIENT

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. In applying the principles of income determination to the accounts of a shareholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income. Under conventional accounting concepts, the shareholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market value of the shares, but until there is a distribution, division, or severance of corporate assets, the shareholder has no income. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance argu-
ments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known. The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber*, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased... the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones.

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

**AS TO THE ISSUER**

*Stock dividends*

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a *dividend* in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, conse-
CHAPTER 5: ARB NO. 43, CH. 7, SEC. B

quently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph 2. Consequently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word dividend in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a split-up effected in the form of a dividend.

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations’ affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions,
it would appear that there would be few instances involving the issuance of additional shares of less than, say 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock split-ups

15. Earlier in this chapter a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups would be recorded as split-ups.

Three members of the committee, Messrs. Knight, Calkins, and Mason, assented with qualification, and one member, Mr. Wilcox, dissented to adoption of section (b) of chapter 7.

Mr. Knight assents with the qualification that he believes the section should recognize the propriety of treating as income stock dividends received by a parent from a subsidiary. He believes the section should
have retained from the original Bulletin No. 11 the statement, "It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries . . . ."

Messrs. Calkins and Mason approve part one, but believe part two is inconsistent therewith in that the former concludes that a stock dividend is not income to the recipient while the latter suggests accounting procedures by the issuer based on the assumption that the shareholder may think otherwise. They believe it is inappropriate for the corporate entity to base its accounting on considerations of possible shareholder reactions. They also believe that part two deals with matters of corporate policy rather than accounting principles and that the purpose sought to be served could be more effectively accomplished by appropriate notices to shareholders at the time of the issuance of additional shares.

Mr. Wilcox dissents from the recommendations made both as to the recipient and as to the issuer. He believes that, with proper safeguards, stock dividends should be regarded as marking the point at which corporate income is to be recognized by shareholders, and denies that the arguments favoring this view are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation. He believes that the arguments regarding severance and maintenance of proportionate interest are unsound, and cannot logically be invoked as they are in this section, since they are widely ignored with respect to distributions of securities other than common stock dividends. Mr. Wilcox believes the recommendations as to the issuer are inconsistent with the rest of the section, involve arbitrary distinctions, hamper or discourage desirable corporate actions, result in meaningless segregation in the proprietorship section of balance sheets, and serve no informative purpose which cannot be better served by explanatory disclosures. He therefore also dissents from the omission of requirements for information and disclosures which were contained in the original Bulletin No. 11 issued in September, 1941.

The date to be used in determining fair value of the shares issued under a stock dividend was not covered in the Bulletin. Although the ex-dividend date and the date of payment have been used, the declaration date is generally used.

Stock dividends declared but unissued at the balance-sheet date should be shown as a separate classification in the stockholders' equity section, and the number of shares to be issued should be indicated. When the shares are issued shortly after the balance-sheet date, but the statements are released some time later, the balance sheet may give effect to the issuance of the shares, appropriately explained. It is also permissible, however, not to show the balance-sheet change resulting from the declaration, other than to disclose by footnote the nature of the declaration and the amount of surplus to be capitalized.

Corporations sometimes declare dividends payable in cash or stock at the option of the stockholders. This may not be a true stock dividend for it may not be a pro rata distribution of shares; the proportions will be changed if cash is taken by some shareholders. However, a corporation which gives the stockholder the choice of a cash dividend or a stock dividend usually makes the offer in such terms that the choice of stock is more attractive to the recipient. When significant amounts of cash are paid in any such distribution, the amount of earned surplus to be capitalized for the entire distribution should be at a rate per share not less than that of the optional cash dividend.

--- Principle B-5 ---

Retained earnings may be decreased by transfers to invested capital accounts when formal corporate action has, in fact, changed the composition of the equity capital. Accumulated deficit accounts may be eliminated against invested capital accounts through formal action approved by stockholders, which establishes a new base line of accountability.

As already indicated under Principle B-4, accounting for the payment of a dividend in stock requires an appropriate transfer from retained earnings to invested capital accounts in excess of par or stated value when the fair market values is in excess of such amounts. Transfers may also be made from retained earnings to invested capital accounts, as stated in the first sentence of the above principle,
when formal corporate action has been taken without any change in the number of shares outstanding. Such action may or may not be accompanied by a change in the par or stated value of the common stock, and it does not involve reconsideration of the amounts at which assets are carried.

A somewhat reverse type of transfer, resulting in a decrease in invested capital accounts is set forth in the second sentence of Principle B-5. This involves the subject of accounting for quasi-reorganizations which is dealt with in ARB. No. 43, Chapter 7A, and in ARB No. 46. These two Bulletins are reproduced below.

**ARB No. 43**  
**Chapter 7**  
**Section A**  

**CAPITAL ACCOUNTS**  

*Quasi-Reorganization or Corporate Readjustment*

1. A rule was adopted by the Institute in 1934 which read as follows:

   Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.1

2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

**PROCEDURE IN READJUSTMENT**

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to
relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum probable losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and
should ordinarily not be prior to the close of the last completed fiscal year.

PROCEDURE AFTER READJUSTMENT

9. When the readjustment has been completed, the company’s accounting should be substantially similar to that appropriate for a new company.

10. After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

1 See chapter 1(a), paragraph 2.

ARB No 46 | DISCONTINUANCE OF DATING EARNED SURPLUS

1. Paragraph 10 of Chapter 7(a), Quasi-Reorganization or Corporate Readjustment, of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, reads as follows:

After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as
the effective date is no longer deemed to possess any special significance.

2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

The statement entitled “Discontinuance of Dating Earned Surplus” was adopted by the assenting votes of twenty members of the committee. One member, Mr. Keating, did not vote.

* * *

Plant accounts may be written down in a quasi-reorganization to more realistic amounts, with the result that depreciation charges in subsequent income statements are less than depreciation deducted for income tax purposes; such “tax benefit” is received by the reorganized company during the remaining life of the related plant. Similarly, when a company undergoing quasi-reorganization has suffered losses in the immediately preceding years, such losses may be availed of by the reorganized company to reduce taxable income in the immediately succeeding years.

Many accountants believe that when realization of such tax benefits by the reorganized company seems likely, they should be recognized at the date of reorganization by setting them up as deferred charges with subsequent charge to income of the tax benefits applicable to each year. Other accountants believe that tax benefits realized in any subsequent year should be reflected in income of that year. The preferable treatment is to exclude from income and retained earnings subsequent to reorganization any tax benefits arising from deductions or losses attributable to periods prior to reorganization. Similarly, any unforeseen gains or losses, applicable prior to reorganization, and their tax effects should be excluded.

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**Principle B-6**

The amount of any revaluation credits should be separately classified in the stockholders' equity section, and it is not available for any type of charge except on reversal of the revaluation.
CHAPTER 5: PRINCIPLE B-6

The committee on accounting procedure stated its position with respect to basing depreciation charges on higher appraisal amounts rather than on cost; the committee did not express an opinion as to the ultimate disposition, if any, that is to be made of appraisal credits. It is believed the above principle sets forth the accepted view that appraisal surplus arising from revaluation of plant and equipment held for permanent use, rather than sale, should be viewed as permanent capital and therefore not available for subsequent transfer to earned surplus as realized through depreciation; also, that it may not be used for purposes appropriate for investment capital in excess of par value, such as absorption of premiums on retired issues or transfers to capital under pooling arrangements. Such credits would, however, be disposed of upon reversal of the revaluation or in connection with a quasi-reorganization.

__________________________ Principle B-7 ____________________________

Disclose status of stock options to employees or others and changes therein during the period or periods covered.

The details of the terms and shares covered by all options on capital stock obviously are of significance to stockholders. Stock options granted to officers and employees are of particular interest because there may be an element of compensation involved. The matter of disclosure and measurement of compensation, if any, under stock purchase plans is covered in ARB No. 43, Chapter 13B, reproduced below.

ARB No. 43
Chapter 13
Section B

COMPENSATION

Compensation Involved In Stock Option and Stock Purchase Plans

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the cor-
poration's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.¹

2. For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also.

RIGHTS INVOLVING COMPENSATION

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

RIGHTS NOT INVOLVING COMPENSATION

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.

5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of
compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

CHAPTER 5: ARB NO. 43, CH. 13, SEC. B

TIME OF MEASUREMENT OF COMPENSATION

6. In the case of stock options involving compensation, the principal problem is the measurement of the compensation. This problem involves selection of the date as of which measurement of any element of compensation is to be made and the manner of measurement. The date as of which measurement is made is of critical importance since the fair value of the shares under option may vary materially in the often extended period during which the option is outstanding. There may be at least six dates to be considered for this purpose: (a) the date of the adoption of an option plan, (b) the date on which an option is granted to a specific individual, (c) the date on which the grantee has performed any conditions precedent to exercise of the option, (d) the date on which the grantee may first exercise the option, (e) the date on which the option is exercised by the grantee, and (f) the date on which the grantee disposes of the stock acquired.

7. Of the six dates mentioned two are not relevant to the question considered in this bulletin—cost to the corporation which is granting the option. The date of adoption of an option plan clearly has no relevance, inasmuch as the plan per se constitutes no more than a proposed course of action which is ineffective until options are granted thereunder. The date on which a grantee disposes of the shares acquired under an option is equally immaterial since this date will depend on the desires of the individual as a shareholder and bears no necessary relation to the services performed.²

8. The date on which the option is exercised has been advocated as the date on which a cost may be said to have been incurred. Use of this date is supported by the argument that only then will it be known whether or not the option will be exercised. However, beginning with the time at which the grantee may first exercise the option he is in effect speculating for his own account. His delay has no discernible relation to his status as an employee but reflects only his judgment as an investor.

9. The date on which the grantee may first exercise the option will generally coincide with, but in some cases may follow, the date on which the grantee will have performed any conditions precedent to exercise of the option. Accordingly this date presents no special
problems differing from those to be discussed in the next paragraph.

10. There remain to be considered the date on which an option is granted to a specific individual and the date on which the grantee has fulfilled any conditions precedent to exercise of the option. When compensation is paid in a form other than cash the amount of compensation is ordinarily determined by the fair value of the property which was agreed to be given in exchange for the services to be rendered. The time at which such fair value is to be determined may be subject to some difference of opinion but it appears that the date on which an option is granted to a specific individual would be the appropriate point at which to evaluate the cost to the employer, since it was the value at that date which the employer may be presumed to have had in mind. In most of the cases under discussion, moreover, the only important contingency involved is the continuance of the grantee in the employment of the corporation, a matter very largely within the control of the grantee and usually the main objective of the grantor. Under such circumstances it may be assumed that if the stock option were granted as a part of an employment contract, both parties had in mind a valuation of the option at the date of the contract; and accordingly, value at that date should be used as the amount to be accounted for as compensation. If the option were granted as a form of supplementary compensation otherwise than as an integral part of an employment contract, the grantor is nevertheless governed in determining the option price and the number of shares by conditions then existing. It follows that it is the value of the option at that time, rather than the grantee's ultimate gain or loss on the transaction, which for accounting purposes constitutes whatever compensation the grantor intends to pay. The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant.

11. The date of grant also represents the date on which the corporation foregoes the principal alternative use of the shares which it places subject to option, i.e., the sale of such shares at the then prevailing market price. Viewed in this light, the cost of utilizing the shares for purposes of the option plan can best be measured in relation to what could then have been obtained through sale of such shares in the open market. However, the fact that the grantor might, as events turned out, have obtained at some later date either more or less for the shares in question than at the date of the grant does not bear upon the measurement of the compensation which can be said to have been in contemplation of the parties at the date the option was granted.
MANNER OF MEASUREMENT

12. Freely exercisable option rights, even at prices above the current market price of the shares, have been traded in the public markets for many years, but there is no such objective means for measuring the value of an option which is not transferable and is subject to such other restrictions as are usually present in options of the nature here under discussion. Although there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value. As to the grantee any positive element may, for practical purposes, be deemed to be largely or wholly offset by the negative effect of the restrictions ordinarily present in options of the type under discussion. From the viewpoint of the grantor corporation no measurable cost can be said to have been incurred because it could not at the grant date have realized more than the fair value of the optioned shares, the concept of fair value as here used encompassing the possibility and prospect of future developments. On the other hand, it follows in the opinion of the committee that the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price below the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price.

13. While market quotations of shares are an important and often a principal factor in determining the fair value of shares, market quotations at a given date are not necessarily conclusive evidence. Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value of shares for the purpose of measuring the cost incurred by a corporation in the issuance of an option, it is appropriate to take into consideration such modifying factors as the range of quotations over a reasonable period and the fact that the corporation by selling shares pursuant to an option may avoid some or all of the expenses otherwise incurred in a sale of shares. The absence of a ready market, as in the case of shares of closely-held corporations, should also be taken into account and may require the use of other means of arriving at fair value than by reference to an occasional market quotation or sale of the security.

OTHER CONSIDERATIONS

14. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the
offer or agreement, the value of the option should be apportioned over the period of service for which the payment of the compensation seems appropriate in the existing circumstances. Accrual of the compensation over the period selected should be made by means of charges against the income account. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

One member of the committee, Mr. Mason, assented with qualification to adoption of section (b) of chapter 13. One member, Mr. Knight, did not vote.

Mr. Mason assents only under the assumption that if an option lapses after the grantee becomes entitled to exercise it, the related compensation shall be treated as a contribution by the grantee to the capital of the grantor.

1 Bulletin 37, “Accounting for Compensation in the Form of Stock Options,” was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, the Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.

2 This is the date on which income or gain taxable to the grantee may arise under Section 130A. Use of this date for tax purposes is doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares.

3 Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value.
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Objective C

Account for the assets invested in the enterprise by stockholders (through property contributed or retained earnings) and creditors, in a meaningful manner, so that when considered with the liabilities and equity capital of stockholders there will be a fair presentation of the financial position of the enterprise both at the beginning and end of the period. It should be understood that financial position or balance sheet statements do not purport to show either present values of assets to the enterprise or values which might be realized in liquidation.

The foregoing expresses the broad objective for dealing with assets in the accounts and financial statements. The means of accomplishing the objective are set forth in numbered principles taken from the summary of generally accepted accounting principles. Before discussing these principles it is appropriate to present the following comments of the committee on terminology on the meaning of the terms balance sheet, assets and liabilities, and cost and value.
The terms balance sheet, assets, and liabilities are so closely related that the three can best be considered together. Indeed, the procedure is often adopted of first defining a balance sheet as a statement of assets and liabilities (or of assets, liabilities, and capital) and then undertaking the definition of assets and liabilities. This procedure, however, overlooks the fact that a balance sheet is historically a summary of balances prepared from books of account kept by double-entry methods, while a statement of assets and liabilities may be prepared for an organization for which no such books are kept; moreover, such a summary may fall short of being an adequate statement of assets and liabilities. Since balance sheet is a distinctly technical accounting term while assets and liabilities are less so, the committee feels that balance sheet should be defined with reference to the origin (that is, the origin in the accounts) of its constituent parts, and that the relation of assets and liabilities to the concept of the balance sheet should be considered subsequently.

In this view a balance sheet may be defined as:

A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept according to principles of accounting.

For purposes of contrast, the definition in the Century Dictionary (taken from Bouvier's Law Dictionary, 1934) is worthy of analysis. It reads as follows:

A statement made by merchants and others to show the true state of a particular business. A balance sheet should exhibit all the balances of debits and credits, also the value of the merchandise, and the result of the whole.

The use of the word true in the first sentence is regrettable since it adds nothing to the definition but suggests a possibility of certainty that does not exist. The second sentence recognizes the nature of the balance sheet as a statement of balances. From the reference to merchandise, one might infer that the definition originated in a day when the inventory was a figure introduced into the books only as a part of the final closing. The use here of the term value is characterized by the looseness noted in the discussion below of the meaning of that term when used in accounting.

The committee once said that the term balance sheet had too often
been construed in a mood of wishful thinking to describe what the
writer would like a balance sheet to be; perhaps the definition just
cited reflected such a mood. With the passing of time and with the
greater development and more widespread understanding of account-
ing principles, the committee now feels that commercial and industrial
usage has tended toward the reconciling of these two definitions so
that in those fields a balance sheet as contemplated in the first may
indeed be the statement of assets and liabilities which appears to be
contemplated in the second.

"Accounting analysis frequently requires that two accounts be car-
rried, with balances on opposite sides, in respect to the same thing
(e.g., a building account, and a building-depreciation account). In
the balance sheet, however, the net amount of such balances is usually
though not invariably shown.

"Those things which are reflected in the net debit balances that are
or would be properly carried forward are termed assets, and those
reflected in net credit balances, liabilities. Hence the expression state-
ment of assets and liabilities is frequently used as synonymous with
balance sheet, though as already pointed out not every statement of
assets and liabilities is a balance sheet.

"The word asset is not synonymous with or limited to property but
includes also that part of any cost or expense incurred which is properly
carried forward upon a closing of books at a given date. Consistently
with the definition of balance sheet previously suggested, the term
asset, as used in balance sheets, may be defined as follows:

Something represented by a debit balance that is or would be
properly carried forward upon a closing of books of account
according to the rules or principles of accounting (provided
such debit balance is not in effect a negative balance applicable
to a liability), on the basis that it represents either a property
right or value acquired, or an expenditure made which has
created a property right or is properly applicable to the future.
Thus, plant, accounts receivable, inventory, and a deferred
charge are all assets in balance-sheet classification.

The last named is not an asset in the popular sense, but if it may be
carried forward as a proper charge against future income, then in an
accounting sense, and particularly in a balance-sheet classification, it is
an asset.

"Similarly, in relation to a balance sheet, liability may be defined as
follows:
Something represented by a credit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock and related or similar elements of proprietorship are balance-sheet liabilities in that they represent balances to be accounted for, though these are not liabilities in the ordinary sense of debts owed to legal creditors.

Consideration of the facts noted in the last sentence of this definition has led some accountants to the view that the aggregate of liabilities as contemplated in this definition should be referred to as the aggregate of liabilities and capital, and that the balance sheet consists of an asset section, a liability section, and a proprietary or capital section, with the monetary amounts represented by the first shown as equal to the sum of those represented by the other two. The committee feels that there is no inconsistency between this view and the suggested definition.

COST

"Cost is the amount, measured in money, or cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received. Costs can be classified as unexpired or expired. Unexpired costs (assets) are those which are applicable to the production of future revenues. Examples of such unexpired costs are inventories, prepaid expenses, plant, investments, and deferred charges. Expired costs are those which are not applicable to the production of future revenues, and for that reason are treated as deductions from current revenues or are charged against retained earnings. Examples of such expired costs are costs of products or other assets sold or disposed of, and current expenses. Unexpired costs may be transferred from one classification to another before becoming expired costs as above defined, e.g., depreciation or insurance on plant may be included in unexpired costs ascribed to inventories.

"The term cost should be used when appropriate in describing the basis of assets as displayed in balance sheets, and properly should
be used in income statements to describe such items as cost of goods sold, or costs of other properties or investments sold or abandoned.”

VALUE AND ITS DERIVATIVES

“Value is a word of many meanings. Just as beauty is said to lie in the eye of the beholder, so worth may lie in the mind of the appraiser. There is often no unique standard of worth which is both realistic and objectively applicable. The fact that there are different criteria of worth is strikingly illustrated in Supreme Court decisions which have applied different methods of determining value in connection with the regulation, taxation, and reorganization, respectively, of railroads. But apart from the difficulty of measuring value when the word is used to connote worth, it is evident that in the literature of business, economics, and accounting, value is used in varying significances, not all of which have any definite connotation of worth. The word is commonly employed in accounting to describe the figure at which an asset or liability is carried in the accounts, even though the amount may be determined by a process which is not one of valuation in any ordinary sense.

“Since accounting is predominantly based on cost, the proper uses of the word value in accounting are largely restricted to the statement of items at cost, or at modifications of cost. In accounting, the term market value is used in senses differing somewhat from those attaching to the expression in law. As applied to securities, it means a sum computed on the assumption that value is measurable by market quotations; as applied to inventories, it is compiled from a variety of considerations, including market quotations, cost of replacement, and probable sales price. In the case of so-called fixed assets the value shown in accounts is the balance of their cost (actual or modified) after deducting recorded depreciation. Thus the following definition would seem to be appropriate:

Value as used in accounts signifies the amount at which an item is stated, in accordance with the accounting principles related to that item. Using the word value in this sense, it may be said that balance-sheet values generally represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

“The word value should seldom if ever be used in accounting statements without a qualifying adjective.”
BOOK VALUE

"The term book value is one of several widely used expressions in which the word value appears with a particular qualifying adjective to denote a particular concept of value. Book value is to be distinguished from such terms as fair or market value or liquidating value, in that it refers to amounts reflected on accounting records and in financial statements.

"The term book value is seldom if ever used in the body of financial statements, either as an indication of the basis of stating an item therein or in connection with owners' equities. To do so would involve a pointless truism and such use is therefore not recommended.

Individual items

"In Accounting Terminology Bulletin No. 1, the term value is defined as follows:

Value as used in accounts signifies the amount at which an item is stated, in accordance with the accounting principles related to that item. Using the word value in this sense, it may be said that balance-sheet values generally represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

"This use of the word value does not involve the concept of current worth, but rather refers to a particular method of quantitative determination.

"The following slight rephrasing of the first sentence of the definition quoted in paragraph 3 above gives the clue to the meaning which some have adopted for book value as applied to individual items in books of account or in financial statements:

Book value signifies the amount at which an item is stated in accordance with the accounting principles related to the item.

"Thus one might refer to the "book value" or "net book value" of fixed assets, or the "book value of investments." More specific terms, however, can be used in describing the kind of value at which individual items are stated; as, for example, cost less depreciation, lower of cost or current replacement cost, or lower of cost or selling price. Similarly the term ledger balance or a term such as the amount shown in published financial statements would more clearly and accurately con-
vey an exact meaning. The committee believes that any reference to a quantitative determination of a specific item can be more clearly and specifically described by terms other than the general and relatively vague term *book value*.

"Recommendation:* The committee recommends that the use of the term *book value* in referring to amounts at which individual items are stated in books of account or in financial statements, be avoided, and that, instead, the basis of amounts intended to apply to individual items be described specifically and precisely.

*Owners' equity*

"The committee recognizes that the term *book value* is also used in various business arrangements such as partnership agreements, contracts for sale of a business interest, and wills and trusts. For example, partnership agreements sometimes contain a provision that a deceased partner's interest may be acquired by surviving partners for an amount which is based at least in part on the "book value" of the interest. Contracts for the sale of going business concerns sometimes specify a price based on the "book value" of either the capital stock or the net assets. When used in such documents, the meaning to be ascribed to the term is a question of legal interpretation of the document and appears to depend primarily on the intent of the contracting or other parties rather than on any accounting definition of such term. While such uses of the term are common, they have given rise to misunderstandings and can easily develop into controversies when the intention of the parties is not clear. One typical difficulty arises when there is a change in circumstances between the time when an agreement regarding "book value" was reached and the time when that agreement must be interpreted. For example, a change from the Fifo to Lifo inventory basis between those two dates would affect the equities involved. Similar situations would arise with respect to any changes in accounting policies or from business combinations, divisive reorganizations, and other comparable events. Even in the absence of such changes, questions arise as to whether "book value" was intended to mean literally amounts shown on ledger accounts or amounts so shown after correction for (a) errors, (b) departures from consistently maintained practices of the enterprise, (c) departures from established practices of the type of organization, or (d) departures from generally accepted accounting principles, or any combination of such corrections.

"When the intent of the parties is not clear as to the use of the term
book value in reference to owners' equity, the committee suggests the following definition:

*Book value* is the amount shown on accounting records or related financial statements at or as of the date when the determination is made, after adjustments necessary to reflect (1) corrections of errors, and (2) the application of accounting practices which have been consistently followed.

"Recommendation: In view of the fact that the intent of the parties to arrangements involving sale or transfer of business interests should govern, and the foregoing definition may not reflect such intent, the committee recommends that the term book value be avoided. Instead of this term it is recommended that any agreement involving the general concept of book value should contain a clearly defined understanding in specific and detailed terms, particularly as to such matters as are referred to under 'owners' equity' (see page 231)."

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**Principle C-1**

Items classified as current assets should be carried at not more than is reasonably expected to be realized within one year or within the normal operating cycle of the particular business. Cash should be segregated between unrestricted and restricted items, and the inclusion of the latter in current assets must be justified by their nature. Receivables should be reduced by allowance accounts to cover expected collection or other losses. Receivables from officers, employees, or affiliated companies should be shown separately. Inventories should be carried at cost or market, whichever the lower. Cost comprises direct costs plus factory overhead costs, and the basis of determination (e.g., Lifo, Fifo or average) should be stated. Prepaid items should be properly chargeable to future periods.

**Working Capital**

It will be noted that the above principle is a composite of the accepted rules for dealing with the classification and determination of amounts at which current assets should be carried in the accounts and
financial statements. The close association and interrelationship of stockholders' equity, assets and liabilities have been recognized in the Objectives B, C, and D of the summary of generally accepted accounting principles as well as in the definitions of terms by the committee on terminology presented in the immediately preceding pages. In the same vein, there is a highly meaningful relationship between current assets and current liabilities because the difference between them represents the working capital of the enterprise. This subject is dealt with in Chapter 3A of ARB No. 43 which is reproduced below.

ARB No. 43
Chapter 3
Section A

WORKING CAPITAL
Current Assets and Current Liabilities

1. The working capital of a borrower has always been of prime interest to grantors of credit; and bond indentures, credit agreements, and preferred stock agreements commonly contain provisions restricting corporate actions which would effect a reduction or impairment of working capital. Many such contracts forego precise or uniform definitions and merely provide that current assets and current liabilities shall be determined in accordance with generally accepted accounting principles. Considerable variation and inconsistency exist, however, with respect to their classification and display in financial statements. In this section the committee discusses the nature of current assets and current liabilities with a view toward a more useful presentation thereof in financial statements.

2. The committee believes that, in the past, definitions of current assets have tended to be overly concerned with whether the assets may be immediately realizable. The discussion which follows takes cognizance of the tendency for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtor's ability to pay in case of liquidation. It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business. Accordingly, the views expressed in this section represent a departure from any narrow definition or strict one year interpretation
of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business.

3. Financial position, as it is reflected by the records and accounts from which the statement is prepared, is revealed in a presentation of the assets and liabilities of the enterprise. In the statements of manufacturing, trading, and service enterprises these assets and liabilities are generally classified and segregated; if they are classified logically, summations or totals of the current or circulating or working assets, hereinafter referred to as current assets, and of obligations currently payable, designated as current liabilities, will permit the ready determination of working capital. Working capital, sometimes called net working capital, is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business. If the conventions of accounting relative to the identification and presentation of current assets and current liabilities are made logical and consistent, the amounts, bases of valuation, and composition of such assets and liabilities and their relation to the total assets or capital employed will provide valuable data for credit and management purposes and afford a sound basis for comparisons from year to year. It is recognized that there may be exceptions, in special cases, to certain of the inclusions and exclusions as set forth in this section. When such exceptions occur they should be accorded the treatment merited in the particular circumstances under the general principles outlined herein.

4. For accounting purposes, the term current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash; (b) inventories of merchandise, raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts; (c) trade accounts, notes, and acceptances receivable; (d) receivables from officers, employees, affiliates, and others, if collectible in the ordinary course of business within a year; (e) installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business; (f) marketable securities representing the investment of cash available for current op-
erations; and (g) prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies. Prepaid expenses are not current assets in the sense that they will be converted into cash but in the sense that, if not paid in advance, they would require the use of current assets during the operating cycle.

5. The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an operating cycle. A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year. However, where the period of the operating cycle is more than twelve months, as in, for instance, the tobacco, distillery, and lumber businesses, the longer period should be used. Where a particular business has no clearly defined operating cycle, the one-year rule should govern.

6. This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts; (b) investments in securities (whether marketable or not) or advances which have been made for the purposes of control, affiliation, or other continuing business advantage; (c) receivables arising from unusual transactions (such as the sale of capital assets, or loans or advances to affiliates, officers, or employees) which are not expected to be collected within twelve months; (d) cash surrender value of life insurance policies; (e) land and other natural resources; (f) depreciable assets; and (g) long-term prepayments which are fairly chargeable to the operations of several years, or deferred charges such as unamortized debt discount and expense, bonus payments under a long-term lease, costs of rearrangement of factory layout or removal to a new location, and certain types of research and development costs.
7. The term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons.

8. This concept of current liabilities would include estimated or accrued amounts which are expected to be required to cover expenditures within the year for known obligations (a) the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The current liability classification, however, is not intended to include a contractual obligation falling due at an early date which is expected to be refunded, or debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long periods. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as for example by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property obligations, the portion of the total obligation to be included as a current liability should be that representing the amount accrued at the balance-sheet date.

9. The amounts at which various current assets are carried do
not always represent their present realizable cash values. Accounts receivable net of allowances for uncollectible accounts, and for unearned discounts where unearned discounts are considered, are effectively stated at the amount of cash estimated as realizable. However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value. The basis for carrying inventories is stated in chapter 4. It is important that the amounts at which current assets are stated be supplemented by information which reveals, for temporary investments, their market value at the balance-sheet date, and for the various classifications of inventory items, the basis upon which their amounts are stated and, where practicable, indication of the method of determining the cost—e.g., average cost, first-in first-out, last-in first-out, etc.

One member of the committee, Mr. Mason, assented with qualification to adoption of section (a) of chapter 3.

Mr. Mason does not accept the view implied in paragraph 6 that unamortized debt discount is an asset. Also, referring to paragraph 9, he believes that the market value is the most significant figure in connection with marketable securities held as temporary investments of cash, and would prefer to show such securities in the accounts at their market value, whether greater or less than cost. He would accept as an alternative the use of cost in the accounts with market value shown parenthetically in the balance sheet.

1 Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes should also, under this concept, be excluded from current assets. However, where such funds are considered to offset maturing debt which has properly been set up as a current liability, they may be included within the current asset classification.

2 Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which will normally be liquidated in the ordinary course of business by the delivery of services. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of the latter
are the issuance of a long-term warranty or the advance receipt by a lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement.

3 Loans accompanied by pledge of life insurance policies would be classified as current liabilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance company with the intent that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation should be excluded from current liabilities.

4 There should, however, be full disclosure that such obligation has been omitted from the current liabilities and a statement of the reason for such omission should be given. Cf note 1.

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Cash

This caption on a balance sheet should include only cash on hand and demand deposits in banks at the close of business on the balance-sheet date.

The practice of including cash received after the close of the period and reducing accounts receivable correspondingly is not in accordance with the foregoing rule although it has been defended on the ground that such receipts were forwarded by debtors before the close of the period and represented cash in transit. Checks drawn prior to the balance-sheet date, but held for later delivery to creditors, and checks drawn after, but dated prior to, the balance-sheet date should not be treated as outstanding checks; they should be restored to the cash balance and to liabilities. These considerations are important when provisions of bond indentures, loan agreements, or preferred stock issues require that certain current ratios be maintained.

Checks should not be listed as outstanding on bank reconciliations indefinitely. A sound practice is to stop payment after a year has elapsed, return the amounts to cash, and credit a liability account. The liability account should be debited and income credited after the applicable statute of limitations has run out, unless state laws provide for other disposition. Dividend checks may require special treatment, for the laws of some states make a distinction between the
liability for uncashed dividend checks and for other uncashed checks.
Cash on a balance sheet is presumed to represent cash on hand or deposits in banks immediately available for any purpose. Cash balances which are restricted as to availability or purpose, when material, should be shown separately and properly described; they may be included in current assets or excluded therefrom, according to their nature.

** Marketable Securities**

An enterprise invests in marketable securities in order to employ profitably otherwise idle funds. The usefulness of the investment will be measured by the dividends and interest received over the life of the investment and the gains or losses when the securities are sold.

The cost of the investment should include not only the amount paid to the seller but also all incidental expenses of the purchase, such as brokerage commissions and sales taxes. Sometimes securities are acquired in exchange for other securities as the result of a consolidation, merger, or other reorganization of the company in which an investment is held, or as the result of the exercise of conversion privileges contained in the terms under which a security was issued; cost in this instance is considered to be the cost of the security delivered in exchange, adjusted for any cash paid or received in effecting the exchange. Exchanges other than these are usually tantamount to purchases and sales, and cost of the security received, therefore, should be considered the equivalent of its fair market value at the time of receipt.

There are two methods in general use for costing sales of part of an issue held; first-in first-out, and average cost. Cost of the specific certificates delivered is sometimes used; in such instances care must be exercised that the method does not produce erratic results.

If the cost of the investment apparently cannot be recovered if sold in the current market, a part of its usefulness to the enterprise has been impaired. Under these conditions it is customary to revalue the cost to only that portion that could be recovered. Evidence of a permanent market decline should be present, since temporary fluctuations are common for many securities.

Marketable securities are usually purchased with the intention to sell them within a short period of time. Their market value should therefore be disclosed so that the reader can estimate the amount that may be realized from their sale.
CHAPTER 6: ASSETS (SECTION C OF SUMMARY)

Receivables

Trade accounts and notes. Separate description and identification may be appropriate for various kinds of trade receivables, such as notes and acceptances, installment accounts, accounts pledged as collateral, accounts past due, and notes discounted. Notes and acceptances receivable arising in the ordinary course of business are frequently shown in combination with accounts receivable under a common designation, such as notes and accounts receivable. Significant amounts of trade installment notes or receivables should be stated separately. Interest accrued on notes receivable may be included with the face amount of the notes, provided the caption so indicates.

Credit balances in accounts receivable that are not direct offsets to debit balances should, if material, be classified as liabilities. Similarly, debit balances in accounts payable that are not direct offsets to credit balances should be segregated for classification in the balance sheet as accounts receivable.

Receivables under government contracts will require special presentation and disclosure. This subject is covered in ARB No. 43, Chapter 11, reproduced under Chapter 4, Principle A-1 of this Inventory.

Nontrade receivables. Nontrade receivables have a different collectibility problem than trade receivables and should, if significant, be classified separately from them. If nontrade receivables are not significant individually, they may be grouped together in one amount described as, for example, “accounts receivable, other.” If they are significant individually, they should be classified into suitable categories. It is particularly important that receivables from officers, employees, or affiliated companies be shown separately. The authorization and terms of collection require particular consideration in determining whether they are properly classed as current assets. The following rule was adopted by the entire membership of the AICPA in 1934 (ARB No. 43, Chapter 1A):

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

Estimated unrealizable amounts. Since computations of unrealizable amounts of accounts receivable are estimates, the reader should be informed of the gross amount of receivables. This may be done by
including the total amount billed in the balance sheet and subtracting
the estimated unrealizable allowance. Alternatively, either the total
amount billed or the estimated unrealizable amount (or both) may be
shown parenthetically. The estimates of unrealizable amounts may be
either combined into one amount or classified into separate categories
for amounts uncollectible because of default, cash discounts, returns
and allowances, etc.

Carrying or interest charges on installment accounts receivable that
have been deferred as unearned are also classified as a deduction from
the receivables, even though they do not actually represent unreal­
izable amounts. The deduction is made either directly from the install­
ment accounts or from the total of the receivables.

Inventories

Components of inventories. Inventories usually include only items
of tangible personal property which will be sold or will enter into the
production of items to be sold currently in the ordinary course of
business. Inventories generally consist of finished stock (goods await­
ing sale), work in process (goods being produced), and raw materials
and supplies (goods which are to enter directly or indirectly into the
production of finished goods).

The question of inventory inclusions and exclusions can usually be
decided without difficulty on the basis of the above definition. Ob­
viously, the nature of the business determines the designation of an
item as inventory; for example, real estate held for sale might well be
inventory to a real estate dealer or a building contractor, but would
rarely be inventory to a manufacturer. Manufacturing and maintenance
supplies are properly includable in inventory, as are spare parts for
machinery which are chargeable to expense when used. In certain
manufacturing businesses, the dividing line between inventories and
short-lived plant equipment is very fine; although expenditures for
tooling represent productive facilities, they may be consumed or
become obsolete in a short time. In practice, assets of this nature may
also be included in fixed assets or deferred charges. Supplies which are
ultimately chargeable to selling, general, and administrative expenses,
if inventoried at all, are classified preferably as deferred charges.

Public utility companies usually are engaged in continuous programs
of construction and maintenance and the same inventory items are
frequently used for both purposes. While the classification of the con­
struction portion as a current inventory item may appear to be a viola-
tion of the principle set forth above, segregation is usually not feasible and probably not essential for the average public utility, and the only practical solution is disclosure. Certain manufacturing companies may have a similar problem.

The term "current" means a period of one year or the normal inventory turnover period (the average period of time between the acquisition of inventories and their sale in the ordinary course of business), whichever is greater. Thus, the accumulation of a substantial inventory of items in quantities greater than can be sold within one year, when the inventory turnover period is one year or less, ordinarily calls for segregation of a portion as a noncurrent asset. It should be borne in mind, however, that almost every inventory contains items or groups of items which have a slower turnover period than the inventory as a whole and, if not impaired in value, they may be considered to be a current asset. Spare parts of special sizes are frequently made up in quantities sufficient for several years' sales in order to achieve manufacturing economies; sometimes these inventories are priced at less than cost.

Thus, in considering an inventory when the indications are that a portion will not be sold within a reasonable period of time, the accountant is primarily concerned with determining whether the slow-moving portion is properly valued; mere segregation of slow-moving inventory is not adequate treatment.

Considerations of title. Legal title to inventories, as to other assets on the balance sheet, may be the line of demarcation followed in determining the inclusion of specific items. This rule should not be followed blindly; it has its limitations as a satisfactory basis for settling doubtful cases and, under certain circumstances, may be disregarded. Customarily, purchases in transit are included in inventory and sales in transit are excluded, regardless of the status of title, although purchases in transit shipped F.O.B. the purchaser's plant may properly be excluded from inventory. For accounting purposes, the treatment should be consistent between periods.

Following are examples of items that should be included in inventories, following the rule of legal title:

Goods in transit (shipped F.O.B. the vendor's shipping point on or prior to the balance-sheet date) should be in the purchaser's inventory.

Consignments out (in the hands of the consignee) should be in the consignor's inventory.
Bailments (in the hands of the bailee) should be in the bailor's inventory.

Goods out on approval (in the hands of the prospective customer) should be in the seller's inventory.

Protective title to C.O.D. and certain types of export shipments remains with the seller until payment is made; the seller of goods on the installment basis may also retain protective title. Shipments under these arrangements are customarily accounted for as sales by the seller before payment is made and title passes. The important consideration is not one of title, but whether the receivable is collectible.

Valuation or costing of inventories. The subject of accounting for inventory costs is treated in Chapter 4 of ARB No. 43, which is reproduced below. The discussion of the assumptions as to flow of cost factors (paragraph 6) are quite brief and are amplified somewhat in the two following paragraphs regarding different Lifo methods and the base stock method.

The last-in first-out method, if applied literally, would result in unreasonable procedural costs for many enterprises. Several simplified procedures have been developed, however, including "unit basis Lifo," "dollar value Lifo," and "retail Lifo" (a "dollar value" method used in conjunction with the retail method of arriving at cost). These methods have in common the use of averages or index numbers to simplify the computation of the inventory amount.

An inventory valuation method which is not allowable for Federal income tax purposes but is an accepted accounting practice is the normal or base stock method. Under this method a basic normal inventory that is considered necessary at all times for normal operations is fixed as to quantity and price. This base stock is not increased unless there is an increase in plant capacity or a change in process which requires an increase in available basic inventory. Increases in inventory above the base stock are priced under one of the conventional cost bases or at market if market is lower than cost. If quantities are reduced below those considered to be normal, a provision is made for replacement of the base stock used in the amount of the difference between the fixed price and the current cost of those items. When the items are replaced, the fixed price is charged to the base stock and the difference between the fixed price and the amount paid is charged against the provision to the extent applicable.
1. Whenever the operation of a business includes the ownership of a stock of goods, it is necessary for adequate financial accounting purposes that inventories be properly compiled periodically and recorded in the accounts. Such inventories are required both for the statement of financial position and for the periodic measurement of income.

2. This chapter sets forth the general principles applicable to the pricing of inventories of mercantile and manufacturing enterprises. Its conclusions are not directed to or necessarily applicable to non-commercial businesses or to regulated utilities.

STATEMENT 1

The term *inventory* is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Discussion

3. The term *inventory* embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of companies such as oil producers are usually treated as inventory.

STATEMENT 2

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.
Discussion

4. An inventory has financial significance because revenues may be obtained from its sale, or from the sale of the goods or services in whose production it is used. Normally such revenues arise in a continuous repetitive process or cycle of operations by which goods are acquired and sold, and further goods are acquired for additional sales. In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

STATEMENT 3

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

Discussion

5. In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost. The definition of cost as applied to inventories is understood to mean acquisition and production cost, and its determination involves many problems. Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges. For example, under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost. Also, general and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges). Selling expenses constitute no part of inventory costs. It should also be recognized that
the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

**STATEMENT 4**

Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in first-out, average, and last-in first-out); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.

**Discussion**

6. The cost to be matched against revenue from a sale may not be the identified cost of the specific item which is sold, especially in cases in which similar goods are purchased at different times and at different prices. While in some lines of business specific lots are clearly identified from the time of purchase through the time of sale and are costed on this basis, ordinarily the identity of goods is lost between the time of acquisition and the time of sale. In any event, if the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the development of general acceptance of several assumptions with respect to the flow of cost factors (such as first-in first-out, average, and last-in first-out) to provide practical bases for the measurement of periodic income. In some situations a reversed mark-up procedure of inventory pricing, such as the retail inventory method, may be both practical and appropriate. The business operations in some cases may be such as to make it desirable to apply one of the acceptable methods of determining cost to one portion of the inventory or components thereof and another of the acceptable methods to other portions of the inventory.

7. Although selection of the method should be made on the basis of the individual circumstances, it is obvious that financial statements will be more useful if uniform methods of inventory pricing are adopted by all companies within a given industry.

**STATEMENT 5**

A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their
disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market.

Discussion

8. Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances cost may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at cost or market, whichever is lower. This provides a practical means of measuring utility and thereby determining the amount of the loss to be recognized and accounted for in the current period.

STATEMENT 6

As used in the phrase lower of cost or market⁴ the term market means current replacement cost (by purchase or by reproduction, as the case may be) except that:
(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and
(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Discussion

9. The rule of cost or market, whichever is lower is intended to provide a means of measuring the residual usefulness of an inventory expenditure. The term market is therefore to be interpreted as indicating utility on the inventory date and may be thought of in terms of the equivalent expenditure which would have to be made in the ordinary course at that date to procure corresponding utility. As a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction. In applying the rule, however, judgment must always be exercised and no
loss should be recognized unless the evidence indicates clearly that a loss has been sustained. There are therefore exceptions to such a standard. Replacement or reproduction prices would not be appropriate as a measure of utility when the estimated sales value, reduced by the costs of completion and disposal, is lower, in which case the realizable value so determined more appropriately measures utility. Furthermore, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower. This might be true, for example, in the case of production under firm sales contracts at fixed prices, or when a reasonable volume of future orders is assured at stable selling prices.

10. Because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule. It should be applied realistically in the light of the objectives expressed in this chapter and with due regard to the form, content, and composition of the inventory. The committee considers, for example, that the retail inventory method, if adequate markdowns are currently taken, accomplishes the objectives described herein. It also recognizes that, if a business is expected to lose money for a sustained period, the inventory should not be written down to offset a loss inherent in the subsequent operations.

STATEMENT 7

Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

Discussion

11. The purpose of reducing inventory to market is to reflect fairly the income of the period. The most common practice is to apply the lower of cost or market rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock — the inventory in its entirety — may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to market may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Simi-
larly, where more than one major product or operational category exists, the application of the cost or market, whichever is lower rule to the total of the items included in such major categories may result in the most useful determination of income.

12. When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of cost or market, whichever is lower may be applied directly to the totals of the entire inventory, rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year.

13. To the extent, however, that the stocks of particular materials or components are excessive in relation to others, the more widely recognized procedure of applying the lower of cost or market to the individual items constituting the excess should be followed. This would also apply in cases in which the items enter into the production of unrelated products or products having a material variation in the rate of turnover. Unless an effective method of classifying categories is practicable, the rule should be applied to each item in the inventory.

14. When substantial and unusual losses result from the application of this rule it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as cost of goods sold.

STATEMENT 8

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements; whenever a significant change is made therein, there should be disclosure of the nature of the change and, if material, the effect on income.

Discussion

15. While the basis of stating inventories does not affect the over-all gain or loss on the ultimate disposition of inventory items, any inconsistency in the selection or employment of a basis may improperly affect the periodic amounts of income or loss. Because of the common use and importance of periodic statements, a procedure adopted for the treatment of inventory items should be consistently applied in order that the results reported may be fairly allocated as between years. A change of such basis may have an important effect upon the interpretation of
the financial statements both before and after that change, and hence, in the event of a change, a full disclosure of its nature and of its effect, if material, upon income should be made.

STATEMENT 9

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

Discussion

16. It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

STATEMENT 10

Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement.

Discussion

17. The recognition in a current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancellable, and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and, if material, should be recognized in the accounts and separately disclosed in the income statement. The utility
of such commitments is not impaired, and hence there is no loss, when the amounts to be realized from the disposition of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

One member of the committee, Mr. Wellington, assented with qualification, and two members, Messrs. Mason and Peloubet, dissented to adoption of chapter 4.

Mr. Wellington objects to footnote (2) to statement 3. He believes that an exception should be made for goods costed on the last-in first-out (Lifo) basis. In the case of goods costed on all bases other than Lifo the reduced amount (market below cost) is cleared from the accounts through the regular accounting entries of the subsequent period, and if the market price rises to or above the original cost there will be an increased profit in the subsequent period. Accounts kept under the Lifo method should also show a similar increased profit in the subsequent period, which will be shown if the Lifo inventory is restored to its original cost. To do otherwise, as required by footnote (2), is to carry the Lifo inventory, not at the lower of cost or current market, but at the lowest market ever known since the Lifo method was adopted by the company.

Mr. Mason dissents from this chapter because of its acceptance of the inconsistencies inherent in cost or market whichever is lower. In his opinion a drop in selling price below cost is no more of a realized loss than a rise above cost is a realized gain under a consistent criterion of realization.

Mr. Peloubet believes it is ordinarily preferable to carry inventory at not less than recoverable cost, and particularly in the case of manufactured or partially manufactured goods which can be sold only in finished form. He recognizes that application of the cost or market valuation basis necessitates the shifting of income from one period to another, but objects to unnecessarily accentuating this shift by the use, even limited as it is in this chapter, of reproduction or replacement cost as market when such cost is less than net selling price.

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1 Prudent reliance upon perpetual inventory records is not precluded.
2 In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.
3 Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance-sheet date standard costs
reasonably approximate costs computed under one of the recognized bases. In such cases descriptive language should be used which will express this relationship, as, for instance, "approximate costs determined on the first-in first-out basis," or, if it is desired to mention standard costs, "at standard costs, approximating average costs."

4 The terms cost or market, whichever is lower and lower of cost or market are used synonymously in general practice and in this chapter. The committee does not express any preference for either of the two alternatives.

**Prepaid Expenses and Deferred Charges**

Prepaid expenses and deferred charges are similar to inventory in that they represent costs awaiting assignment to future revenues. The problem of assuming an order of cost flows is not as complicated, however, since the future benefit is generally in the form of services rather than physically divisible units. An allocation of an equal amount to each period of time benefiting is probably the most common method, but units of production and sales are also used.

When the benefits to be derived cannot be related to specific periods or to production or sales, it is not usual to defer any part of these costs, even though future periods may benefit to some extent. Accepted accounting practice requires that if these costs are deferred at all, they should be written off as rapidly as may be reasonable in the circumstances, usually in equal though arbitrarily computed installments.

The services inherent in prepaid expenses and deferred charges often extend over more than one operating cycle. Part of their unexpired cost should then be classified as noncurrent on the balance sheet. The preceding discussion applies, however, to both current and noncurrent prepaid expenses and deferred charges.

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**Principle C-2**

*Fixed assets should be carried at cost of acquisition or construction in the historical accounts, unless such cost is no longer meaningful. Cost of land should ordinarily be shown separately. Cost of construction includes direct costs and overhead costs incurred, such as engineering, supervision and administration, interest, and taxes. Items treated as fixed assets should have at least one year of ex-
pected useful life to the enterprise, and normally the life is considerably longer. Practicable yardsticks or criteria should be established in order that consistent distinctions may be made between fixed assets, operating expenses and maintenance. Ordinarily, this should be accomplished by creating a catalogue of property units to be included in fixed assets, any lesser items to be charged to current expense. Items no longer in service should be removed by charge to depreciation reserve or expense in order that fixed assets will represent the cost of properties in service.

Those tangible assets used in operations and not intended for sale in the ordinary course of business are classified on the balance sheet as fixed assets provided they have an expected service life of more than one year. No one designation of this category has been accepted, and captions such as "fixed assets," "property, plant, and equipment," "general property," "properties," and numerous others are found in published financial statements. Depreciable and nondepreciable property ordinarily should be shown separately, and a further classification is often given.

**Property Stated on Cost Basis**

It has long been an accepted practice in financial position presentation that, unless there is a notation to the contrary, the reader may assume that property, plant, and equipment is carried at cost less allowance for depreciation. Cost means cost in cash or its equivalent. Preferably, the words "at cost" are appended to the principal plant caption to avoid any possibility of misunderstanding.

Although cost is the accepted basis of reporting property, plant, and equipment, there are situations in which cost is no longer meaningful. By carrying plant at cost, less accumulated depreciation, there is a representation that the remaining balance of the investment is properly chargeable to future operations and has a fair chance to be recovered. If this assumption appears no longer valid with respect to material items, it may be prudent to recognize the loss by reducing the book value to the estimated remaining useful cost to the enterprise. This refers to adjustments for particular items rather than a general revaluation such as corporations going through reorganization or quasi-reorganization. The subject of quasi-reorganizations is discussed under Principle B-5 of Chapter 5 of this Inventory.
Components of Cost

The cost of properties acquired by purchase is the net price paid on a cash basis, plus all incidental payments necessary to put the asset in condition and location for use, such as freight and installation costs. When several assets are acquired at a group price, the price paid is allocated between the assets based on their relative value, as determined by such evidence as independent appraisal by professional appraisers or real estate brokers, or assessed valuations for property tax purposes.

If property other than cash is the consideration in a transaction, a fair measure of the actual cash cost is the amount of money which would have been realized if such property had first been directly converted into cash. If the property has no determinable fair market value, the market value of the properties received in the exchange may be used. A gain or loss will occur when fair market value differs from the book value of the property given up. In practice, exchanges of fixed assets often are recorded at the book values of the properties given up.

If the consideration employed in acquiring properties is in the form of the capital stock of the buying enterprise, the par or stated value cannot be assumed to express actual cost. A fair measure of actual cost is the amount of money which could have been raised through the issue of the securities for cash. If the securities are of uncertain value, however, an alternative measurement would be the estimated fair market price of the property acquired.

Sometimes properties of unquestioned value are acquired by an enterprise without cost, or at a cost which is inadequate to express economic significance. A fair market value should be assigned to these properties, since recognition in the accounts of every facility employed by the enterprise is necessary to determine subsequent earnings properly. If stock has been issued, the credit for the excess value would be capital paid in in excess of par or stated value and, if stock is not involved, the credit would go to an appropriately titled paid-in capital account.

The principle of costing of self-constructed property, plant, and equipment is similar to the principle of costing of purchased assets of this type — they are recorded at the price paid to get them in condition and location for use. The practical problems involved in determining their cost are the same problems that are encountered in determining the cost of goods manufactured for resale. The direct costs of materials and labor are readily identified and charged to construction
work in process. Indirect or overhead costs may be specifically identifiable items as well as those allocated to construction in process on supportable cost-incurrence principles. Overhead costs include supervision, engineering and interest during construction. Enterprises which do not normally carry out their own construction usually follow the incremental cost method by limiting the overhead charged to construction to the increase which can be directly attributed to the work done on the plant and equipment. It is also the general practice of industrial companies, as distinguished from public utilities, to limit any interest capitalized to costs incurred on funds specifically borrowed for construction purposes.

Land and land rights. These asset accounts should include the purchase cost of land owned in fee and of rights, interest, and privileges held in land owned by others. The following incidental costs are also properly included, among others: commissions to agents, attorneys' fees, demolition, clearing and grading, streets, sewer lines, and relocating or reconstructing property of others elsewhere in order to acquire possession.

Buildings. A building is a relatively permanent structure designed to house or safeguard property or persons, and its total cost should include not only the cost of the shell, but also expenditures for service equipment and fixtures made a permanent part of the structure. In addition to direct costs of construction, it is proper to capitalize such items as permits, architects' and engineers' fees, legal fees, and overhead directly applicable to construction.

Machinery and equipment. It is important to include all costs of purchase or manufacture together with all costs of installation. The latter would include such costs as transportation, labor, and testing during an experimental period. If machines are purchased under an agreement providing for royalties to be paid on units of production, these royalty payments are not costs of acquisition and should be charged to operating expenses.

Criteria for Capitalization

The criteria of usefulness and length of life beyond one year are of importance in distinguishing between capital and expense items; but it is necessary for business enterprises to adopt more definite criteria to identify property units and minimum cost limits to be capitalized. Unit
property records are essential for an orderly system of property accounting. The criteria of capitalization are ordinarily reflected in a catalog of property units to be included in fixed assets; any item or component less than the units listed in the catalog to be charged to current expense. The units to be charged to current expense should include not only those whose expected life is less than one year, but also should include properly capitalizable units of lesser amount than the minimum set by enterprise policy.

The minimum capitalization amount should clearly not be so small that it serves no useful purpose. It should rather be set at an amount resulting in fair financial presentation achieved without unreasonable burden of procedural accounting cost to the enterprise. A particular amount may be appropriate for one enterprise, however, but not for another, if the two differ in size or type of operation. Each enterprise should set an amount that fits its own particular situation. It follows, of course, that the criteria adopted should be consistently followed.

**Accounting for Retirements**

The asset accounts for property, plant, and equipment should include the costs of only those units which are used and useful to the enterprise; the allowance for depreciation accounts should relate to those units, and to no others. Although these objectives are theoretically simple, they are in practice difficult to achieve.

In large part, deviance from these objectives is due to the lumping together of literally scores of heterogeneous items into large mass aggregates, such as buildings, leasehold improvements, and equipment. As a result, the plant accounts may soon lose any meaningful relationship to fixed assets in service. An orderly system of retirement accounting based on unit property records would appear essential in order to avoid this situation.

For enterprises that keep such detailed property records and compute depreciation on a unit-life basis, the accepted accounting treatment of retirements is well defined. At the time a unit of property is retired from service, its cost should be credited to the appropriate plant account, and the related accumulated depreciation should be charged to the allowance for depreciation account; any profit or loss, adjusted for salvage value and cost of removal and disposition, should be reported in the income statement or as a direct charge or credit to retained earnings, whichever is appropriate.
If a company computes depreciation on a composite rate basis, the cost of plant units retired in the normal course of business should also be credited to the appropriate property account; the same amount, plus cost of removal and less salvage value, is charged to the allowance for depreciation. No profit or loss is therefore recognized in the accounts, since the composite rate contemplates that items in the group will be retired both before and after expiration of the estimated average life. When retirements are abnormal or unusual, however, profits and losses should be recorded in the accounts, since composite rates do not anticipate such retirements.

Idle plant, reserve, and stand-by equipment. Plant assets on the balance sheet may include property in use and property held with reasonable expectation of its being used in the business. It is not customary to segregate or indicate the existence of temporarily idle plant, reserve, or standby equipment. Property abandoned but not physically retired and facilities still owned but no longer adapted for use in the business, if material in amount, should be removed from plant accounts and recorded separately at an estimated realizable amount, appropriately explained.

When a material portion of plant and equipment has been idle for a protracted period with no apparent likelihood of resuming operations, the amount should be set forth separately with an appropriate caption. Such idle plant facilities involve a continuing expense, and creditors, stockholders, and others interested should be apprised of the fact that property, plant, and equipment exceeds apparent reasonable needs.

Wasting Assets

Natural resources are products of the land. They are called “wasting assets” while in their natural state because they are physically exhausted through extraction and, except for timber, they are irreplaceable. When removed from the land these resources become articles of trade and are classified as inventory. Until removed, however, they are classed as fixed assets because there is generally no physical loss or deterioration with the passage of time while they remain in their natural state, and their complete exploitation may take many years.

The purchase of land containing valuable mineral deposits or other natural resource is a joint or group purchase; therefore, its cost should be allocated between the residual value of the land and the depletable
natural resource in the same manner that any group or joint acquisition is made.

Valuable natural resources are sometimes acquired with the purchase of land without their presence being known at that time. Even if the presence of the resource is known at the time of purchase, the extent of the deposit may not be ascertained until considerable development work has been completed. When the presence of a natural resource is discovered subsequent to acquisition of the property, or when the extent of the deposit is determined to be materially more extensive than previously assessed, it is accepted practice to reconsider previous allocations of aggregate cost.

The search for new resources is a continuing endeavor among companies that exploit wasting assets except in those cases in which the company does not plan to continue in business after present resources are exhausted. This endeavor necessitates large outlays for exploration, options, lease bonuses, advance royalties, abstract and recording fees, geological and geophysical staff expenses, and so forth. Even when the most advanced geological and geophysical technology is used to predict reserves, there is no assurance that resource deposits in paying quantities will be located, or that once located, the original estimates of the deposit will hold up. The uncertainty characteristic of extractive industries presents difficult problems of cost determination and allocation. It is accepted practice either to capitalize or expense the outlays mentioned above; but the majority practice is to capitalize the costs that are readily identifiable with the successful acquisition of specific resources in paying quantities and to expense the others.

Fixed Assets Carried at Appraisal Amounts

When plant assets are carried at appraised amounts, not cost, the balance sheet should clearly so indicate. It is good practice to indicate in the descriptive matter the fact that the appraisal was made by independent appraisers and the date and basis of the appraisal. The appraiser should be informed of the language proposed to be used and his approval or suggested modifications sought.

If the appraisal was made by the board of directors, by company engineers, or by other employees who may not be considered independent, that fact should be indicated clearly. If study of available data indicates that amounts recorded are not reasonable, the auditor should suitably qualify his report.
Principle C-3

Appropriate provision or allowances should be made in order to charge operations with the investment in depreciable assets over the estimated life thereof. The accumulated allowances, less property retirements, should be shown as a deduction from fixed assets.

Accumulated allowances for depreciation or depletion should be shown on the balance sheet either as deductions from the group of assets to which they relate, or as a deduction from the total of depreciable or depletable assets. Sometimes plant assets are shown after deducting the related allowances for depreciation or depletion; allowances should then be indicated parenthetically or in a footnote.

Ordinarily allowances for depreciation and depletion should not be shown on the liability side of the balance sheet. However, the uniform systems of accounts prescribed by some state regulatory commissions for use by certain public utilities provide for showing such reserves on the liability side of the balance sheet. Some utilities so reflect the reserves in their reports to the commissions and in their published reports to stockholders. The uniform system of accounts adopted by the Federal Power Commission contains similar provisions; however, that Commission's annual report forms require the reserves to be shown as deductions from the related assets. Similarly, Regulation S-X which prescribes the form and content of financial statements required to be filed with the Securities and Exchange Commission states in Rule 3-11 that "valuation and qualifying reserves shall be shown separately in the financial statements as deductions from the specific assets to which they apply." Further discussion of depreciation and depletion is presented under Principle A-3, Chapter 4, of this Inventory.

Principle C-4

Long-term investments in securities ordinarily should be carried at cost. When market quotations are available, the aggregate quoted amounts should be disclosed. Investments in affiliates should be segregated from other investments.
One of the noncurrent classifications applicable to assets is that of investments. Common investments owned by business enterprises include shares of stock, bonds, and other securities, mortgages and contracts receivable, life insurance policies on the lives of officers that designate the company as beneficiary, and special funds to finance plant expansion or to retire long-term debt. Temporary investments are classed as current assets; only long-term holdings of securities are classified as investments.

Investments in securities are usually recorded initially at cost which includes brokerage, taxes, and other charges directly applicable to the purchase. In the case of bonds and other interest-bearing instruments, amounts paid due to interest accrued are excluded from the investment account. Any difference between cost and maturity value of bonds, mortgages and notes is amortized over the life of the issue except where there is doubt as to the ultimate realization.

The value of investment securities is not normally affected by fluctuations in their market value. Adjustments to the initial valuation are normally made only when there is evidence of a permanent decline in value, such as default of bond interest or principal. When market quotations are available, the aggregate quoted amounts should be disclosed.

Life insurance policies on the lives of officers are carried at their cash surrender value. Special funds are carried at the amount of cash plus the cost of securities or other assets in the fund.

Land and equipment contracts receivable are valued at cost less subsequent principal receipts. Payments received (usually monthly) apply first to interest accrued to date, and the balance is applied against principal. A breakdown of the composition of level payments will show a decreasing portion applied to interest and an increasing portion applied to principal.

Investments in shares of stock of subsidiaries usually are carried at cost, reduced by amounts received as dividends paid from earnings prior to acquisition and by provision for losses after that date. They may also be carried at cost adjusted periodically to reflect increases through earnings in the underlying net assets of the subsidiaries. Where this is done, the undistributed earnings of subsidiaries should be identified in the accounts. Bonds, notes, long-term advances, and mortgages of subsidiaries and other affiliated companies should be recorded at cost unless circumstances, such as default of interest or principal, indicate the desirability of a write-down. In any event, investments in affiliates should be shown separately from other investments.
The costs of intangible items, such as debt discount and expense, patents, copyrights, research and development (if deferred) and goodwill should be shown separately. Limited-term items should be amortized against earnings over their estimated lives. The policy in regard to amortization of unlimited-term intangibles should be disclosed.

Intangible assets represent expenditures for rights, privileges, or competitive advantages which are valuable because they contribute to an increase in revenues or income through their employment in the enterprise; these rights are either purchased outright or developed in the regular course of business. Unamortized debt discount and expense is classified as an intangible asset or deferred charge, although it may be argued that it should be an adjustment of a liability account (see Principle D-4, Chapter 7, of this Inventory).

Intangible Assets Purchased Outright

All expenditures incident to the acquisition of an intangible asset are part of its cost. In addition to the price paid to a seller, cost of an intangible may include government fees, attorneys' fees and expenses, experiment and development costs, assignment costs (where royalty and license agreements have been assigned for a consideration) and other expenditures directly identifiable with their acquisition. For example, legal and other expenses of successfully defending against an interference suit in Patent Office proceedings are part of the cost of acquiring a patent.

The problem of accounting for intangible assets purchased outright, such as patents, leases, licenses, and goodwill, is covered in ARB No. 43, Chapter 5, which is reproduced below.

Accounting Research Study No. 5 on Business Combinations was published in 1962. Because of the close relation of purchased goodwill to business combinations, a research study of goodwill has been undertaken, and the author of the latter study will consult with the author of the previous study to explore the possibilities of coordination or integration of the two studies. These accounting research studies will provide the APB with needed material for reconsideration of the
CHAPTER 6: ASSETS (SECTION C OF SUMMARY)

bulletins now outstanding relating to goodwill and to business combinations (see Chapter 8 for the latter).

1. This chapter deals with problems involved in accounting for certain types of assets classified by accountants as intangibles, specifically, those acquired by the issuance of securities or purchased for cash or other consideration. Such assets may be purchased or acquired separately for a specified consideration or may be purchased or acquired, together with other assets, for a lump-sum consideration without specification by either the seller or the purchaser, at the time of purchase, of the portions of the total price which are applicable to the respective assets thus acquired. In dealing with the intangible assets herein considered, important questions arise as to the initial carrying amount of such assets, the amortization of such amount where their term of existence is definitely limited or problematical, and their write-down or write-off at some later time where there is a substantial and permanent decline in the value of such assets. These questions involve basic accounting principles of balance-sheet presentation and income determination and this chapter is designed to promote a fuller consideration of those principles. It does not, however, deal with the problems of accounting for intangibles developed in the regular course of business by research, experimentation, advertising, or otherwise.

CLASSIFICATION OF INTANGIBLES

2. The intangibles herein considered may be broadly classified as follows:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration);

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

3. The intangibles described above will hereinafter be referred to
as type (a) and type (b) intangibles, respectively. The portion of a lump-sum consideration deemed to have been paid for intangible elements when a mixed aggregate of tangible and intangible property is acquired, or the excess of a parent company’s investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter’s books at the date of acquisition, in so far as that excess would be treated as an intangible in consolidated financial statements of the parent and the subsidiary, may represent intangibles of either type (a) or type (b) or a combination of both.

**INITIAL CARRYING AMOUNT**

4. The initial amount assigned to all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, as, for example, where intangibles are acquired in exchange for securities, cost may be considered as being either the fair value of the consideration given or the fair value of the property or right acquired, whichever is the more clearly evident.

**AMORTIZATION OF INTANGIBLES**

*Type (a)*

5. The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness. If it becomes evident that the period benefited will be longer or shorter than originally estimated, recognition thereof may take the form of an appropriate decrease or increase in the rate of amortization or, if such increased charges would result in distortion of income, a partial write-down may be made by a charge to earned surplus.

*Type (b)*

6. When it becomes reasonably evident that the term of existence of a type (b) intangible has become limited and that it has therefore become a type (a) intangible, its cost should be amortized by systematic charges in the income statement over the estimated remaining period of usefulness. If, however, the period of amortization is relatively short so that misleading inferences might be drawn as a result of inclusion of substantial charges in the income statement a partial write-down may be made by a charge to earned surplus, and the rest of the cost may be amortized over the remaining period of usefulness.

7. When a corporation decides that a type (b) intangible may not
continue to have value during the entire life of the enterprise it may amortize the cost of such intangible by systematic charges against income despite the fact that there are no present indications of limited existence or loss of value which would indicate that it has become type (a), and despite the fact that expenditures are being made to maintain its value. Such amortization is within the discretion of the company and is not to be regarded as obligatory. The plan of amortization should be reasonable; it should be based on all the surrounding circumstances, including the basic nature of the intangible and the expenditures currently being made for development, experimentation, and sales promotion. Where the intangible is an important income-producing factor and is currently being maintained by advertising or otherwise, the period of amortization should be reasonably long. The procedure should be formally approved and the reason for amortization, the rate used, and the shareholders' or directors' approval thereof should be disclosed in the financial statements.

**WRITE-OFF OF INTANGIBLES**

8. The cost of type (b) intangibles should be written off when it becomes reasonably evident that they have become worthless. Under such circumstances the amount at which they are carried on the books should be charged off in the income statement or, if the amount is so large that its effect on income may give rise to misleading inferences, it should be charged to earned surplus. In determining whether an investment in type (b) intangibles has become or is likely to become worthless, consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value.

**LIMITATION ON WRITE-OFF OF INTANGIBLES**

9. Lump-sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus. If not amortized systematically, intangibles should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles.

**PURCHASE OF SUBSIDIARY'S STOCK OR BASKET PURCHASE OF ASSETS**

10. A problem arises in cases where a group of intangibles or a mixed aggregate of tangible and intangible property is acquired for a lump-
sum consideration, or when the consideration given for a stock investment in a subsidiary is greater than the net assets of such subsidiary applicable thereto, as carried on its books at the date of acquisition. In this latter type of situation there is a presumption that the parent company, in effect, placed a valuation greater than their carrying amount on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. The parent corporation may have (a) paid amounts in excess of carrying amounts for specific assets of the subsidiary or (b) paid for the general goodwill of the subsidiary. In these cases, if practicable, there should be an allocation, as between tangible and intangible property, of the cost of the mixed aggregate of property or of the excess of a parent's investment over its share of the amount at which the subsidiary carried its net assets on its books at the date of acquisition. Any amount allocated to intangibles should be further allocated to determine, if practicable, a separate cost for each type (a) intangible and for at least the aggregate of all type (b) intangibles. The amounts so allocated to intangibles should thereafter be dealt with in accordance with the procedures outlined in this chapter.

1 See chapter 8, paragraphs 11, 12, and 13.

* * *

Intangible Assets Developed in the Regular Course of Business

Many firms use their own facilities for research, development, and experimentation. In some industries, expenditures for this purpose are infrequent and are often related to a definite project. Although these expenditures may well be charged to expense currently, it is not improper to accumulate them as deferred charges until the results of the work are determined. If the objectives are attained, the deferred charges may be amortized over an arbitrary, but usually relatively short period. If the work is not successful, the unamortized balance should be charged off at once.

Research and development expenditures of substantial amounts are now regularly recurring characteristics of many businesses. Chemical companies, for example, find continuous experimental work necessary to develop new products and to improve processes for manufacturing existing products. The most practical treatment is to charge these expenditures to expense currently, for it is usually difficult to determine
in advance the benefit that may result in future periods. The account-
ing research study now in progress will broaden our knowledge of this
subject and will give thorough consideration to its accounting aspects.

Advertising costs incident to developing consumer preference for
commodities identified by trademarks, trade names and brands, create
intangible assets of value to the future. It is, however, impossible to
delineate the portion of advertising costs that have expired in the
production of current revenue from the portion that may be applicable
to the future. Treatment as current expense is, therefore, accepted
practice.

**Unamortized Debt Discount and Expense**

Bonds are sold at a discount because the rate of interest specified in
the coupons is less than the rate that the issuing company must pay for
the use of money. This discount, together with the expense of issue, is
customarily charged to unamortized debt discount and expense and
written off over the period from the date of issue to the date of maturity
of the bonds.

If bonds are retired before maturity and the debt is not refunded,
the balance of unamortized discount and expense should be written off,
usually against income. If the amount is so material that its inclusion
in income charges would impair the significance of net income, the
amount, less the related reduction in income taxes, should be charged
to retained earnings.

Unamortized discount, premiums and expense relating to debt which
is convertible into capital stock is properly includable in paid-in capital
upon conversion.

The disposition of unamortized discount, issue cost, and redemption
premium on bonds refunded is discussed in *ARB No. 43*, Chapter 15,
which is reproduced below.

**ARB No. 43 | UNAMORTIZED DISCOUNT, ISSUE COST, AND
Chapter 15 | REDEMPTION PREMIUM ON BONDS REFUNDED**

1. Until the early days of the century, bond discount was commonly
regarded as a capital charge. When the unsoundness of this treatment
was recognized, alternative methods of treatment became accepted,
under one of which the discount was distributed over the term of the issue, and under the other the discount was charged immediately against surplus, the latter being regarded generally as the preferable course.

2. Present-day treatment recognizes that on an issue of bonds the amount agreed to be paid (whether nominally as interest or as principal) in excess of the net proceeds constitutes the compensation paid for the use of the money. Where bonds are issued at a discount it is customary to distribute the discount over the term of the bond issue and to charge both the coupon interest and the allocated discount directly to income.

3. In the committee's opinion it is a sound accounting procedure to treat such discount as a part of the cost of borrowed money to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company. The anticipation of this income charge by a debit to income of a previous year or to surplus has in principle no more justification than would a corresponding treatment of coupons due in future years.

4. The argument advanced in favor of immediately writing off discount was that it extinguished an asset that was only nominal in character and that it resulted in a conservative balance sheet. The weight attached to this argument has steadily diminished, and increasing weight has been given to the arguments that all such charges should be reflected under the proper head in the income account, and that conservatism in the balance sheet is of dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant.

TREATMENT OF UNAMORTIZED DISCOUNT, ISSUE COST, AND REDEMPTION PREMIUM ON BONDS REFUNDED

5. Discussion of the treatment of unamortized discount, issue cost, and redemption premium on bonds refunded (hereinafter referred to as unamortized discount) has revolved mainly about three methods of disposing of the unamortized balance:

(a) A direct write-off to income or earned surplus,
(b) Amortization over the remainder of the original life of the issue retired, or
(c) Amortization over the life of the new issue.

Each of these methods has had support in court decisions, in deter-
minations by regulatory agencies, and in accounting literature. The reasoning and conclusions reached by the committee in regard to them are given here.

**Direct write-off**

6. It is acceptable accounting to write off unamortized discount in full in the year of refunding. This treatment is based on the view that the unamortized bond discount represents in effect the cost of the privilege of terminating a borrowing contract which has become disadvantageous and hence comes under the accounting doctrine that a loss or expense should be recognized as such not later than the time when the series of transactions giving rise to it is completed.

7. The decision as to whether a direct write-off of unamortized bond discount is to be made by a charge to income or to earned surplus should be governed by the criteria set forth in chapter 8, paragraphs 11, 12, and 13. Where a write-off is made to earned surplus it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise.¹

**Amortization over remainder of original life of retired issue**

8. The second alternative, distributing the charge over the remainder of the original life of the bonds refunded, has strong support in accounting theory. Its chief merit lies in the fact that it results in reflection of the refinancing expense as a direct charge under the appropriate head in a series of income accounts related to the term of the original borrowing contract.

9. This method is based on the accounting doctrine that when a cost is incurred the benefits of which may reasonably be expected to be realized over a period in the future, it should be charged against income over such period. In behalf of this method, it is argued that the unamortized bond discount represents the cost of making a more advantageous arrangement for the unexpired term of the old agreement. In other words, such discount is regarded as the cost of an option included in the borrowing contract to enable a corporation to anticipate the maturity of its obligations if it finds it possible to refund them at a lower cost, either as the result of a favorable change in interest rates or as the result of its own improved credit. Continuing this line of reasoning, it is argued that the cost of money over the entire period of the original issue is affected by the terms of the original contract, and that if the cost of anticipating maturity is incurred, it is only because it is advantageous to do so; if the saving over the
unexpired term of the old bonds will exceed the amount of unamortized discount to be disposed of, such discount should properly be spread over that unexpired term as a proper element of the cost of borrowed money.

10. This method should be regarded as preferable. It conforms more closely than any other method to current accounting opinion.

11. Where this method is adopted a portion of the unamortized discount equal to the reduction in current income tax resulting from the refunding should be deducted in the income statement and the remainder should be apportioned over the future period.\(^2\)

**Amortization over life of new issue**

12. The third alternative, amortization over the life of the new issue, runs counter to generally accepted accounting principles. It cannot be justified on the ground that cost may be spread over the period during which the benefit therefrom may be presumed to accrue. Clearly discernible benefits from a refunding accrue only for the period during which the new issue is replacing the previously outstanding issue. To determine whether any benefit will accrue to an issuing corporation for the period during which the new issue is to be outstanding after the maturity date of the old issue would require an ability to foresee interest rates to be in effect during that period. Since such foresight is plainly impossible, there is no ground for assuming a benefit will result during that period. Moreover, the method does not possess any marked practical advantages in comparison with the second alternative. On the contrary, it results in an understatement of the annual cost of money after refunding and during the remainder of the term of the old issue, and consequently might tend to encourage consumption of transactions which are not, when properly viewed, advantageous. Furthermore, not only is there a lack of logical relationship between the amount of unamortized discount on the old issue and the term of the new issue, but also it is unconservative from both the balance-sheet and the income standpoints to carry forward part of the unamortized discount over the longer period. The committee considers the argument that the expense of retiring the old issue is a part of the cost of the new transaction to be untenable. In view of the above considerations the committee's conclusion is that this method is not acceptable.

**OTHER CONSIDERATIONS**

13. If the unamortized discount is carried forward after refunding
it is acceptable to accelerate the amortization over a shorter period than that mentioned in paragraph 9, as long as the charge is made against income and is not in any year so large as seriously to distort the income figure for that year. Such acceleration may be regarded as a middle course between two alternatives (immediate writing off and spreading over the life of the old issue), each of which is acceptable, and, therefore, as being itself acceptable.

14. If the debt is to be paid off through a new issue with a term less than the remaining life of the old issue the amortization should be completed over the shorter period.

15. The method employed should be clearly disclosed, and if the unamortized discount is carried forward the amount of the annual charge should, if significant in amount, be shown separately from other charges for amortization of bond discount and expense.

16. The committee does not regard the charging of unamortized bond discount to capital surplus as an acceptable accounting treatment.

17. If the debt is discharged — otherwise than by refunding — before the original maturity date of the issue, any balance of discount and other issue cost then remaining on the books, and any redemption premium, should be written off at the date of such retirement by a charge against income, unless the amount is relatively so large as to fall within the provisions of chapter 8, paragraphs 11, 12, and 13.

Four members of the committee, Messrs. Peoples, Queenan, Werntz, and Williams, assented with qualification, and one member, Mr. Mason, dissented to adoption of chapter 15.

Messrs. Peoples, Queenan, Werntz, and Williams do not agree with the conclusions expressed in paragraph 12. They believe there are circumstances in which the unamortized discount and redemption premium applicable to an issue being refunded can properly be considered as a cost of the opportunity of issuing new bonds under more favorable terms. They believe there is support to be found in accounting theory and practice for this view. They further believe that it is inappropriate to disapprove this particular treatment and at the same time to approve the wide variety of treatments permitted by paragraphs 6 through 11, and paragraph 13.

Mr. Mason dissents since he believes that, with the exception of a public utility where an equitable result under regulatory procedures
may call for the second alternative, the items under discussion should be a direct write-off to income or earned surplus, where lower interest rates have led to the refunding operation. If the refunding takes place in order to extend present interest rates in anticipation of higher rates in the future, the probable benefits would, in his opinion, justify spreading the costs over the life of the new issue.

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1 See Chapter 10(b), paragraph 10.
2 See chapter 10(b), paragraph 12.

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Principle C-6

The nature and extent of hypothecated or pledged assets should be shown.

Assets may be pledged as security for a loan by transferring title or possession of the assets to the creditor or a third party, or by granting the creditor a lien against the property until the debt is satisfied. Any asset may serve as security for a loan and the agreement may take many forms.

Borrowing accompanied by pledge or other encumbrance of fixed assets, securities, receivables, inventory, etc., should be stated as a liability and the amount of any category of asset pledged should be disclosed. Retention of protective title by lenders or third parties should also be disclosed. In certain industries it is customary for a substantial part of the capitalization to be represented by funded debt. In these instances the terms of the debt, for example, “First Mortgage Bonds,” are descriptive of the fact that there is a mortgage lien on all of the fixed assets and the existence of this lien is not usually repeated in the fixed asset section of the balance sheet.
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for Chapter 7
| Objective D: | Account for all known liabilities in a meaningful manner in order that their summarization, considered together with the statement of assets and equity invested by stockholders, will fairly present the financial position of the enterprise at the beginning and end of the period. |
| Principle D-1: | All known liabilities should be recorded regardless of whether the definite amount is determinable. If the amounts cannot be reasonably approximated, the nature of the items should be disclosed on the face of the summary of liabilities or by footnote. |
| Principle D-2: | Current liabilities should include items payable within one year or at the end of the operating business cycle used in the classification of current assets. Accounts should be shown separately for notes payable to banks, notes payable to others, accounts payable (may include payrolls), Federal income taxes accrued, other accrued taxes, accounts or notes payable to officers and accounts or notes payable to affiliates. |
| Principle D-3: | Long-term liabilities should be described and due dates and rates of interest shown. |
| Principle D-4: | The nature and extent to which specific liabilities are a preferred lien on assets should be shown. |
| Principle D-5: | Deferred income should be separately classified and described. |
| Principle D-6: | Contingent liabilities of importance should be disclosed. |

ARB No. 43, Ch. 3B, "Application of United States Government Securities Against Liabilities for Federal Taxes on Income" |

ARB No. 50, "Contingencies"
Account for all known liabilities in a meaningful manner in order that their summarization, considered together with the statement of assets and equity invested by stockholders, will fairly present the financial position of the enterprise at the beginning and end of the period.

The foregoing objective may be accomplished by adherence to the numbered principles. The close interrelationship of liabilities to assets and equity is indicated in the wording of the objective and reference is made to Chapter 6 for the committee on terminology's definitions of the terms balance sheet, assets and liabilities.
All known liabilities should be recorded regardless of whether the definite amount is determinable. If the amounts cannot be reasonably approximated, the nature of the items should be disclosed on the face of the summary of liabilities or by footnote.

Liabilities are obligations to pay sums of money, to convey assets other than money, or to render service. These obligations result from past actions and transactions and require settlement in the future. Some of the common actions and transactions that give rise to liabilities include the purchase of goods and services on credit, borrowing money, levy by tax authorities, product guaranties, dividend declaration, receipt of payment prior to rendering goods and services and so forth.

The dollar amount of the obligation may be definite at the balance-sheet date or it may be dependent on future occurrences that are not controllable by the entity. In the latter case the amounts must be estimated. If a reasonable approximation of the liability cannot be made, the existence of the liability should be disclosed in the face of the balance sheet or in the notes.

These cases where there is an actual liability at the balance-sheet date but the dollar amount depends on future occurrences must be distinguished from “contingent liabilities,” which are not liabilities at the present and may or may not become liabilities in the future. The degree of certainty as to whether there will or will not be a liability differentiates a “contingent liability” from an actual liability. Contingent liabilities are those which are possible, but not probable. The following are types of items, among others, which may be either actual or contingent liabilities depending on the degree of certainty of liability:

Matters in litigation, such as alleged patent, copyright, and trade-mark infringements, or breach of contract;

Possible claims by employees for back compensation under laws, the interpretation of which is uncertain;

Proposed additional taxes for prior periods, which the company believes are unwarranted;

Possible liability for refunds arising from renegotiation, which the company believes unjustified;

Claims which counsel believes there is substantial doubt that
they can be adequately defended, and with respect to which the amount of liability, if any, will be fixed by judge or jury subsequent to the balance-sheet date;

See Principle D-6 for further discussion of contingent liabilities.

Some of the Accounting Research Bulletins issued by the accounting procedures committee were concerned with the special problems involved in estimating the amount of the liability and related expense or reduction of revenue in those cases in which the dollar amount of the obligation depends on future events. For example, see ARB No. 43, Chapter 11B reproduced under Principle A-1, of Chapter 4, for liability from renegotiation of government contracts, and ARB No. 47, reproduced under Principle A-2 for liability under pension plans.

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**Principle D-2**

Current liabilities should include items payable within one year or at the end of the operating business cycle used in the classification of current assets. Accounts should be shown separately for notes payable to banks, notes payable to others, accounts payable (may include payrolls), Federal income taxes accrued, other accrued taxes, accounts or notes payable to officers and accounts or notes payable to affiliates.

Criteria for determining whether an obligation is to be classified as a current liability are described in ARB No. 43, Chapter 3A as follows (Chapter 3A is reproduced in its entirety under Principle C-1, Chapter 6).

7. The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short
period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons.\textsuperscript{3}

8. This concept of current liabilities would include estimated or accrued amounts which are expected to be required to cover expenditures within the year for known obligations (a) the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The current liability classification, however, is not intended to include a contractual obligation falling due at an early date which is expected to be refunded,\textsuperscript{4} or debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long periods. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as for example by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property obligations, the portion of the total obligation to be included as a current liability should be that representing the amount accrued at the balance-sheet date.

\textsuperscript{2} Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which will normally be liquidated in the ordinary course of business by the delivery of services. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of the latter are the issuance of a long-term warranty or the advance receipt by a lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement.

\textsuperscript{3} Loans accompanied by pledge of life insurance policies would be classified as current liabilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance company with the intent that it will not be
CHAPTER 7: PRINCIPLE D-2

paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation should be excluded from current liabilities.

There should, however, be full disclosure that such obligation has been omitted from the current liabilities and a statement of the reason for such omission should be given.

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Assets are sometimes earmarked or segregated for the purpose of liquidating specific liabilities. Even when so circumscribed, however, these assets and liabilities should not offset each other in the balance sheet except where the right of offset exists. The right of offset in the case of some United States Government securities against Federal taxes on income is discussed in ARB No. 43, Chapter 3B, which is reproduced below.

ARB No. 43
Chapter 3
Section B

WORKING CAPITAL
Application of United States Government Securities Against Liabilities for Federal Taxes on Income

1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of set-off exists. An example of such exception was the showing of United States Treasury Tax Notes, Tax Series A-1943 and B-1943, as a deduction from the liability for federal taxes on income, which the committee approved in 1942.

2. In view of the special nature of the terms of the 1943 tax notes, the intention of the purchaser to use them to pay federal income taxes could be assumed, since he received no interest or other advantage unless they were so used. Some purchasers doubtless viewed their purchase of the notes as being, to all intents and purposes, an advance payment of the taxes.

3. In the absence of evidence of a contrary intent, it was considered acceptable, and in accordance with good accounting practice, to show the notes in the current liability section of the balance sheet as a deduction from federal taxes on income in an amount not to exceed the accrued liability for such taxes. The full amount of the accrued liability
was to be shown with a deduction for the tax payment value of the notes at the date of the balance sheet.

4. It also was recognized as clearly proper to show the notes in the current asset section of the balance sheet as any other temporary investments are shown. If at the balance-sheets date or at the date of the independent auditor's report there was evidence that the original intent was changed, the notes were to be shown in the current asset section of the balance sheet.

5. Government securities having restrictive terms similar to those contained in the 1943 tax series notes are no longer issued, although certain other types of government securities have since been issued which are acceptable in payment of liabilities for federal taxes on income. However, because of the effect on the current position of large tax accruals and the related accumulations of liquid assets to meet such liabilities, many companies have adopted the practice of acquiring and holding government securities of various issues in amounts related to the estimated tax liability. In their financial statements these companies have often expressed this relationship by showing such securities as a deduction from the tax liability, even though the particular securities were not by their terms acceptable in payment of taxes. If the government securities involved may, by their terms, be surrendered in payment of taxes, the above practice clearly falls within the principle of the permissive exception described in paragraph 1. The committee further believes that the extension of the practice to include the offset of other types of United States government securities, although a deviation from the general rule against offsets, is not so significant a deviation as to call for an exception in an accountant's report on the financial statements.

6. Suggestions have been received that similar considerations may be advanced in favor of the offset of cash or other assets against the income and excess profits tax liability or against other amounts owing to the federal government. In the opinion of the committee, however, any such extension or application of the exception, recognized as to United States government securities and liabilities for federal taxes on income, is not to be regarded as acceptable practice.

One member of the committee, Mr. Calkins, assented with qualification to adoption of section (b) of chapter 3.

Mr. Calkins does not approve the concluding sentence of paragraph 5, which states that the offset of other types of United States Gover-
ment securities, although a deviation from the general rule against offsets, is not so significant a deviation as to call for an exception in an accountant's report. He believes that the significance of such a deviation is a matter for judgment based on the facts of a particular case; that the broader language of the statement constitutes a condonation of the practice of offsetting against tax liabilities United States Government obligations which are not by their terms acceptable in payment of federal taxes; and that the condonation of such a practice is inconsistent with the opinion of the committee expressed in paragraph 6, with which he agrees, that cash and other assets should not be offset against liabilities for federal taxes.

* * *

Accounts payable include accounts with trade creditors that arise through the purchase of merchandise or services and all other unpaid invoices of whatever nature, as well as accrued liabilities. The preferred practice is to distinguish between the various liabilities, in which case accounts with trade creditors might be called trade accounts payable.

Trade creditors accounts are recorded at either (1) the amount of cash or equivalent that will be required to satisfy the obligation, or (2) the gross invoice price including the amount of allowable cash discount. The choice is not usually disclosed but it can sometimes be inferred from other accounts. For example, the presence of an account for purchase discounts on the income statement would indicate that accounts payable are probably carried at gross amounts, whereas an account for purchase discounts lost would probably indicate that they are carried net.

Short-term notes payable are usually recorded at face amount whether interest is included in the face amount of the note or is payable in addition to the face amount. Notes involve interest; therefore, recording notes at face amount results in recording some notes at present value of the notes and interest and others at future (maturity) value. When interest is not included in the face amount, the amount of interest accrued at the balance-sheet date is carried as a liability, usually in a separate interest payable account. The face amount of the note plus the interest accrued at the balance-sheet date given the present value of future cash payments. When interest is included in the face amount, the note is carried at maturity value which exceeds
present value by the amount of interest included that is applicable to the remaining life of the note. When notes which include interest in the face amount have been discounted, the difference between the maturity value and the proceeds from the note is usually recorded in a "prepaid interest" account which is amortized over the life of the note, even though there has been no prepayment of interest.

Some liabilities accumulate for which invoices are not normally received from the creditor, but must be periodically computed from other source documents. These obligations are referred to as accrued liabilities. Some of them accumulate on a regular recurring basis and are payable at regular time intervals, e.g., payroll and interest. Others accumulate as a result of established policies, e.g., product guarantees, and may result in an obligation to perform a service or render material in addition to or instead of payment of money.

Accrued payroll includes wages, salaries, bonuses, commissions, and other employee compensation earned but not paid through the close of business on the last day of the accounting period. The amounts that are definitely determinable are recorded at the amount of cash or equivalent that will have to be paid to satisfy the obligation. Amounts that are not definite are estimated, based on currently available information and past experience.

Related to accrued payroll are liabilities for unclaimed wages, payroll taxes, and withholding taxes payable. Unclaimed wages are credited to revenue or retained earnings after a number of years unless they escheat to the state. Payroll tax liabilities are computed according to the applicable statutes and withholding taxes payable are recorded at the amounts actually withheld.

Product guarantees that provide for free repair or replacement are obligations to pay cash (if the work is done by dealers) or to disburse labor, material, and transportation charges in indefinite amounts. The liability involved in current sales with product guarantees is estimated based on past experience and knowledge of the characteristics of current products. Only that portion that meets the criteria described in ARB No. 43, Chapter 3A, paragraphs 7-8 (previously presented in this section) need be included in current liabilities.

Dividends payable in cash or other assets are normally current liabilities and should be shown separately. Dividends that are declared payable in the company's own capital stock are not liabilities in that there is no obligation to deliver money, goods, or services. They should, therefore, be shown in the equity capital section rather than among the liabilities. When a dividend is payable in assets other
than cash, there are two alternative amounts that may be charged to retained earnings and credited to the liability account: (1) the cost or other book value of the asset to the distributing corporation, or (2) the fair market value of the property at the date the dividend is declared. The first alternate appears to be the most common. When the second alternate is used, the difference between book value and market value at the date the dividend is declared is charged or credited to income or to retained earnings. When the dividend is payable in either cash or the stock of the disbursing company at the option of the stockholder the amount potentially payable in cash is the amount of the liability.

Collections from customers or clients prior to performing the services or delivering the goods for which payment is being received (e.g., magazine subscriptions, rent collected in advance, advances on uncompleted contracts, collections on “lay-away” or “will-call” sales prior to delivery, etc.) result in liabilities to perform. The amount collected usually exceeds the expected cost of the goods to be delivered or services to be rendered. For this reason, some accountants advocate splitting the liability into two parts: (1) the estimated cost of performance which they would include in current liabilities to the extent that the obligations are to be liquidated within a year or the normal operating cycle, whichever is longer, and (2) the estimated profit to be derived, which they would exclude from current liabilities (sometimes referred to as a deferred credit to income). Other accountants advocate including the entire amount collected in advance of performance as a current liability to the extent that the obligation will be liquidated within a year, or the normal operating cycle, whichever is longer. Deferred income is discussed under Principle D-5.

Lay-away and will-call sales are also accorded another accounting treatment; they are sometimes accounted for in the same manner as installment sales, even though the goods are not delivered until payment is complete. This results in showing an account receivable for the unpaid balance instead of a liability for the collection in advance.

Security deposits paid to utility companies are current liabilities under uniform systems of accounts prescribed by public utility regulatory bodies. Security deposits paid to landlords that are applied as payment of rent for the final period of the lease need not be classified as a current liability by the landlord until a year before the lease expires.

Accounting for deposits on returnable containers that are refunded when the containers are returned depends on the manner in which
the account is usually settled. If the return of the containers is customarily settled by a credit to accounts receivable, the container liability account may be offset against accounts receivable. Liability for containers arising from cash receipts that are normally settled by payment of cash should not be offset against accounts receivable but should be shown as liabilities, usually current. In those cases in which industry experience indicates that customers do not return containers promptly, the portion of the liability that will not be refunded for more than a year may be estimated and excluded from current liabilities provided that the containers are not carried as current assets. Since containers are not always returned, the liability account should be adjusted periodically to equal the estimated refunds that may be expected to be made based on past experience.

The liability for real and personal property taxes is discussed in ARB No. 43, Chapter 10A which is reproduced under Principle A-2, Chapter 4, and the liability for income taxes (including excess profits taxes) is the subject of ARB No. 43, Chapter 10B which is also reproduced under Principle A-2.

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**Principle D-3**

Long-term liabilities should be described and due dates and rates of interest shown.

Long-term liabilities are present obligations, arising out of past actions or transactions, that are not due to be paid within the year or normal operating cycle, whichever is longer. Incurring long-term debt is often accompanied by considerable formality and may require the approval of the stockholders or board of directors. Common examples of long-term debt are bonds, mortgage and other long-term notes, and installment payment contracts. Bonds are used to borrow from the general public for the long term use of capital funds when the amount of money needed is too large for one or a small number of lenders to supply; when smaller amounts are needed, other forms of debt are more often used.

Most long-term debt, in whatever form, is issued subject to various covenants for the protection of lenders. The covenants are set forth in the trust indenture or note agreements, a copy of which may be printed on, or incorporated by reference in, the formal instrument
which evidences the obligation. Stipulations in the indenture or agreement include the amounts authorized to be issued, interest rate (or rates since changes are sometimes made), due date or dates (frequently provision is made for installment payments of principle), property pledged, sinking fund, maintenance fund, working capital and dividend restrictions, basis of issuance of additional securities, and other important provisions. Whenever these stipulations are significant to an adequate interpretation of the financial statements they should be described in the face of the balance sheet or the notes thereto. In addition to the title of the long-term debt, its description should include the amount registered, issued, outstanding, and in treasury, the rate of interest, due dates, and call price, if any. Convertibility of bonds into capital stock should be indicated. Subordination of long-term debt by agreement with the lenders should be disclosed. If there has been a significant default in principal, interest, sinking fund, redemption, or other requirements of the indenture, disclosure of the facts and amounts should be made in a notation to the balance sheet and reference thereto may be desirable in the auditor's report.

The effective rate of interest that will prevail in the bond market cannot be estimated precisely prior to issuing the bonds. A difference between the nominal rate of interest (i.e., the rate the issuer agrees to pay on the face amount of the bond issue) and the effective rate results in the bonds being issued at either a premium or discount depending on which rate is higher. The bonds-payable account is usually credited for the face amount and the premium or discount is charged or credited to a separate account, the amount of which is amortized over the life of the bond issue. The bonds-payable account could be credited with the proceeds of the bond issue and the difference between the proceeds and face value amortized over the life of the bond issue without the use of separate discount or premium accounts. The use of separate accounts, however, appears to be the preferred practice.

Premium on bonds payable is shown either in the long-term liabilities section added to the bonds-payable account to which it applies or in a separate section between long-term liabilities and capital. Discount on bonds payable is shown either in a noncurrent asset section or in the long-term liabilities section deducted from the bonds-payable account to which it applies. The former appears predominant. When there is both premium and discount on bonds payable, they may be shown net.

Accounting for unamortized discount, issue cost, and redemption
premium on bonds refunded was the subject of a pronouncement by the committee on accounting procedure in ARB No. 43, Chapter 15, which is reproduced under Principle C-5, Chapter 6.

Long-term liabilities are often subdivided into two groups, the first of which includes long-term debt, such as bonds and notes issued under an indenture or other formal agreement, and the second, other long-term liabilities, such as deferred credits, customers' deposits, product guaranties, and estimated liabilities for tax or other disputed claims.

If part of the liability matures or otherwise becomes payable within one year after the balance-sheet date (e.g., serial maturities on long-term debt), accountants classify that portion as a current liability. If refunding arrangements have been concluded with respect to a maturing issue, or if such arrangements are in process and reasonably certain of being successfully concluded, the maturing issue may be properly treated as long-term rather than current debt and the circumstances described in a note to the balance sheet. If funds have been provided to retire the maturing obligation and are segregated as noncurrent assets, the maturing liability should remain in the long-term debt category.

If an entire convertible debenture note issue has been called for redemption and conditions at the time of the call and experience in similar circumstances indicate unlikelihood that cash funds will be required to satisfy the obligation, the appropriate amounts, including premiums, may be included in the capital section of the balance sheet with an appropriate explanatory note. This note should indicate the reasons for such treatment and amounts and description of capital shares expected to be issued.

An alternative presentation shows the entire convertible issue as a long-term liability with disclosure of pertinent facts in a footnote. In these circumstances no part of the issue should be classified as a current liability, despite stated maturity within one year from the balance sheet date.

It is not considered good practice to deduct long-term debt from assets pledged against them. There may be exceptions to this rule. For example, when a company, engaged in buying, selling, and operating real estate, purchases property subject to a mortgage, the liability for which it does not assume, it may show the investment at gross purchase price (plus, any additions at cost) and deduct therefrom the amount of the mortgage not assumed rather than showing the mortgage as a liability.
The portion of liabilities described under Principles D-1 and D-2 that does not meet the criteria for classification as current liabilities are classed as long-term liabilities. Other liabilities which are long-term include obligations under deferred compensation and pension plans, estimated liability for fire loss (when the entity elects to assume the risk of absorbing losses from fire without the protection of fire insurance policies) and, in some industries, liability for repairs and renewals. This latter item is customary in industries in which there are wide fluctuations in maintenance expenditures from year to year. A fixed amount is credited to the account annually based on the average cost over a period of years. Actual expenditures are charged against the estimated liability provision.

--- Principle D-4 ---

The nature and extent to which specific liabilities are a preferred lien on assets should be shown.

The balance sheet should clearly indicate the nature and amount of the security supporting the liabilities. While this information is usually included in the liability section of the balance sheet in the description of the liability account, it is sometimes indicated on the asset section also, in order to identify the assets which are pledged and therefore not available for the payment of other liabilities.

The property mortgaged as security for a loan may be land and buildings in which case it would be called a real-estate mortgage, or it may be personal property (e.g., merchandise, securities, equipment) in which case it is called a chattel mortgage. Contracts with some long-term creditors include restrictive provisions concerning the payment of dividends or incurring of additional debt instead of requiring specific property to be pledged or mortgaged. Others provide that a sinking fund be established for the purpose of liquidating the debt.

Long-term liabilities are not the only obligations for which assets are pledged, however. Chattel, particularly, is frequently pledged for short-term or current obligations, especially when call loans are involved. Whenever assets are pledged for any class of liability, the nature and extent of the assets pledged or otherwise restricted should be disclosed.
Deferred income should be separately classified and described.

The term "deferred income" is used to describe items that are (1) deducted from asset accounts, (2) items included in current liabilities, (3) items included in long-term liabilities, and (4) items that are shown above the stockholders' equity section. At the present time, an account having a credit balance at the balance-sheet date may be classified as deferred income for balance-sheet purposes, if it will eventually be credited to income. However, many accountants advocate limiting the term to those items which will be credited to income without incurrence of further costs. In the case of amounts collected in advance of performing the service or delivering the goods, they would include only the profit element as deferred income; the costs to be incurred would be classified as a current liability.

Deferred credit items that are deducted from the related asset include advances on uncompleted contracts, unearned profit on installment contracts and unearned interest and finance charges. Deferred income due to collections from customers or clients prior to performing the services or delivering the goods for which payment has been received is discussed under Principle D-2. Portions of these items which are not to be liquidated within the year or normal operating cycle, whichever is longer, may be classified as a long-term liability or deferred income. Collections in advance include billings on uncompleted contracts, rent on leased equipment, customer service prepayments, unearned deposits and royalties, magazine subscriptions, unfinished voyage revenue, and so forth. The diversity of deferred income items makes it necessary that the individual items be adequately described.

This is an area of accounting which needs clarification as poignantly expressed by Professor W. A. Paton, in an article published in the September 1961 *Journal of Accountancy*, from which the following paragraphs were taken:

Advances by customers or clients fall into two main arithmetic patterns. In one case the customer advances substantial sums irregularly from time to time to assist in financing plant construction or other major needs (for example, an advance to a supplier by a government agency to facilitate acquisition of equipment necessary to the production of defense materials), and the amounts contributed do not correspond closely if at all to the selling price of a unit or number of units of the product that it is
expected will be made and furnished to the customer, as agreed. In the other and more familiar case the amount advanced by the customer matches the amount of the selling price of a particular segment of product (such as a three-year magazine subscription) to be delivered later. It is this second situation that seems to be peculiarly subject to misinterpretation. Apparently the minds of many tax agents, lawyers, and judges and—let us confess it—some accountants, are incapable of drawing and hanging on to a distinction between two basically separate phenomena when each has the same arithmetic measure. But surely the proposition holds that receiving an advance from a customer precisely equal in amount to the price of a specified segment of product is basically the same kind of transaction as the case of an advance of $25,000 accompanying an order for heavy machinery with a total contract price of $1 million. A coincidence of arithmetic measures should not blind us to real differences. The goat weighing 100 pounds is not identical with a sheep of the same weight. And $100 in cash borrowed (or received as an advance) should not be confused with a product having a sale price of $100, even if both factors are covered by a single contract.

If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production, and not from borrowing or otherwise raising funds. Moreover, for most lines of business, revenue is regarded as recognizable when product is delivered to the customer. It is also axiomatic that net income, if any, is the amount by which total revenue for the period, represented by the sale value of the delivered product, exceeds all the expenses, losses, and taxes properly applicable to such total revenue. In the face of these basic considerations how can we justify using the word “income,” even with the qualifying term “deferred” attached, to describe the amount of a customer advance? Such an advance may be received before the process of production has even been started, before any costs have been incurred, and before anyone knows for certain that any “income” will ever be realized on the particular operation or contract!

It must be said for the accountant that he carefully avoids the gross error of treating advances by customers as recognizable income when received. It remains for the Internal Revenue Service, with astonishing court support, to follow this completely unsound and unjustified course. But I am afraid that we in accounting have contributed at least indirectly to this unfortunate and almost incredible state of affairs, via long use of misleading terms, sloppy recording and reporting, and confusing and inadequate description and explanation.

* * *
Principle D-6

Contingent liabilities of importance should be disclosed.

Existing conditions which may or may not result in a liability, depending on a related future event, should be disclosed because of the possible effect on financial position or results of operations. The committee on accounting procedure considered contingencies in ARB No. 50, which is reproduced below.

ARB No. 50

CONTINGENCIES

1. In the preparation of financial statements presenting financial position or operating results, or both, it is necessary to give consideration to contingencies. In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency.

DISCUSSION

2. The contingencies with which this bulletin is primarily concerned are those in which the outcome is not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations. Examples of contingencies which may result in the incurrence of liabilities, or in losses, are pending or threatened litigation, assessments or possible assessments of additional taxes, or other claims such as renegotiation refunds, that are being or would be contested, guarantees of indebtedness of others, and agreements to repurchase receivables which have been sold. Examples of contingencies which may result in the acquisition of assets, or in gains, are
claims against others for patent infringement, price redetermination upward and claims for reimbursement under condemnation proceedings. Material contingencies of the types discussed in this paragraph should be disclosed.

3. Other contingencies may exist where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables. Contingencies of this type which are expected to result in losses should be reflected in the accounts. However, contingencies which might result in gains usually are not reflected in the accounts since to do so might be recognized revenue prior to its realization, but there should be adequate disclosure.

4. There are also general risk contingencies that are inherent in business operations and which affect many if not all companies, such as the possibility of war, strike, losses from catastrophes not ordinarily insured against, or a business recession. Contingencies of this type need not be reflected in financial statements either by incorporation in the accounts or by other disclosure.

DISCLOSURE

5. Disclosure of contingencies referred to in paragraph 2 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as a law suit involving a substantial amount, management may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or assets to avoid misleading implications as to the likelihood of realization. The discussion in this bulletin does not deal with the question as
to whether the existence of any of the contingencies discussed above is such as to require a qualified opinion or a disclaimer of an opinion by the independent certified public accountant.

6. Certain other situations requiring disclosures have sometimes inappropriately been described as though they were contingencies, even though they are of a nature not possessing the degree of uncertainty usually associated with the concept of a contingency. Examples are unused letters of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or an obligation to reduce debts, maintain working capital, or restrict dividends. While some of these situations may develop into contingencies, they should not be described as contingencies prior to such eventuality.

The statement entitled “Contingencies” was adopted unanimously by the twenty-one members of the committee, of whom two, Messrs. Bedford and Halvorson, assented with qualification.

Mr. Bedford objects to the provision in paragraph 3 that anticipated losses due to a contingency should be recognized in an accounting period prior to the actual incurrence of the loss. He believes that such deductions from revenue, in order to match adequately costs and revenues, should be based upon sufficient statistical evidence or experience to justify an accounting treatment different from that afforded gains. Without the sufficient statistical evidence or experience and without evidence to indicate a loss has been incurred, he believes a contingent loss should be disclosed in such a manner as not to require the recognition of the loss until the loss has been incurred.

Mr. Halvorson believes the bulletin fails in the essential matter of definition in the second sentence of paragraph 1. He feels that “a considerable degree of uncertainty” is beside the point, and that the definition as it stands would not exclude many types of commitments. He believes that the point should be that the “existing condition” and the “related future event” would affect present financial position or present or past operations, and would be so recorded in the statements, if all the uncertainties could be resolved at the time the statements are being issued. He also believes that the bulletin should not deal with the “general risk” contingencies described in paragraph 4, as they are not
of a peculiarly accounting nature, and the attempt to accommodate them in an accounting bulletin has required a definition that is so broad as to fail in its purpose.

1 See Chapter 1, Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins.
2 For the committee's position with respect to contingency reserves, see Chapter 6 of Accounting Research Bulletin No. 43.
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Principle E-4: Where two or more previously independent entities merge or otherwise combine in such a manner as to constitute a pooling of interests, the new entity inherits the bases of accountability of the constituent entities.

ARB No. 48, “Business Combinations”

APPENDIX—CHAPTERS 7, 8, 9, AND 11 OF STATEMENTS ON AUDITING PROCEDURE NO. 33
Financial Statements
(Section E of Summary)

Objective E

Financial statements should comply with the applicable reporting standards included in generally accepted auditing standards. Reporting to investors should be performed on an entity basis.

Principle E-1

Generally accepted reporting standards applicable to financial statements are set forth in Chapters 7, 8, 9 and 11 of Statements on Auditing Procedure No. 33, which are incorporated in this Inventory.

The chapter titles shown below will indicate the inherently close relationship to financial statement presentation.

Chapter 7 — Adherence to Generally Accepted Accounting Principles
Chapter 8 — Consistency of Application of Generally Accepted Accounting Principles
Chapter 9 — Adequacy of Informative Disclosure
Chapter 11 — Reporting on Subsequent Events

The foregoing chapters of Statements on Auditing Procedure No. 33 are incorporated in this Inventory, and are reproduced as the Appendix to this chapter.
CHAPTER 8: PURPOSES AND LIMITATIONS OF HISTORICAL FINANCIAL STATEMENTS

Purposes and Limitations of Historical Financial Statements

It has been stated in a preceding section that accounting serves many internal and external purposes in the broad fabric of corporate business; and that the most important external purpose is to supply the comprehensive and dependable information required so that management may fulfill its fiduciary accountabilities to stockholders, creditors, government and others having bona fide interests. In this Inventory, we have attempted to classify a summary of generally accepted accounting principles in relation to the fiduciary accountabilities which may be met by coordinated financial statements for given fiscal years.

The historical financial statements of a business entity are intended to present fairly the financial position and the results of operations for the period in accordance with generally accepted accounting principles applied consistently with those of the preceding period. On the basis of his examination, the CPA expresses his opinion on whether or not the foregoing standards have been met. Such an opinion usually is addressed to the directors, to the stockholders or to both, and the CPA is guided in his examination and report by “Generally Accepted Auditing Standards.” (See Chapter I.)

It is important to note that historical financial statements purport to fulfill management’s fiduciary accountabilities and the needs of persons having bona fide interests, even the stockholders, only to the extent of presenting fairly the financial position and results of operations for the period in accordance with generally accepted accounting principles consistently applied.

Most corporations having numerous stockholders present a great deal of information in reports to stockholders in addition to the financial statements. Such information usually relates to economic conditions and factors affecting the company’s business, past, present and future — major products, company policies, research and development, marketing and advertising, plans for capital expenditures and future financing, dividend policies, etc. Even with this generous amount of information, the stockholder will need to make further studies of the performance and prospects of other companies or seek professional investment advice as an adequate basis for investment decisions.

In regard to the other parties having bona fide interests, general creditors may obtain reports to stockholders and special reports by credit agencies. Trust indentures securing long-term bonds and debentures usually provide for specific information to be reported to the trustee under the indenture in addition to the regular financial state-
ments. The government's most important interest is income taxes, and these are determined on a statutory basis which may differ widely from reported income of the entity determined in accordance with generally accepted accounting principles. Employees and customers of an enterprise are sometimes referred to as interested parties. Whether they have need for information beyond the regular financial statements, and have a right to receive it, are questions for settlement between those parties and the management.

Managements of a business enterprise and members of the accounting profession obviously have a continuous concern and obligation to present financial statements of the greatest possible usefulness to investors and others having bona fide interests. Financial statements, although indispensable as an instrument for partial fulfillment of fiduciary accountabilities, have serious limitations in providing a basis for investment decisions. They are historical and based on cost, not value. There are very wide, and often irreconcilable, gaps between the equity of stockholders in the historical cost of net assets of corporate entities and current stock market quotations. The latter presumably reflect current appraisals of future earnings prospects by buyers and sellers of stocks, the former being somewhat more optimistic than the latter.

It seems clear that about the only light shed on current quoted values of securities by financial statements are from (1) the record of past earnings shown in the income statements, and (2) the extent to which invested capital as shown in the balance sheets may be judged adequate to maintain or expand the past earnings in the future. Even in regard to these items, investors should keep in mind that timeliness in financial reporting requires estimates based on judgment and, in times of inflation, that historical costs of items purchased in prior periods are usually less than current costs and, therefore, the reported income probably exceeds income fully stated in current dollars.

Form of Presentation of Financial Statements

The AICPA committees on accounting have not dealt with the form of presentation of financial statements. Undoubtedly it has been considered advisable to leave the form flexible so that managements and independent accountants may experiment with both form and terminology in order to make the statements more readily understood by the users of the statements. Accordingly, this Inventory does not deal with forms of financial statements but summarizes the generally accepted accounting principles comprehended in a fair presentation. It is believed, however, that a useful purpose may be served by brief
comments of the major trends in the form of presentation of financial statements.

**Trend in Financial Position Presentation**

The customary form usually shows the assets on the left-hand side of the statement, with liabilities and stockholders' equity on the right-hand side. Subheadings or classifications are made within the total assets and liabilities in order to identify current assets and current liabilities and other significant items are set forth with appropriate descriptions and disclosures.

The newer but less commonly used form of presenting assets, liabilities and equity is called, usually, the financial position form. This form attempts to give some financial analysis by presenting a grouping of current assets, less a grouping of current liabilities, in order to show the amount of working capital. Working capital plus other assets, less long-term liabilities, is then equated with stockholders' equity.

When the *Trends and Techniques* studies of the Institute were begun (for 1946) of 600 annual reports, 584 followed the customary form of presentation of balance sheets and 16 followed the financial position form. In the reports for 1962, 529 followed the customary form of presentation and 71 followed the financial position form.

**Trend in Income Statement Presentation**

The form of income statement presentation falls into two general types, namely, the "multiple-step" form and the "single-step" form. The multiple-step form sets out several intermediate stages of income such as the following:

- Gross sales
- Deduct—sales returns and allowances
- Net sales
- Deduct—cost of goods sold
- Gross profit on sales
- Deduct operating expenses—
  - selling, general, and administrative
- Net operating income
- Add or deduct other income and expense
- Net income before income tax
- Deduct Federal income tax
- Net income before extraordinary items
- Add or deduct extraordinary items
  - (net of related income tax)
- Net income for the year
If the extraordinary items are sufficient to distort net income, the preceding net income step should be labeled “net income for the year.”

The managements of many companies and many CPAs believe that the multiple-step income statement is subject to misinterpretation, since users may gain the impression that some costs take precedence over others and that the intermediate profit or income figures represent some form of significant earning power. The “single-step” form of income statement was developed to overcome these objections and is illustrated below.

\[
\begin{align*}
\text{Sales, less returns and allowances} & \quad \text{Other income} \\
\text{Costs and expenses—} & \\
\text{costs of goods sold} & \\
\text{selling expense} & \\
\text{general and administrative expense} & \\
\text{other expenses} & \\
\text{Federal income taxes} & \\
\text{Net income before extraordinary items} & \\
\text{Add or deduct extraordinary items} & \text{ (net of related income tax)} \\
\text{Net income for the year} & \\
\end{align*}
\]

There are, of course, numerous variations in the particular items set forth in both forms of income statement presentation.

The Institute study of 600 annual reports, *Trends and Techniques*, shows that in the reports for the year 1946, 468 companies followed the multiple-step form of presentation, 125 followed the single-step form, and 7 did not present an income statement. In the reports for the year 1962, 257 companies used the multiple-step form, 342 used the single-step form, and one company did not present an income statement. Thus, the use of the single-step form of presentation has increased from 21% to 57% of the total reports surveyed during the past seventeen years.

**Comparative Financial Statements**

The study of some 600 annual reports of corporations in the 1963 issue of *Trends and Techniques* states that comparative statements were presented in 90 per cent of the reports. Certified public accountants should continue to urge clients to present comparative statements in all annual reports to stockholders.

Comments on comparative financial statements are presented in *ARB No. 43*, Chapter 2, Section A, reproduced below.
1. The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. Such presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an installment of what is essentially a continuous history.

2. In any one year it is ordinarily desirable that the balance sheet, the income statement, and the surplus statement be given for one or more preceding years as well as for the current year. Footnotes, explanations, and accountants' qualifications which appeared on the statements for the preceding years should be repeated, or at least referred to, in the comparative statements to the extent that they continue to be of significance. If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information should be furnished which will explain the change. This procedure is in conformity with the well recognized principles that any change in practice which affects comparability should be disclosed.

3. It is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out.

4. Circumstances vary so greatly that it is not practicable to deal here specifically with all situations. The independent accountant should, however, make very clear what statements are included within the scope of his report.

* * *

Inclusion of All Gains and Losses in Statements of Income

It is stated in the summary of generally accepted accounting principles, Principle A-7, that:

There is a strong presumption that all gains and losses will be included in periodic income statements unless they are of such magnitude in relation to revenues and expenses from regular operations as to cause the statements to be misleading.

This principle is supported in paragraph 3 of Chapter 2, Section B,
of ARB No. 43, which is presented below. It is supported also by ARB No. 43, Chapter 8, which is reproduced in Chapter 4 of this Inventory.

ARB No. 43
Chapter 2
Section B

FORM OF STATEMENTS
Combined Statement of Income and Earned Surplus

1. Attention has already been called in the introduction to the increased significance attributed to the income statement by users of financial statements and to the general tendency to regard the balance sheet as the connecting link between successive income statements. It therefore becomes important to consider the problems presented by the practice of combining the annual income statement with the statement of earned surplus.

2. The combining of these two statements, where possible, will often be found to be convenient and desirable. Where this presentation is contemplated, however, certain considerations should be borne in mind if undesirable consequences are to be avoided.

ADVANTAGES OF THE COMBINED STATEMENT

3. Over the years it is plainly desirable that all costs, expenses, and losses, and all profits of a business, other than decreases or increases arising directly from its capital-stock transactions, be included in the determination of income. If this principle could in practice be carried out perfectly, there would be no charges or credits to earned surplus except those relating to distributions and appropriations of final net income. This is an ideal upon which all may agree, but because of conditions impossible to foresee it often fails of attainment. From time to time charges and credits are made to surplus which clearly affect the cumulative total of income for a series of years, although their exclusion from the income statement of a single year is justifiable. There is danger that unless the two statements are closely connected such items will be overlooked, or at any rate not given full weight, in any attempt on the part of the reader to compute a company's long-run income or its income-earning capacity.

4. There is a marked tendency to exaggerate the significance of the net income for a single year, particularly the degree to which the net income can be identified exclusively with that year. In so far as the combined form calls attention to the character of the income statement
as a tentative installment in the long-time financial results it serves a useful purpose.

5. To summarize, the combined income and earned surplus statement serves the purpose of showing in one statement both the earnings applicable to the particular period and modifications of earned surplus on a long-run basis. It distinguishes current charges and credits related to a company’s more usual or typical business operations from material extraordinary charges and credits which may have arisen during the period by placing them in different sections of a continuous statement.

DISADVANTAGES AND LIMITATIONS

6. In the combined statement, net income for the year appears somewhere within the statement and not at the end. Such wording and arrangement should be used as will make this item unmistakably clear and leave the reader in no doubt as to the point at which the net income has been determined.

7. While it is true that the net income amount, when expressed as earnings per share, is often given undue prominence and its significance exaggerated, there nevertheless remain the responsibility for determination of net income by sound methods and the duty to show it clearly. The adoption of the combined statement provides no excuse for less care in distinguishing charges and credits to income from charges and credits to surplus than would be required if separate statements of income and surplus were presented. Failure to exercise care in the use of this form of statement would immediately discredit it.

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1 See chapter 8, paragraphs 11, 12, and 13.

Earnings Per Share

ARB No. 49 | EARNINGS PER SHARE

1. Statistical presentations of periodic net income (or loss) in terms of earnings per share are commonly used in prospectuses, proxy material, and annual reports to shareholders, and in the compilation of business earnings statistics for the press, statistical services, and other publications. This bulletin deals with a number of problems arising in the computation and presentation of such statistics.
2. The committee has previously considered certain aspects of this matter and now reaffirms its earlier conclusions that:

(a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;

(b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and

(c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per-share amount of such charges and credits should be reported separately and simultaneously.

3. Not only does the use of a single figure for earnings per share involve the same limitations of usefulness as does a single figure for net earnings, but also, in many circumstances, the computation of earnings per share involves unique problems. While it is desirable to achieve as much uniformity as is feasible, clear explanation and disclosure of methods used are especially important in this area of financial reporting.

4. The committee suggests the following general guides to be used in computing and presenting earnings per share:

(a) Where used without qualification, the term *earnings per share* should be used to designate the amount applicable to each share of common stock or other residual security outstanding.

(b) Earnings per share, and particularly comparative statistics covering a period of years, should generally be stated in terms of the common stock position as it existed in the years to which the statistics relate, unless it is clear that the growth or decline of earnings will be more fairly presented, as for example, in the case of a stock split, by dividing prior years' earnings by the current equivalent of the number of shares then outstanding.

(c) *In all cases in which there have been significant changes in stock during the period to which the computations relate, an appropriate explanation of the method used should accompany the presentation of earnings per share.*

**SINGLE-YEAR COMPUTATIONS**

5. In the computation of earnings per share for a single year, minor increases or decreases in the number of shares outstanding during the
year may be disregarded, and it is appropriate to base the computation on the number of shares outstanding at the end of the year. In the case of a substantial increase or decrease in the number of shares resulting from the issuance or reacquisition of stock for cash or other property during the year, it is generally appropriate to base the computation of earnings per share on a weighted average of the number of shares outstanding during the year. Where there has been little or no opportunity to utilize the proceeds from the issuance of such shares, as would most clearly be the case when the shares were issued shortly before the end of the year, such shares may be disregarded in the computation. When an increase in the number of shares outstanding results from a stock dividend or a stock split, or a reduction in the number of shares outstanding results from a reverse split, without proceeds or disbursements, the computation should be based on the number of shares outstanding at the end of the year. For purposes of determining the number of shares outstanding, reacquired shares should be excluded.

6. If there has been a stock split or a reverse split after the balance-sheet date but before the issuance of the financial report, it is desirable to base the computation of earnings per share on the new number of shares, since the reader’s primary interest is presumed to be in the present stock position. Similar considerations may apply to stock dividends, although a relatively small stock dividend may properly be disregarded. In these cases of changes after the balance-sheet date, it is preferable to choose the more useful and informative basis of computation rather than to present two simultaneous and possibly confusing computations on different bases. When computations of earnings per share reflect changes in the number of shares after the balance-sheet date, it is important that this fact be clearly disclosed since there may be a presumption that earnings per share are based on the number of shares shown on the balance sheet. It is equally important that significant changes in the number of shares after the balance-sheet date be disclosed when such changes are not reflected in the computation of earnings per share.

7. Where there are shares outstanding senior to the common stock or other residual security, the claims of such securities on net income should be deducted from net income or added to net loss before computing per-share figures, since the term earnings per share is ordinarily used to designate the amount applicable to each share of common stock or other residual security outstanding. In arriving at net income applicable to common stock for purposes of the per-share computations, provision should be made for cumulative preferred dividends for the
year, whether or not earned. In the case of a net loss, the amount of the loss should be increased by any cumulative preferred stock dividends for the year. Where such dividends are cumulative only if earned, no adjustment of this nature is required except to the extent of income available therefor. In all cases the effect that has been given to dividend rights of senior securities in arriving at the earnings per share of common stock should be disclosed.

8. The following special considerations relate to convertible securities:

(a) When debt capital, preferred stock, or other security has been converted into common stock during the year, earnings per share should ordinarily be based on a weighted average of the number of shares outstanding during the year. When the weighted average is used in such cases, adjustments for the year in respect of interest or other related factors are not made.

(b) When capitalizations consist essentially of two classes of common stock, one of which is convertible into the other and is limited in its dividend rights until conversion takes place as, for example, when certain levels of earnings are achieved, two earnings-per-share figures, one assuming conversion, are ordinarily necessary for full disclosure of the situation.

COMPARATIVE STATISTICS

9. Presentations of earnings-per-share data for a period of several years should be governed basically by the criteria for single year presentations, but may involve a number of special considerations in view of changes in conditions during the period, and the purpose for which the data are to be used. It should be recognized that any tabulation of earnings per share for a period of years may have little bearing on the present position, and may fail to give any indication of present expectations. Variations in the capital structure may have substantial effects on earnings per share. The usefulness of such statistics depends in large measure on collateral historical information and disclosure of methods of computation used. The committee's recommendations which follow are intended as guides to general uniformity but not as substitutes for explanations and disclosures or as cures for the inherent defects in statistical presentations of earnings per share.

10. When computations of earnings per share for a period of years, such as are submitted in annual reports and in prospectuses, include
periods in which there have been stock splits or reverse splits, the
earnings for periods prior to the dates of the splits should be divided by
the current equivalent of the number of shares outstanding in the
respective prior periods in order to arrive at earnings per share in terms
of the present stock position. Similar treatment should be accorded to
stock dividends; however, it is permissible not to extend such treatment
to small recurrent stock dividends, although in a prospectus or when
such dividends in the aggregate become material, consideration should
be given to recognizing the cumulative effect thereof. On the other
hand, where, during the period of years for which data are given, there
have been issuances or reacquisitions of stock for cash or other property,
or, issuances in connection with conversions of debt capital, preferred
stock, or other security, the computations of earnings per share for the
years prior to such changes are not affected; it follows that earnings per
share for these years should be based on the number of shares outstanding in the various years. When both situations have occurred, the effect of each should be reflected in accordance with the foregoing recom-
mendations.

11. When equity securities are being publicly offered:

(a) If there have been significant conversions of debt capital, pre-
ferred stock, or other security during the period of years for
which data are given, it is appropriate to present supplementary
calculations revising past figures to reflect subsequent conver-
sions, on a pro forma basis.

(b) If the securities being offered, or their proceeds, are to be used
to retire outstanding securities in circumstances which assure
such retirement, it may be useful to present, in addition to other-
wise appropriate calculations, supplementary computations to
show pro forma earnings per share for at least the most recent
year as if such substitution of securities had been made. When
this is done, the basis of the supplementary computations should
be clearly disclosed. Where, however, the securities being
offered, or their proceeds, are to be used, not to retire existing
securities, but for such purposes as expansion of the business,
earnings per share should be computed without adjustment for
any increase in the number of shares anticipated as a result of
such offering.

12. Where there has been a pooling of interests during the period
of years for which data are given, in connection with which the number
of shares outstanding or the capital structure in other respects has been changed, the method used in computing earnings per share for those years prior to the pooling of interests should be based on the new capital structure. When there is to be a pooling of interests in connection with which the number of shares outstanding or the capital structure in other respects will be changed, earnings per share for any period for which income statements of the constituent companies are presented in combined form should be computed on a basis consistent with the exchange ratio to be used in the pooling of interests. In either case earnings per share should, in all other respects, be computed in conformity with the principles set forth in the foregoing paragraphs.

**Earnings Coverage of Senior Securities**

13. Where periodic net income is related to outstanding shares of senior securities, such as preferred stock, the committee believes that, under most circumstances, the term *earnings per share* is not properly applicable in view of the limited dividend rights of such senior securities. In such cases it may be helpful to show the number of times or the extent to which the requirements of senior dividends have been earned, but such information should not be designated as earnings per share.

**Miscellaneous**

14. It is impracticable to deal, in this bulletin, with all of the possible conditions and circumstances under which it may be necessary or desirable to compute data in terms of earnings per share — for example, acquisitions, mergers, reorganizations, convertible and participating securities, outstanding stock options, retirements, and various combinations of these circumstances. While such situations should be dealt with in harmony with the recommendations made in this bulletin, they call for especially careful consideration of facts and the exercise of judgment in the light of all the circumstances of the case and the purposes for which the data are prepared. In such complex situations as those mentioned in this paragraph, a clear disclosure of the basis on which the computations have been made is essential.

**Dividends Per Share**

15. Although this bulletin deals primarily with earnings per share, certain considerations may apply comparably to dividends per share. In general, dividends per share constitute historical facts and should be so reported. However, in certain cases, such as a stock split as
mentioned in paragraph 10, a presentation of dividends per share in terms of the current equivalent of the number of shares outstanding at the time of the dividend is necessary so that dividends per share and earnings per share will be stated on the same basis. When dividends per share are stated on any other than the historical basis, it is generally desirable that such statement be supplemental to the historical record, and its basis and significance should be fully explained.

The statement entitled “Earnings per Share” was unanimously adopted by the twenty-one members of the committee.

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1 As used herein, the term earnings per share connotes either earnings or losses per share.
2 Accounting Research Bulletin No. 43, “Restatement and Revision of Accounting Research Bulletins” (1953), Chapter 8, par. 14. Also see Chapter 2(b), par. 4.
3 See Accounting Research Bulletin No. 43, Chapter 7(b).

The Statement of Source and Application of Funds

APB Opinion No. 3

THE STATEMENT OF SOURCE AND APPLICATION OF FUNDS

INTRODUCTION

1. Increased attention has been given in recent years in the United States to what has generally come to be known as “Flow of Funds Analysis.” For several years the Board of Governors of the Federal Reserve System has published quarterly and annual statistics in the Federal Reserve Bulletin showing the flow of funds in the economy. The Flow-of-Funds National Accounts of the Federal Reserve Board have joined the National Income Accounts of the Department of Commerce as important tools of national fiscal and monetary policy. Management, analysts, and investors have also become increasingly aware of the value of this aspect of financial reporting for the individual corporation.
2. Accountants have long prepared statements of source and application of funds for management, which are in fact reports on the flow of funds in individual companies. These statements have often been presented in annual reports. The concept of "funds" used in these statements has varied somewhat in practice, and variations in the concept have resulted in variations in the nature of the statements. For example, "funds" has sometimes been interpreted to mean cash or its equivalent; in such cases the resulting statement of source and application of funds is a statement of cash receipts and disbursements. The most common concept of "funds" has, however, been that of working capital, i.e., current assets less current liabilities. If the definition is applied literally, the resulting statement includes only those transactions which affect the current assets or the current liabilities. A broader interpretation identifies "funds" as all financial resources arising from transactions with parties external to the business enterprise.  

3. The Accounting Principles Board has considered the matter of reporting the flow of funds of a business enterprise. Certain aspects of this matter are referred to in this Opinion, including (1) the importance of information about the flow of funds, (2) the essential features of the flow of a company's funds from a reporting standpoint, and (3) the distinction between information regarding flow of funds and information regarding net income.

4. Information about the sources from which a company obtains funds and the uses to which such funds are put may be useful for a variety of purposes affecting both operating and investment decisions. Some of this information is evident from the financial statements. The statement of source and application of funds is helpful because it presents other information which ordinarily cannot be obtained from the financial statements and because it presents articulated information about the flow of funds. A statement of source and application of funds cannot supplant the income statement, but it can provide a useful and significant summary of certain transactions which, taken by themselves, have meaning, namely those affecting the flow of funds.

5. The chart on page 313, prepared by Arthur Dahlberg, President of the U. S. Economics Corporation, shows the sources and uses of business funds in the United States. A fundamental feature of the source and application of funds shown by the chart is that all funds come either externally from borrowing or issuing equity securities or
Source and Uses of Corporate Funds for Non-Financial Business Firms
Average Year 1950—1959
(Billions of Dollars)

599.7 Billions
Corporate Income (100¢)

547.4
Basic Factor Costs-Wages
Raw Materials, Some Taxes
—etc. (91¢)

52.3
Profits, Federal
Corporation Taxes
and Depreciation (9¢)

Community
Savings

35.6
Profit Before
Taxes (6¢)

6.1
Sale of Stocks
and Bonds

2.2
Other Long-
Term Debt

2.0
Short-Term
Bank Loans

18.3
Federal Corporate Taxes
(3¢)

17.3
Profit After Taxes
(3¢)

2.7
Increase in
Trade Payables

13.0
Total New Money
From
External Sources

8.6
Dividends
(1½¢)

8.7
Retained Profits
(1½¢)

16.7
Depreciation and
Depletion (3¢)

38.4

23.7
Plant and
Equipment

2.7
Increase in
Inventories

5.0
Increase in
Receivables

7.0
Increase in Cash—
Other Assets—and
Discrepancies

Source: Federal Reserve Board, Flow of Funds in the United States

internally from revenues. Another characteristic is that the funds made available by revenues are classifiable in two distinct ways. Funds equal to the net income after deducting dividends paid to shareholders are added to the resources of the business and are available for any purpose. Funds equal to the sum of depreciation, depletion, and similar charges are also added to the resources of the business by revenues because such items, although properly deducted as operating expenses in the computation of net income, require no current outlay of funds. They represent a partial recovery, through revenues, of funds previously spent for fixed assets and are, therefore, analytically related to current expenditure for renewals and replacements of such assets.

6. In recent years a new concept (or more correctly, an old concept with a new name) has become increasingly important in the analysis of the flow of funds. The term “cash flow” has been used to refer to a variety of concepts, but its most common meaning in financial literature, and to a lesser extent in accounting literature, is the same as “funds derived from operations” in a statement of source and application of funds. It is often defined as “net income plus depreciation,” or “net income before deducting depreciation, depletion, amortization, etc.” Synonyms which are sometimes used include “cash earnings,” “cash income,” and “cash throw-off.”

7. Many of the comments made in connection with “cash flow” analysis leave the reader with the erroneous impression that “cash flow” or “cash earnings” is superior to net income as a measure of a company’s real earning power. Calculations of the Price/Cash Flow ratio are sometimes made and presented as a substitute for or supplement to the Price/Earnings ratio in evaluating a company’s stock. The amount of “cash flow” or the “cash flow per share” has often been presented in the president’s letter, the financial review, or the statistical section of the annual report of a corporation apart from or in the absence of a complete statement of source and application of funds in the report. In other words, there has been a growing tendency on the part of some people to single out one of the items on the statement of source and application of funds, thereby implying that this figure is more important than other information regarding the flow of funds and often carrying the implication that “net income plus depreciation” is the best measure of the company’s profitability. There is a strong implication running through the comments in the literature, including those in the annual reports of some corporations, that the total “cash flow” can be considered available for the payment of dividends.²
CHAPTER 8: APB OPINION NO. 3

8. The Board believes that a statement of source and application of funds should be presented as supplementary information in financial reports. The inclusion of such information is not mandatory, and it is optional as to whether it should be covered in the report of the independent accountant.

9. The concept of “funds” underlying the preparation of a statement of source and application of funds should be consistent with the purpose of the statement. In the case of statements prepared for presentation in annual reports, a concept broader than that of working capital should be used which can be characterized or defined as “all financial resources,” so that the statement will include the financial aspects of all significant transactions, e.g., “non-fund” transaction such as the acquisition of property through the issue of securities.

10. Types of transactions reflected in the statement of source and application of funds may vary substantially in relative importance from one period to another. As a result, consistency of arrangement of items from period to period and uniformity of arrangement as between reporting enterprises are of less significance than in the case of the balance sheet or income statement. In a statement of source and application of funds it is desirable to disclose and to emphasize the more important financial events of the period covered by the statement. Related items should be shown together when the result contributes to the clarity of the statement, and less important items should be combined. Significant changes in individual current assets and current liabilities should be shown as separate items whenever they are not otherwise adequately disclosed in the financial statements; changes in the other current items may then be combined and shown as a single amount.

11. The title of a statement of this type should be as descriptive as possible and need not be the same in all cases. “Statement of Resources Provided and Applied” and “Statement of Source and Application of Funds” are examples of appropriate titles. Of the various forms of the statement, the preferred one follows the common practice of beginning with the funds derived from operations (net income plus or minus “non-fund” adjustments), the calculation being shown either at the beginning of the statement or in a footnote.

12. Both increases and decreases in capital stock (other than stock dividends or splits), in noncurrent liabilities, and in noncurrent assets should be shown where the amounts are material. The proceeds from
an issue of securities should appear as a separate source of funds. Where significant in amount, the proceeds from the sale of property should be disclosed and shown separately from property acquisitions.

13. The presentation of comparative and consolidated statements of source and application of funds should conform to the policies adopted for the basic financial statements. A statement of source and application of funds which is cumulative for a period of years is sometimes prepared in addition to the statement for the current year, and is often helpful in furnishing a broad review of the financial activities over a period of time.

14. Whether or not a cash distribution to shareholders is a return of capital or a distribution of earnings can be determined only by comparing the distribution with the amount of retained earnings available. No generalization or conclusion can be drawn as to the significance of the “cash flow” without reference to the entire flow of funds as reflected in the complete statement of source and application of funds. Adding back depreciation provisions to show the total funds generated from operations can be misleading unless the reader of financial statements keeps in mind that the renewal and replacement of productive facilities require substantial “cash outflow,” which may well exceed the depreciation provisions. The “funds derived from operations” (cash flow) is one, but only one, of the important items in the statement, and its significance can be determined only by relating it to the other items.

15. The amount of funds derived from operations cannot be considered as a substitute for or an improvement upon properly determined net income as a measure of results of operations and the consequent effect on financial position. Misleading implications can result from isolated statistics in annual reports of “cash flow” which are not placed in proper perspective to net income figures and to a complete analysis of source and application of funds. “Cash flow” and related terms should not be used in annual reports in such a way that the significance of net income is impaired, and “cash earnings” or other terms with a similar connotation should be avoided. The Board regards computations of “cash flow per share” as misleading since they ignore the impact of cash expenditures for renewal and replacement of facilities and tend to downgrade the significant economic statistic of “earnings per share.”

The Opinion entitled “The Statement of Source and Application of Funds” was unanimously adopted by the twenty members of the Accounting Principles Board, of whom three, Messrs. Armstrong, Blough, and Spacek, assented with qualification.
Messrs. Armstrong and Blough approve the issuance of this Opinion because they believe its forceful warning against the improper preparation of “flow of funds analyses” and against their misuses is timely. However, they do not agree with the recommendation contained in paragraph 8 or the expressions contained in paragraphs 1 and 4 stating or implying that such analyses may be helpful in making investment decisions. They believe that such analyses do not deal with significant accounting matters and that relatively few investors who receive annual corporate reports are capable of using such statistical data in a useful manner. Instead, they believe their inclusion in annual reports tends to confuse most investors and affords a source of information which naive or unscrupulous persons may use to mislead the “ordinary” investor in the very ways warned against elsewhere in this Opinion.

Mr. Spacek concurs in issuance of this Opinion because he considers it to be a step in the right direction; but he does not believe that it deals adequately with the subject. In his view, since the Board believes that a funds statement should be presented in financial reports and yet does not require such presentation (par. 8), it fails in its primary responsibility of determining standards that meet the needs of investors and others who use financial statements. He states that making recommendations on the preparation of annual reports other than in the financial statements is not a Board function. He believes that the funds statement is essential for reporting to the public, and that it should be required as a part of the regular financial statements, along with the balance sheet and statements of income and surplus. He gives the illustration that no prudent corporate management, financial analyst or lending institution would evaluate the financial aspects of a business without benefit of all such statements, as a minimum; and, therefore, prudent investors who rely upon published financial statements should not be deprived of similar information.

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1 Examples of different uses of the term “funds” are found in “‘Cash Flow’ Analysis and the Funds Statement,” by Perry Mason, Accounting Research Study No. 2, published by the American Institute of CPAs in Nov. 1961, pp. 51-56. This study contains numerous examples of other aspects of these statements. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on accounting issues.)

2 For illustrations of these practices, see the sections, “Use of Cash Flow Concept in Financial Literature,” pp. 4-15, and “Presentation of Cash Flow Data in Annual Reports,” pp. 16-29, in Accounting Research Study No. 2.
Reporting to Investors on an Entity Basis

Objective E of the summary of generally accepted accounting principles says in the second sentence that reporting to investors should be performed on an entity basis, and the following subordinate principles are presented:

Principle E-2. Where there is a parent company and one or more subsidiaries, there is a presumption that consolidated statements are more meaningful than separate statements.

Principle E-3. The accounts of consolidated subsidiaries or divisions operating in foreign countries should be translated into dollars at the appropriate rates of exchange.

Principle E-4. Where two or more previously independent entities merge or otherwise combine in such a manner as to constitute a pooling of interests, the new entity inherits the bases of accountability of the constituent entities.

The foregoing principles are supported, respectively, by ARB No. 51, Chapter 12 of ARB No. 43, and ARB No. 48. These Bulletins are reproduced below.

ARB No. 51

CONSOLIDATED FINANCIAL STATEMENTS

PURPOSE OF CONSOLIDATED STATEMENTS

1. The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

CONSOLIDATION POLICY

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule
ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful. However, the fact that the subsidiary has a relatively large indebtedness to bondholders or others is not in itself a valid argument for exclusion of the subsidiary from consolidation. (Also, see Chapter 12 of Accounting Research Bulletin No. 43 for the treatment of foreign subsidiaries.)

3. In deciding upon consolidation policy, the aim should be to make the financial presentation which is most meaningful in the circumstances. The reader should be given information which is suitable to his needs, but he should not be burdened with unnecessary detail. Thus, even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements. On the other hand, separate statements or combined statements would be preferable for a subsidiary or group of subsidiaries if the presentation of financial information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation. For example, separate statements may be required for a subsidiary which is a bank or an insurance company and may be preferable for a finance company where the parent and the other subsidiaries are engaged in manufacturing operations.

4. A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure
or otherwise to the effect of intervening events which materially affect
the financial position or results of operations.

5. Consolidated statements should disclose the consolidation policy
which is being followed. In most cases this can be made apparent by
the headings or other information in the statements, but in other
cases a footnote is required.

CONSOLIDATION PROCEDURE GENERALLY

6. In the preparation of consolidated statements, intercompany
balances and transactions should be eliminated. This includes inter­
company open account balances, security holdings, sales and purchases,
interest, dividends, etc. As consolidated statements are based on the
assumption that they represent the financial position and operating
results of a single business enterprise, such statements should not
include gain or loss on transactions among the companies in the group.
Accordingly, any intercompany profit or loss on assets remaining within
the group should be eliminated; the concept usually applied for this
purpose is gross profit or loss. (See also paragraph 17.) However, in a
regulated industry where a parent or subsidiary manufactures or con­
structs facilities for other companies in the consolidated group, the
foregoing is not intended to require the elimination of intercompany
profit to the extent that such profit is substantially equivalent to a
reasonable return on investment ordinarily capitalized in accordance
with the established practice of the industry.

ELIMINATION OF INTERCOMPANY INVESTMENTS

7. Where the cost to the parent of the investment in a purchased¹
subsidiary exceeds the parent's equity in the subsidiary's net assets
at the date of acquisition, as shown by the books of the subsidiary, the
excess should be dealt with in the consolidated balance sheet according
to its nature. In determining the difference, provision should be made
for specific costs or losses which are expected to be incurred in the
integration of the operations of the subsidiary with those of the parent,
or otherwise as a result of the acquisition, if the amount thereof can be
reasonably determined. To the extent that the difference is considered
to be attributable to tangible assets and specific intangible assets, such
as patents, it should be allocated to them. Any difference which cannot
be so applied should be shown among the assets in the consolidated
balance sheet under one or more appropriately descriptive captions.
When the difference is allocated to depreciable or amortizable assets,
depreciation and amortization policies should be such as to absorb the
excess over the remaining life of related assets. For subsequent treatment of intangibles, see Chapter 5 of Accounting Research Bulletin No. 43.

8. In general, parallel procedures should be followed in the reverse type of case. Where the cost to the parent is less than its equity in the net assets of the purchased subsidiary, as shown by the books of the subsidiary at the date of acquisition, the amount at which such net assets are carried in the consolidated statements should not exceed the parent’s cost. Accordingly, to the extent that the difference, determined as indicated in paragraph 7, is considered to be attributable to specific assets, it should be allocated to them, with corresponding adjustments of the depreciation or amortization. In unusual circumstances there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis. A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable.

9. The earned surplus or deficit of a purchased subsidiary at the date of acquisition by the parent should not be included in consolidated earned surplus.

10. When one company purchases two or more blocks of stock of another company at various dates and eventually obtains control of the other company, the date of acquisition (for the purpose of preparing consolidated statements) depends on the circumstances. If two or more purchases are made over a period of time, the earned surplus of the subsidiary at acquisition should generally be determined on a step-by-step basis; however, if small purchases are made over a period of time and then a purchase is made which results in control, the date of the latest purchase, as a matter of convenience, may be considered as the date of acquisition. Thus there would generally be included in consolidated income for the year in which control is obtained the post-acquisition income for that year, and in consolidated earned surplus the postacquisition income of prior years, attributable to each block previously acquired. For example, if a 45% interest was acquired on October 1, 1957 and a further 30% interest was acquired on April 1, 1958, it would be appropriate to include in consolidated income for the year ended December 31, 1958, 45% of the earnings of the subsidiary for the three months ended March 31, and 75% of the earnings for the nine months ended December 31, and to credit consolidated earned
surplus in 1958 with 45% of the undistributed earnings of the subsidiary for the three months ended December 31, 1957.

11. When a subsidiary is purchased during the year, there are alternative ways of dealing with the results of its operations in the consolidated income statement. One method, which usually is preferable, especially where there are several dates of acquisition of blocks of shares, is to include the subsidiary in the consolidation as though it had been acquired at the beginning of the year, and to deduct at the bottom of the consolidated income statement the preacquisition earnings applicable to each block of stock. This method presents results which are more indicative of the current status of the group, and facilitates future comparison with subsequent years. Another method of prorating income is to include in the consolidated statement only the subsidiary's revenue and expenses subsequent to the date of acquisition.

12. Where the investment in a subsidiary is disposed of during the year, it may be preferable to omit the details of operations of the subsidiary from the consolidated income statement, and to show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate item in the statement.

13. Shares of the parent held by a subsidiary should not be treated as outstanding stock in the consolidated balance sheet.

MINORITY INTERESTS

14. The amount of intercompany profit or loss to be eliminated in accordance with paragraph 6 is not affected by the existence of a minority interest. The complete elimination of the intercompany profit or loss is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single business enterprise. The elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests.

15. In the unusual case in which losses applicable to the minority interest in a subsidiary exceed the minority interest in the equity capital of the subsidiary, such excess and any further losses applicable to the minority interest should be charged against the majority interest, as there is no obligation of the minority interest to make good such losses. However, if future earnings do materialize, the majority interest should be credited to the extent of such losses previously absorbed.
INCOME TAXES

16. When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign-tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation.

17. If income taxes have been paid on intercompany profits on assets remaining within the group, such taxes should be deferred or the intercompany profits to be eliminated in consolidation should be appropriately reduced.

STOCK DIVIDENDS OF SUBSIDIARIES

18. Occasionally, subsidiary companies capitalize earned surplus arising since acquisition, by means of a stock dividend or otherwise. This does not require a transfer to capital surplus on consolidation, inasmuch as the retained earnings in the consolidated financial statements should reflect the accumulated earnings of the consolidated group not distributed to the shareholders of, or capitalized by, the parent company.

UNCONSOLIDATED SUBSIDIARIES IN CONSOLIDATED STATEMENTS

19. There are two methods of dealing with unconsolidated subsidiaries in consolidated statements. Whichever method is adopted should be used for all unconsolidated subsidiaries, subject to appropriate modification in special circumstances. The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company or companies in the subsidiaries’ net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity has accrued to the credit of the group. (Adjustments of the investment would also be made for “special” debits or credits shown on the income statements of the unconsolidated subsidiaries below the net income for the period, and for similar items shown in the schedule...
of earned surplus.) The other method, more commonly used at present, is to carry the investment at cost, and to take up income as dividends are received; however, provision should be made for any material impairment of the investment, such as through losses sustained by the subsidiaries, unless it is deemed to be temporary. When the latter method is followed, the consolidated statements should disclose, by footnote or otherwise, the cost of the investment in the unconsolidated subsidiaries, the equity of the consolidated group of companies in their net assets, the dividends received from them in the current period, and the equity of the consolidated group in their earnings for the period; this information may be given in total or by individual subsidiaries or groups of subsidiaries.

20. Whichever method of dealing with unconsolidated subsidiaries is followed, if there is a difference between the cost of the investment and the equity in net assets at the date of acquisition, appropriate recognition should be given to the possibility that, had the subsidiaries been consolidated, part of such difference would have been reflected in adjusted depreciation or amortization. Also, appropriate recognition should be given to the necessity for an adjustment for intercompany gains or losses on transactions with unconsolidated subsidiaries. If sales are made to unconsolidated subsidiaries and the investment in the subsidiaries is carried at cost plus the equity in undistributed earnings, an elimination of unrealized intercompany gains and losses should be made to the same extent as if the subsidiaries were consolidated. The same applies where intercompany sales are made by the unconsolidated subsidiaries. If, however, the investment is carried at cost, it is not necessary to eliminate the intercompany gain on sales to such subsidiaries, if the gain on the sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries. If such gain is material, it should be appropriately disclosed. Where the sales are made by the unconsolidated subsidiaries to companies included in the consolidated group, the intercompany gains or losses should be eliminated in arriving at the amount of the equity in the undistributed earnings of the unconsolidated subsidiaries which will be disclosed in a footnote or otherwise. (See paragraph 19.)

21. Where the unconsolidated subsidiaries are in the aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate.
22. To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

23. Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods, or income taxes, they should be treated in the same manner as in consolidated statements.

PARENT-COMPANY STATEMENTS

24. In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information.

Mr. Bedford objects to the provision in paragraph 2 that ownership of over fifty per cent of the outstanding voting stock is the general rule governing consolidation policy. He believes the over fifty per cent ownership requirement is at best only one of several criteria evidencing the existence of a consolidated entity.

Messrs. Graese and Hoyler do not agree with the statement made in the last sentence of paragraph 8. Mr. Graese believes there are cases
in which the crediting of a capital surplus account with the “excess credit” will result in a more appropriate presentation of consolidated operations and financial position, particularly in (but not limited to) situations where the acquisition of control of the subsidiary has been accomplished over an extended period of time or where there are acquisitions of minority interest at a date considerably after obtaining control. Mr. Hoyler is of the opinion that there have been, and probably will be, circumstances under which credits to capital surplus of the excesses referred to in this paragraph will be appropriate.

Messrs. Halvorson and Werntz object to the relative emphasis given to the recommendations in paragraph 10, which they believe should be reversed. They believe that the date of the purchase which results in control should generally be considered to be the date of acquisition; however, if a limited number of purchases are made over a period of time pursuant to a plan or program which culminates in control, they agree that the earned surplus of the subsidiary at acquisition may be determined on a step-by-step basis.

Mr. Halvorson disagrees with the recommendation in paragraph 18. In his view, the usual subsidiary is a closely held corporation, and consequently is under no pressure to declare stock dividends and is under no compulsion to follow the “fair value” method of accounting for them if it does. If it does capitalize earned surplus by means of a stock dividend or otherwise, particularly “otherwise,” he feels that it must have been done with a purpose relating to its financial position, at the direction of, and with the acquiescence of, the parent company, and that the capitalization should carry through into the consolidated surplus accounts. If the subsidiary is one in which there is a publicly held minority interest, and a stock dividend is issued and accounted for on a fair-value basis in the manner of an independent publicly owned corporation, the accounting for earned surplus in respect of the majority interest would be the same as that for the minority interest, and again he believes that the capitalization should follow through into the consolidated surplus accounts. Mr. Powell also disagrees with the conclusion expressed in this paragraph. He believes that if a parent causes a subsidiary to freeze a part or all of its earned surplus through the payment of a stock dividend or otherwise, thus making such surplus unavailable for ordinary dividends, it should follow a similar procedure on consolidation.

Mr. Kent believes the consolidation policy section is deficient since it fails to restrict the increasing practice of not including certain subsidiaries in consolidated financial statements. He suggests that the
bulletin may possibly result in further increasing such practice as a consequence of the preference expressed in paragraph 19 for the inclusion of the equity in earnings of unconsolidated subsidiaries in consolidated statements. It is his belief that in the usual situation a full consolidation policy as implied in paragraph 1 is generally preferable, supplemented by such summarized financial information, in footnotes or otherwise, as may be appropriate.

Messrs. Dunn and Graham believe that the “preferable” method in paragraph 19 should be recognized as the only acceptable method of dealing with unconsolidated subsidiaries in consolidated statements, and that the method which carries the investment in unconsolidated subsidiaries at cost, and takes up as income only the dividends received, should be discontinued as rapidly as is practicable. They feel that the “preferable” method conforms to the purpose of consolidated statements as set forth in paragraph 1 — to present the results of operations and the financial position essentially as if the group were a single company, and that its uniform adoption would increase the comparability of the financial statements of different companies, and would avoid the possibility of manipulation of reported consolidated earnings through the control of dividends received by the parent.

Mr. Dunn believes that paragraph 20 should require the elimination of intercompany gain on sales to unconsolidated subsidiaries if the failure to do so would have a material effect on the reported consolidated income, regardless of whether the gain on intercompany sales exceeds the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries.

\(^1\) See Accounting Research Bulletin No. 48, “Business Combinations,” for the difference in treatment between a purchase and a pooling of interests.

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This Bulletin also incorporated in paragraph 9 the following rule which was adopted by the membership of the Institute in 1934 (ARB No. 43, Chapter 1A, paragraph 3).

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.
1. The recommendations made in this chapter apply to United States companies which have branches or subsidiaries operating in foreign countries.

2. Since World War I foreign operations have been influenced to a marked degree by wars, departures from the gold standard, devaluations of currencies, currency restrictions, government regulations, etc.

3. Although comparatively few countries in recent years have had unrestricted currencies and exchanges, it is nevertheless true that many companies have been doing business in foreign countries having varying degrees of restrictions; in some cases they have been carrying on all operations regarded as normal, including the transmission of funds. In view of the difficulties mentioned above, however, the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business and to be included or reflected in the financial statements of United States companies requires careful consideration.

4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto. Appropriate provision should be made also for known losses.

5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant, and they should be reserved against the extent that their realization in dollars appears to be doubtful.

6. As to assets held abroad, the accounting should take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned. Under these conditions it is important that especial care be taken in each case to make full disclosure in the financial statements of United States companies of the extent to which they include significant foreign items.

7. Where more than one foreign exchange rate is in effect, care should be exercised to select the one most clearly realistic and appropriate in the circumstances.
CHAPTER 8: ARB NO. 43, CH. 12

CONSOLIDATION OF FOREIGN SUBSIDIARIES

8. In view of the uncertain values and availability of the assets and net income of foreign subsidiaries subject to controls and exchange restrictions and the consequent unrealistic statements of income that may result from the translation of many foreign currencies into dollars, careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries with the statements of United States companies. Whether consolidation of foreign subsidiaries is decided upon or not, adequate disclosure of foreign operations should be made.

9. The following are among the possible ways of providing information relating to such foreign subsidiaries:

(a) To exclude foreign subsidiaries from consolidation and to furnish (1) statements in which only domestic subsidiaries are consolidated and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company’s equity therein. The total amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it acceptable practice to include intercompany profits which would be eliminated if such subsidiaries were consolidated.

(b) To consolidate domestic and foreign subsidiaries and to furnish in addition the summary described in (a) (2) above.

(c) To furnish (1) complete consolidated statements and also (2) consolidated statements for domestic companies only.

(d) To consolidate domestic and foreign subsidiaries and to furnish in addition parent company statements showing the investment in and income from foreign subsidiaries separately from those of domestic subsidiaries.

LOSSES AND GAINS ON FOREIGN EXCHANGE

10. Realized losses or gains on foreign exchange should be charged against or credited to operations.

11. Provision should be made, ordinarily by a charge against opera-
tions, for declines in translation value of foreign net current and working assets (unrealized losses). Unrealized gains should preferably be carried to a suspense account, except to the extent that they offset prior provisions for unrealized losses, in which case they may be credited to the account previously charged.

TRANSLATION OF ASSETS, LIABILITIES, LOSSES, AND GAINS

Balance sheet

12. Fixed assets, permanent investments, and long-term receivables should be translated into dollars at the rates prevailing when such assets were acquired or constructed. When large items are purchased for United States dollars (or from the proceeds of sale of such dollars), the United States dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency (obtained from earnings or borrowings), then the cost of the assets should be the equivalent of the amount of foreign currency in United States dollars, at the rate of exchange prevailing at the time payment is made. An exception to the foregoing general principle might be made where fixed assets, permanent investments, or long-term receivables were acquired shortly before a substantial and presumably permanent change in the exchange rate with funds obtained in the country concerned, in which case it may be appropriate to restate the dollar equivalents of such assets to the extent of the change in the related debt.

13. In consolidating or combining the accounts, depreciation should be computed on the amount of fixed assets as expressed in United States dollars, even though for purposes of local taxation it may be impossible to show the foreign currency equivalent of the full amount of depreciation on the foreign statements.

14. Cash, accounts receivable, and other current assets, unless covered by forward exchange contracts, should be translated at the rate of exchange prevailing on the date of the balance sheet.

15. Inventory should follow the standard rule of cost or market, whichever is lower in dollars. Where accounts are to be stated in which the question of foreign exchange enters and the inventory is not translated at the rate of exchange prevailing on the date of the balance sheet, as is usually done with current assets, the burden of proof is on those who wish to follow some other procedure.

16. There are, however, undoubtedly many cases where the cost or a portion of the cost of an article was incurred when the foreign
currency was at a substantially higher rate of exchange than existed on the closing day of the financial period. In many cases such an asset could not be replaced for the amount in foreign currency at which it appears in the records of the branch or subsidiary company. In some cases the replacement price in foreign currency would undoubtedly have increased since the fall in exchange, and it would be inequitable to treat the lower of cost or market as a mere translation at the closing rate of the foreign currency cost price, where the article could now be replaced only at a much higher amount in foreign currency. Where the selling price obtainable in dollars, after deducting a reasonable percentage to cover selling and other local expenses, exceeds the cost of the article in dollars at the rate prevailing as of the date of purchase, such original dollar equivalent may be considered as the cost for purposes of inventory.

17. Current liabilities payable in foreign currency should be translated into dollars at the rate of exchange in force on the date of the balance sheet.

18. Long-term liabilities and capital stock stated in foreign currency should not be translated at the closing rate, but at the rates of exchange prevailing when they were originally incurred or issued. This is a general rule, but an exception may exist in respect to long-term debt incurred or capital stock issued in connection with the acquisition of fixed assets, permanent investments, or long-term receivables a short time before a substantial and presumably permanent change in the exchange rate. In such instances it may be appropriate to state the long-term debt or the capital stock at the new rate and proper to deal with the exchange differences as an adjustment of the cost of the assets acquired.

Profit and loss statement

19. The operating statements of foreign branches or subsidiaries, or of domestic corporations conducting their business in foreign currencies (buying, selling, and manufacturing), should preferably, where there have been wide fluctuations in exchange, be translated at the average rate of exchange applicable to each month or, if this procedure would involve too much labor, on the basis of a carefully weighted average.

20. Where a major change in an exchange rate takes place during a fiscal year, there may be situations in which more realistic results will be obtained if income computed in foreign currencies is translated for the entire fiscal year at the new rates in effect after such major
fluctuation. This procedure would have the practical advantage of making unnecessary a cutoff at the date of the change in the exchange rate. Where dividends have been paid prior to a major change in the exchange rate, out of earnings of the current fiscal year, that portion of the income for the year should be considered as having been earned at the rate at which such dividend was paid irrespective of the rates used in translating the remainder of the earnings.

21. While the possibility of losses from currency devaluation may ordinarily be considered to be a risk inherent in the conduct of business in foreign countries, the world-wide scope and unprecedented magnitude of devaluations that have occurred in recent years are such that they cannot be regarded as recurrent hazards of business. Accordingly, exchange adjustments arising from such extraordinary developments, if so material in amount that their inclusion in the income statement would impair the significance of net income to an extent that misleading inferences might be drawn therefrom, appear to be of such nature that they might appropriately be charged to surplus.

22. The foregoing is no more than a brief résumé of the generally accepted principles pertaining to the treatment of foreign exchange as applied to the statements of accounts of American corporations. The practical problems which arise in their application should receive careful consideration in each case.

Two members of the committee, Messrs. Lindquist and Mason, assented with qualification to adoption of chapter 12.

Mr. Lindquist believes that the accounting indicated in paragraph 11 for unrealized losses and gains arising from exchange fluctuations should be consistent for losses and gains to the extent that they result from normal temporary fluctuations in exchange rates.

Mr. Mason does not approve the inconsistent treatment of unrealized losses and unrealized gains from exchange fluctuations. He would prefer to defer them both. He also believes that long-term receivables and long-term liabilities should be translated at current rates.

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The foregoing chapter of ARB No. 43 has become outmoded in relation to present practice, particularly in the translation of long-term assets and liabilities, due to the prevalence of major currency revaluations and continued substantial inflation in many countries. Research Report No. 36, "Management Accounting Problems in Foreign Op-
From the standpoint of the U. S. shareholder, two classes of items may be distinguished in the balance sheet of a foreign subsidiary. First, there are financial items consisting of local currency and claims to receive or to pay a fixed number of local currency units. The dollar equivalent of local currency financial assets and liabilities is immediately affected by a change in the rate of exchange. The reason is that if the local currency declines relative to the U. S. dollar, financial assets in local currency will yield fewer dollars on conversion and debts payable in local currency can be satisfied with fewer dollars. Local currency financial assets are always at risk from unfavorable movements in the exchange rate. This risk can be minimized by keeping net financial assets of the foreign subsidiary as low as possible. Because financial items are immediately and directly affected by fluctuations in exchange rates, the exchange rate prevailing on the date of the balance sheet yields the best translation for financial items expressed in a foreign currency.

The physical assets constitute the second class of items in the balance sheet of a foreign subsidiary. Physical items such as inventories and fixed assets tend to be unaffected by exchange rate fluctuations. Since a substantial decline in value of a foreign currency unit relative to the dollar is usually a consequence of inflation in the foreign country, prices in that country may be expected to rise and physical assets will command increased selling prices in the devalued currency. Such assets are logically translated at the rate of exchange current on the date in foreign subsidiary acquired the assets.

This classification of local currency balance sheet items into financial and physical items for the purpose of translation differs from the conventional practice of translating current items at the current rate of exchange and fixed assets and long-term debt at historical rates of exchange. However, the study points that long-term receivables and long-term debt are affected like current financial items by permanent changes in the dollar value of the local currency. Similarly it may be expected that, in the long-run, management will not continue to sell goods in a foreign country unless the local currency equivalent of dollar cost can be obtained. For this reason inventories are not viewed as a source of exchange loss.

Unlike assets and liabilities, the question of how to translate net worth items cannot be answered directly by observing the effect.
which exchange rate fluctuations have on these items. In order to preserve the amount of the original dollar investment in the subsidiary, capital stock is translated at historical exchange rates. Retained earnings are made up of annual earnings translated in each of the years of accumulation less excess of foreign exchange losses over gains to the date of the current balance sheet.

Revenues and expenses arise day by day and local currency profits could be measured in dollars by translation at exchange rates prevailing when each transaction occurred. However, this is impractical where there are many transactions and average exchange rates are used for translation of income statement accounts other than depreciation, depletion, and amortization expense. Here the problem is to construct an average which represents exchange rates prevailing during the period. The report describes and illustrates methods for deriving average rates which can represent various patterns of fluctuation in actual exchange rates.

ARB No. 48 | BUSINESS COMBINATIONS

1. Whenever two or more corporations are brought together, or combined, for the purpose of carrying on the previously conducted businesses, the accounting to give effect to the combination will vary depending largely upon whether an important part of the former ownership is eliminated or whether substantially all of it is continued. This bulletin differentiates these two types of combinations, the first of which is designated herein as a purchase and the second as a pooling of interests, and indicates the nature of the accounting treatment appropriate to each type.

2. For accounting purposes, the distinction between a purchase and a pooling of interests is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form (such as a merger, an exchange of shares, a consolidation, or an issuance of stock for assets and businesses), or in the number of corporations which survive or emerge, or in other legal or tax considerations (such as the availability of surplus for dividends).

3. For accounting purposes, a purchase may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or
corporations is eliminated or in which other facts requisite to a pooling of interests are not present.

4. In contrast, a pooling of interests may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors discussed below are present. Such corporation may be one of the constituent corporations or it may be a new corporation. After a pooling of interests, the net assets of all of the constituent corporations will in a large number of cases be held by a single corporation. However, the continuance in existence of one or more of the constituent corporations in a subsidiary relationship to another of the constituents or to a new corporation does not prevent the combination from being a pooling of interests if no significant minority interest remains outstanding, and if there are important tax, legal, or economic reasons for maintaining the subsidiary relationship, such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses.

5. In determining the extent to which a new ownership or a continuity of old ownership exists in a particular business combination, consideration should be given to attendant circumstances. When the shares of stock that are received by the several owners of one of the predecessor corporations are not substantially in proportion to their respective interests in such predecessor, a new ownership or purchase of the predecessor is presumed to result. Similarly, if relative voting rights, as between the constituents, are materially altered through the issuance of senior equity or debt securities having limited or no voting rights, a purchase may be indicated. Likewise, a plan or firm intention and understanding to retire a substantial part of the capital stock issued to the owners of one or more of the constituent corporations, or substantial changes in ownership occurring shortly before or planned to occur shortly after the combination, tends to indicate that the combination is a purchase. However, where a constituent corporation has had two or more classes of stock outstanding prior to the origin of the plan of combination, the redemption, retirement, or conversion of a class or classes of stock having senior or preferential rights as to assets and dividends need not prevent the combination from being considered to be a pooling of interests.
6. Other attendant circumstances should also be taken into consideration in determining whether a purchase or a pooling of interests is involved. Since the assumption underlying the pooling-of-interests concept is one of continuity of all of the constituents in one business enterprise, abandonment or sale of a large part of the business of one or more of the constituents militates against considering the combination as a pooling of interests. Similarly, the continuity of management or the power to control management is involved. Thus, if the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated. Relative size of the constituents may not necessarily be determinative, especially where the smaller corporation contributes desired management personnel; however, where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests.

7. No one of the factors discussed in paragraphs 5 and 6 would necessarily be determinative and any one factor might have varying degrees of significance in different cases. However, their presence or absence would be cumulative in effect. Since the conclusions to be drawn from consideration of these different relevant circumstances may be in conflict or partially so, determination as to whether a particular combination is a purchase or a pooling of interests should be made in the light of all such attendant circumstances.

8. When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

9. When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, should be carried forward; and the combined earned surpluses and deficits, if any, of the constituent corporations should be carried for-
ward, except to the extent otherwise required by law or appropriate corporate action. Adjustments of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination are ordinarily equally appropriate if effected in connection with a pooling of interests; however, the pooling-of-interests concept implies a combining of surpluses and deficits of the constituent corporations, and it would be inappropriate and misleading in connection with a pooling of interests to eliminate the deficit of one constituent against its capital surplus and to carry forward the earned surplus of another constituent.

10. Where one or more of the constituent corporations continues in existence in a subsidiary relationship, and the requirements of a pooling of interests have been met, the combination of earned surpluses in the consolidated balance sheet is proper since a pooling of interests is not an acquisition as that term is used in paragraph 3 of chapter 1(a) of Accounting Research Bulletin No. 43 which states that earned surplus of a subsidiary corporation created prior to acquisition does not form a part of the consolidated earned surplus. Under the pooling-of-interests concept, the new enterprise is regarded as a continuation of all the constituent corporations and this holds true whether it is represented by a single corporation or by a parent corporation and one or more subsidiaries. If, however, prior to the origin of a plan of combination one party to the combination had been acquired by another such party as a subsidiary in circumstances which precluded the transactions from being considered a pooling of interests, the parent's share of the earned surplus of the subsidiary prior to such acquisition should not be included in the earned surplus of the pooled corporations.

11. Because of the variety of conditions under which a pooling of interests may be carried out, it is not practicable to deal with the accounting presentation except in general terms. A number of problems will arise. For example, if a single corporation survives in a pooling of interests, the stated capital of such corporation may be either more or less than the total of the stated capitals of the constituent corporations. In the former event, the excess may be deducted first from the total of any other contributed capital (capital surplus), and next from the total of any earned surplus, of the constituent corporations. When the stated capital of the surviving corporation is less than the combined stated capitals of the constituent corporations, the difference should appear in the balance sheet of the surviving corporation as other contributed
CHAPTER 8: FINANCIAL STATEMENTS (SECTION E OF SUMMARY)

capital (capital surplus), analogous to that created by a reduction in stated capital where no combination is involved.

12. When a combination is considered to be a pooling of interests, statements of operations issued by the continuing business for the period in which the combination occurs should ordinarily include the combined results of operations of the constituent interests for the part of the period preceding the date on which the combination was effected; if combined statements are not furnished, statements for the constituent corporations prior to the date of combination should be furnished separately or in appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was effected, when presented for comparative purposes, may be stated on a combined basis, or shown separately where, under the circumstances of the case, that presentation is more useful and informative. Disclosure that a business combination has been, or in the case of a proposed combination will be, treated as a pooling of interests should be made and any combined statements clearly described as such.

The statement entitled “Business Combinations” was unanimously adopted by the twenty-one members of the committee.

1 As used in this bulletin, the term “ownership interests” refers basically to common stock, although in some cases the term may also include other classes of stock having senior or preferential rights as well as classes whose rights may be restricted in certain respects.

* * *

It should be noted that certain of the suggested criteria for identification of a pooling, particularly relative size (par. 6), have not been generally followed in practice. Accounting Research Study No. 5 on business combinations has not yet been considered by the APB.
Appendix to Chapter 8

Chapters 7, 8, 9 and 11 of Statements on Auditing Procedure
No. 33

SAP No. 33
Chapter 7

ADHERENCE TO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

1. The first standard of reporting reads:

   The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The term “principles of accounting” as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them. The first reporting standard is construed to require not a statement of fact by the auditor, but an opinion as to whether the financial statements are presented in conformity with such principles. If limitations on the scope of the auditor’s examination make it impossible for him to form an opinion as to such conformity, appropriate qualification of his report is required.

3. The determination of whether financial statements are presented in accordance with “generally accepted accounting principles” requires exercise of judgment as to whether the principles employed in the statements have found general acceptance. The determination further requires a familiarity with alternative principles, sometimes more than one, which may be applicable to the transaction or facts under con-
sideration, and a realization that an accounting principle may have only limited usage but still have general acceptance.

4. Generally accepted accounting principles evolve and change. Pronouncements issued by authoritative bodies of the American Institute of Certified Public Accountants give recognition to such changes. The first reporting standard contemplates that the independent auditor will be alert to such pronouncements. He must also be alert to changes which become acceptable through common usage by business although not a subject of an Institute pronouncement.

5. Reference should be made to chapters 8, 10, and 13 which contain further comments on the application of this standard.

Chapter 8

CONSISTENCY OF APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

1. The second standard of reporting reads:

The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

2. The term “current period” means the most recent year or period of less than one year upon which the independent auditor is reporting. It is implicit in the standard that such principles have been consistently observed within each period. As noted in chapter 7, the term “principles of accounting” as used in the reporting standards is construed to include not only accounting principles and practices, but also the methods of applying them.

3. The objective of the consistency standard is: (1) to give assurance that the comparability of financial statements as between periods has not been materially affected by changes in the accounting principles employed or in the method of their application; or (2) if comparability has been materially affected by such changes, to require a statement of the nature of the changes and their effects on the financial statements.

COMPARABILITY OF FINANCIAL STATEMENTS

4. Proper application of the consistency standard requires a clear understanding by the independent auditor of the relationship of con-
sistency to comparability. The consistency standard involves the consistent application of accounting principles; lack of consistency produces lack of comparability. However, lack of comparability may be caused by other factors unrelated to consistency and even unrelated to accounting.

5. In general, comparability of financial statements as between years is affected by changes arising from: (a) a change in accounting principles employed, (b) changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed, and (c) changed conditions unrelated to accounting.

6. Only the first of these three classes involves the consistency standard and therefore only changes of this class having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Changes of the second and third classes having a material effect on the financial statements will not ordinarily be commented upon in the independent auditor's report. However, fair presentation may require their disclosure in the notes to the financial statements. Distinguishing characteristics of the types of changes included in each of these three classes are more fully described and commented upon in the following paragraphs.

A. **Comparability of financial statements affected by a change in accounting principles employed**

7. A characteristic of this type of change is that it involves a choice by management from among two or more accounting principles. The reason for the change need not be stated. Examples are a change from the straight-line method to the declining-balance method of depreciation, and a change from the pay-as-you-go basis to the accrual basis of accounting (whether or not funded) for an existing pension commitment or plan.

8. This type of change is intended to be covered by the consistency standard and should be recognized in the independent auditor's opinion.

B. **Comparability of financial statements affected by changed conditions which necessitate accounting changes but which do not involve changes in the accounting principles employed**

9. A characteristic of this type of change is that it is an accounting change required by altered conditions (rather than by the consum-
mation of a business transaction). It involves no choice by management since the accounting principles employed have not changed; hence, although comparability may be affected, consistency is not involved. Examples are a change in the estimated remaining useful life of plant property arising from operating experience or obsolescence, and a changed provision for pension plan accruals arising from revisions in actuarial assumptions based upon experience of the plan.

10. A change of this type having a material effect on the financial statements should be disclosed in a note to the financial statements. It would not ordinarily be commented upon in the independent auditor’s report* since it would not affect his opinion as to consistency. If commented upon in his report, it would be as a disclosure matter under the third standard of reporting.

C. Comparability of financial statements affected by changed conditions unrelated to accounting

11. A characteristic of this type of change is that it results from some specific happening or transaction which has accounting effect, as do most business transactions, but which does not involve a change in any accounting principle employed. As a result, an accounting principle may be employed for the first time; this is not a “change” in accounting principles and therefore does not require comment as to consistency in the independent auditor’s opinion. Examples are the acquisition or disposition of a subsidiary or plant, and the original adoption of a pension plan.

12. Only in unusual circumstances would this type of change be commented upon in the independent auditor’s report, although fair presentation may require disclosure in the notes to the financial statements; if commented upon in the independent auditor’s report it would be as a disclosure matter and not as a consistency matter.

RECLASSIFICATIONS

13. Although reclassifications of items in the financial statements may result in lack of comparability, they are usually not of sufficient importance to necessitate any disclosure. However, material changes in classification should be indicated and explained in the financial statements or notes; if appropriately disclosed, such changes ordinarily need not be referred to in the independent auditor’s report.
PERIOD TO WHICH THE CONSISTENCY STANDARD RELATES

14. The consistency standard is aimed at comparability of the financial statements of the current year with those of the preceding year (whether presented or not) and at comparability of all financial statements presented in comparative form. When the independent auditor's opinion covers the statements of two or more years, there is generally no need to disclose an inconsistency with a year prior to the years for which statements are being presented. Accordingly, the phrase "on a basis consistent with that of the preceding year" is ordinarily inapplicable whenever the opinion covers two or more years. Instead, language similar to "consistently applied during the period" or "applied on a consistent basis" should be used.

REPORTING ON INCONSISTENCY

15. When a change has been made in the accounting principles employed during the year or years the independent auditor is reporting upon (type A referred to on page 341) and the change has a material effect upon financial position or results of operations, he should refer in his opinion paragraph to a note to the financial statements which adequately describes the change and its effect, or describe adequately in his report the nature of the change and its effect. Where the change affects net income, the disclosure should include the amount by which net income is affected after consideration of related income taxes.

16. Ordinarily, the disclosure would give the amount by which the current year's net income was affected as a result of the change; however, there may be instances where the effect of change would have had on the prior year's net income would be considered an appropriate disclosure.

17. Although the independent auditor's advice is frequently sought and followed, management has the responsibility for the selection of the appropriate accounting principles to be employed in its financial statements. The expression of the independent auditor's opinion of changes affecting consistency will vary with the circumstances, as explained in the following paragraphs 18-20.

Change to an Alternative Generally Accepted Accounting Principle

18. When the client makes a change from the use of one generally accepted accounting principle, practice or method of application to
another which is generally accepted, the independent auditor need not indicate whether he approves or accepts the change. Although reference to the change is required in his opinion, the absence of qualification regarding fair presentation in conformity with generally accepted accounting principles is sufficient to indicate that the independent auditor considers the newly adopted accounting principle to be generally accepted. However, if he wishes, the independent auditor may express his approval of the change in his report (see footnote, p. 349). An illustration of expression of approval follows:

...in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year, except for the change, (insert expression of approval), in pricing of inventories...as described in Note__ to the financial statements.

(Note: Some expressions of approval are “which we approve,” “in which we concur,” “to an accepted alternative method,” and “to which we do not object.” The use of these expressions is optional.)

Change From a Principle or Practice Which Lacks General Acceptance to a Generally Accepted Accounting Principle

19. Ordinarily, the independent auditor will want to express his approval of a change from a principle or practice which lacks general acceptance to a generally accepted accounting principle. In these instances the illustration above and on pages 346 and 347 are considered appropriate.

Change to a Principle or Practice Which Lacks General Acceptance

20. Where the effect of a change to a principle or practice which is not generally accepted is material, the independent auditor should so state in his report. Such statement requires either a qualification of his opinion as to fair presentation in conformity with generally accepted accounting principles or, if the change is sufficiently material, an adverse opinion on the financial statements taken as a whole.

Illustrations follow:

Qualified Opinion

(Opinion paragraph)
In our opinion, except for (brief description of the change and its effect) as explained in Note__, a practice which we believe is at
variance with generally accepted accounting principles, the accompanying statements present fairly the financial position of X Company at October 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Adverse Opinion

(Middle paragraph)
The company has heretofore followed the practice of (brief description of prior practice) and has now adopted the practice of (brief description of new practice). As a result of this change, reported net income for the year ended October 31, 19__, and retained earnings as of that date, are each $_______ greater than they otherwise would have been.

(Opinion paragraph)
In view of the materiality of the effect of the above noted change to a practice which we believe is at variance with generally accepted accounting principles, we are of the opinion that the financial statements do not present fairly the financial position of X Company at October 31, 19__, or the results of operations for the year then ended, in conformity with generally accepted accounting principles.

(Note: Since the independent auditor completed his examination in accordance with generally accepted auditing standards, and has an opinion (adverse) on the statements, he should not disclaim an opinion.)

CHANGES EXPECTED TO HAVE A MATERIAL FUTURE EFFECT

21. If a change is made in the accounting principles employed which has no material effect on the financial statements in the current year, but which is reasonably certain to have substantial effect in later years, it should be appropriately disclosed in a note to the financial statements for the year in which the change is adopted by the client. An example of such a note follows:

It has been the consistent practice of the company to provide for the depreciation of properties on a straight-line basis over their estimated useful lives. Commencing with the current year, the company is providing for depreciation on new additions to property on the declining-balance method. This change has no material effect on the current financial statements.

22. If such a change is appropriately disclosed in a note to the financial statements as indicated above, it need not be mentioned in
the independent auditor's report. However, if such a change is not set forth in a note to the financial statements, it should be disclosed by the independent auditor in his report.

**RESTATED AMOUNTS IN FINANCIAL STATEMENTS OF PRIOR YEARS**

23. When a change has been made in the accounting principles employed and the accounts have been adjusted retroactively, it is desirable to restate financial information which is presented for any prior year, or years, affected. Such a restatement places all the periods being compared on the same basis with respect to the use and application of accounting principles.

24. In such cases, the independent auditor may report only on the current year, or he may report on all the years which have been restated, as well as on the current year. In either case, disclosure of the change should be made in the financial statements or the notes with an indication of its effect on the year or years restated in the comparative financial statements.

25. When he reports only on the current year, a change in that year should be referred to in his opinion somewhat as follows:

...in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year after giving retroactive effect to the inclusion, which we approve, of the accounts of foreign subsidiaries as explained in Note— to the financial statements.

(Note: The use of "which we approve" is optional, see footnote p. 349.)

26. When the independent auditor reports on all the years which have been restated as well as on the current year, he may be giving a new opinion with respect to the earlier years. Even though all years covered by his report are on a consistent basis, and the changes made are adequately disclosed in the financial statements and notes, his report should make reference to the restatement in the year of change. If such reference is made in the opinion paragraph, it may read somewhat as follows:

...applied on a consistent basis after giving retroactive effect to the inclusion, which we approve, of the accounts of foreign subsidiaries as explained in Note— to the financial statements.

(Note: The use of "which we approve" is optional, see footnote, p. 349.)
27. If the change took place in other than the current year and prior years have been restated, no reference to the change is necessary in the independent auditor's report. However, disclosure of the change should be made in the financial statements or notes relating to any prior year restated in comparative financial statements.

FINANCIAL STATEMENTS OF PRIOR YEARS NOT RESTATED

28. When financial statements are presented in comparative form and prior years are not restated to give effect to a change in the accounting principles employed, adequate disclosure requires a description of the nature and effect of the change.

29. When the change took place in the current year, it should be disclosed in the independent auditor's report as explained in paragraph 34 (see p. 348).

30. When the change took place in other than the current year and the independent auditor:

(a) Is reporting on all the years, he should refer in the opinion paragraph of his report to a note to the financial statements which adequately describes the change and its effect, or make such disclosure in his report;

(b) Is reporting only on the current year, no reference is necessary in his report but disclosure of the change should be made in an appropriate note to the financial statements.

THE INDEPENDENT AUDITOR'S FIRST REPORT

31. When the independent auditor reports on the first accounting period of a newly organized company, he need make no reference to consistency, since there exists no previous period with which to make a comparison.

32. When the independent auditor makes his first examination of an established company, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent as between the current and the preceding year. Where adequate records have been maintained by the client, it is practicable and reasonable to extend auditing procedures sufficiently to give an opinion on consistency. Limitations imposed by the client with respect to these procedures would require appropriate qualification.
33. There may be situations where the inadequacy of the financial records for the earlier years precludes the independent auditor from forming an opinion as to the consistent application of accounting principles and the reasonable accuracy of the account balances at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would be unable to express an opinion on the current year's statement of income. When this is the case the independent auditor should state in his report that the inadequate condition of the records prevents him from expressing an opinion not only on consistency but also on the statements of income and retained earnings for the current year. For example, the independent auditor's report might contain the following:

... and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.

Because of major inadequacies in the company's accounting records for the previous year, it was not practicable to extend our auditing procedures sufficiently to enable us to express an opinion on the statement(s) of income and retained earnings for the year ended (current year) or on the consistency of application of accounting principles with the preceding year.

In our opinion, the accompanying balance sheet presents fairly the financial position of the X Company as of (current year end) in conformity with generally accepted accounting principles.

34. If accounting records for prior years were kept on a basis which did not result in a fair presentation of financial position and results of operations for those years, comparison of the statements upon which the independent auditor is reporting with those of prior years would be of little significance. Accordingly, the customary reference to consistency in the independent auditor's report may be omitted and his report could be presented as follows:

(Middle paragraph)
The company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition having been accorded accounts receivable, accounts payable, or accrued expenses. At the beginning of the current year the company, with our approval, adopted the accrual basis of accounting, and appropriate adjustments, where material, have been made to retained earnings as of the beginning of the year.

(Opinion paragraph)
In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the
financial position of the X Company as of October 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles.

POOLING OF INTERESTS

35. When companies have been merged or combined in accordance with the accounting concept known as a "pooling of interests," appropriate effect of the pooling should be given in the presentation of results of operations and earnings per share of years prior to the year of pooling as described in Accounting Research Bulletins No. 48 and 49. Comparative financial statements which do not give appropriate recognition to the pooling are not presented on a consistent basis. The inconsistency arises, in this case, not from a change in the application of an accounting principle in the current year but from the lack of such application to prior years. Accordingly, in order to avoid a misleading inference which might otherwise arise, the independent auditor should refrain from the use of the expression "on a basis consistent with that of the preceding year" whenever comparative statements are presented in which prior years' operating statements of the constituents have not been appropriately combined or shown separately. In such instances he should disclose in his report the lack of consistency and describe, or refer to a note to the financial statements which describes: (1) the nature of the pooling and (2) the effect of the pooling upon results of operations of all prior years presented.

36. When single-year statements only are presented, a note to the financial statements should adequately disclose the pooling transaction and state the net incomes of the constituent companies for the preceding year separately or on a combined basis. Omission of such a disclosure would require appropriate comment in the independent auditor's report. With either type of disclosure, the independent auditor may express the usual opinion on consistency.

* With respect to financial statements filed with the Securities and Exchange Commission, Regulation S-X requires the independent auditor to disclose in his report, and express his opinion of any material changes in accounting principles or practices or methods of applying them which affect comparability, or any material retroactive adjustments of the accounts, as described in the applicable rules. With respect to a type B change described above, these requirements may be met by the use of a middle paragraph which describes the change and expresses the independent auditor's view thereon; when this is done the change should not be referred to in the opinion paragraph since the consistency standard is not involved.
Chapter 9  ADEQUACY OF INFORMATIVE DISCLOSURE

1. The third standard of reporting reads:

   informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

2. The fairness of presentation of financial statements, apart from the relationship to generally accepted accounting principles, is dependent upon the adequacy of disclosures involving material matters. These matters relate to the form, arrangement, and content of the financial statements with their appended notes; the terminology used; the amount of detail given, the classification of items in the statements; the bases of amounts set forth, for example, with respect to such assets as inventories and plants; liens on assets; dividend arrearages, restrictions on dividends, contingent liabilities; and the existence of affiliated or controlling interests and the nature and volume of transactions with such interests. This enumeration is not intended to be all inclusive, but simply indicative of the nature and type of disclosures necessary to make financial statements sufficiently informative.

3. Verbosity should not be mistaken for adequate disclosure. What constitutes a matter requiring disclosure is for the independent auditor to decide in the exercise of his judgment in light of the circumstances and facts of which he is aware at that time. That later events may give greater importance to matters which at the time appeared to be of minor consequence does not, of itself, impugn the soundness of his judgment. Foresight and hindsight cannot be admitted to be of equal weight in passing upon conclusions reached at the earlier time, hindsight should be eliminated from the factors by which the soundness of past conclusions is judged.

4. If matters which the independent auditor believes require disclosure are omitted from the financial statements, the matters should be included in his report and he should appropriately qualify his opinion.

5. Disclosure should not be considered to require publicizing certain kinds of information that would be detrimental to the company or its stockholders. For example, the threat of a patent infringement suit might impel a conscientious management to set up an ample reserve for possible loss, even though it would expect to fight the issue vigor-
ously. But publicity given to such a loss provision might inure to the harm of the company or its stockholders, for courts have held that a reserve for patent infringement constituted an allocation of infringement profits (where ready determination otherwise was not feasible) notwithstanding a refusal on the part of the company or its management to concede that such an amount might be an equitable allotment of the profits in dispute.

6. Somewhat related to the matter of disclosure is the matter of information which the auditor receives in confidence akin to the status of privileged communication. Without such confidence the auditor might at times find it difficult to obtain information necessary for him in the formulation of his opinion. If the information received does not, in his judgment, require disclosure for the financial statements not to be misleading, this standard does not require disclosure of such information. The matter of disclosure of events occurring subsequent to the balance-sheet date is discussed in chapter 11.

Chapter 11

REPORTING ON SUBSEQUENT EVENTS

1. An independent auditor's report is ordinarily rendered in connection with financial statements which purport to present financial position at a stated date and results of operation for a period ended on that date. Such financial statements are essentially historical in character. Financial statements for a given period represent one installment in the financial history of a business enterprise. They are so considered by the auditor in making his examination and in expressing his opinion with regard to the statements. However, events or transactions sometimes occur subsequent to the balance-sheet date which may have a material effect on the financial statements or which may be important in connection with consideration of the statements and, therefore, require adjustment or annotation of the statements.

2. A considerable portion of the independent auditor's examination must necessarily take place after the balance-sheet date. Although the independent auditor has no duty to extend the usual audit procedures to cover transactions of the subsequent period, his audit program ordinarily includes, (a) certain procedures which ordinarily are
carried out after the balance-sheet date (such as cash cut-offs, review of subsequent collections, confirmation follow-ups, etc.), and (b) certain general procedures which normally are continued throughout his examination (such as reading available minutes and interim reports, discussions with management, etc.).

THE RESPONSIBILITY FOR REPORTING

3. The independent auditor's responsibility for reporting with regard to subsequent events or transactions is directly related to the third reporting standard, which states that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The independent auditor should consider subsequent events and require, as appropriate, adjustment of the accounts or disclosure of those matters essential to proper interpretation of the financial statements being presented.

TYPES OF "SUBSEQUENT" EVENTS OR TRANSACTIONS

5. In general, there are three types of subsequent events or transactions.

6. Subsequent events of the first type are those which affect the financial statements directly and should be recognized therein. If subsequent information is acquired which would have been utilized had it been available at the balance-sheet date, appropriate adjustments should be made in the financial statements. Examples are collection of receivables, or settlement or determination of liabilities on a substantially different basis from that previously anticipated.

7. Subsequent events of the second type are those which have no direct effect on the financial statements of the prior year but their effects may be such that disclosure is advisable. These do not require adjustment. Examples of this type of transaction or event are the sale of a capital stock issue, or large bond issue with restrictive covenants, purchases of businesses, or serious damage from fire, flood or other casualty.

8. Subsequent events of the third type are those not likely to require disclosure in financial statements; for example, nonaccounting matters such as war, legislation, management changes, product changes, strikes, unionization, marketing agreements, and loss of important customers. Disclosure of such conditions or events frequently creates
doubt as to the reason therefor, and inferences drawn could be misleading as often as they are informative. However, in rare cases they may have such weighty effects as to require disclosure.

AUDITING PROCEDURES WHICH EXTEND INTO THE SUBSEQUENT PERIOD

9. The independent auditor does not ordinarily have the responsibility for extending the usual auditing procedures to transactions of any specific period of time subsequent to the balance-sheet date. However, as part of the examination of the financial statements for the period ended on the balance-sheet date, the usual auditing procedures include the reading of available minutes of meetings and interim company statements, and certain procedures (see paragraph 2a) which are carried out after the balance-sheet date. The auditor should inquire of management whether any event or transaction has occurred after the balance-sheet date which is material in relation to the financial statements. His procedure should also include follow up of the status of items included in or excluded from financial statements on the basis of tentative data. These procedures are illustrative, and although usually appropriate are not always mandatory, or all-inclusive.

10. There is no predetermined period, after the balance-sheet date, with which the auditor must be concerned in completing various phases of his examination. The duration of this period will depend upon the practical requirements of each examination and may vary from a relatively short period to one of several months. Also, all audit procedures are not carried out at the same time and some phases of an examination will extend in varying degrees to transactions of the subsequent period, whereas others will be substantially completed on or before the balance-sheet date. Accordingly, the independent auditor's contact and familiarity with transactions of the subsequent period ordinarily will be progressively less as he approaches completion of the various audit procedures which do extend into the subsequent period.

11. When the report of an independent auditor is included in a filing with the Securities and Exchange Commission under one of the federal securities statutes, his responsibility with respect to subsequent events is basically the same as that outlined in preceding paragraphs. In addition, the provisions of the Securities Act of 1933 dealing with possible liability of an independent auditor acting as an expert in a registration statement extend the period of time for which the auditor has a responsibility with respect to subsequent events to the effective date of the registration statement.
12. Section 11 of the Securities Act of 1933 provides in effect that, among other persons, no independent auditor shall be liable, as provided therein, if such auditor shall sustain the burden of proof that as to the part of the registration statement purporting to be made on his authority as an expert,

... he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading...

13. To sustain the burden of proof that he has made a "reasonable investigation," the auditor should supplement his audit procedures by performing certain additional procedures with respect to subsequent events up to, or reasonably close to the effective date, to the extent reasonable and practicable in the circumstances. The responsibility for disclosure of subsequent events must, as a practical matter, decrease following the close of the field work and, subsequent to that time, the independent auditor must rely, for the most part, on inquiries of responsible officials and employees. Under ordinary circumstances the additional procedures should include the following:

(1) Read the entire prospectus and review other pertinent portions of the registration statement.

(2) Read the latest available interim financial statements in conjunction with similar statements of an appropriate prior period or periods.

(3) Read the available minutes of meetings of stockholders, directors and committees of officers or directors, as appropriate; as to meetings for which minutes are not available inquire as to matters dealt with at such meetings.

(4) Obtain a letter of representation from an officer (or officers) as to whether or not there have occurred any events subsequent to the date of the financial statements included in the registration statement and reported upon by the independent auditor, which, in the officer's opinion, would have a material effect upon those financial statements or would require mention in the notes thereto; if such a letter has previously been obtained as a part of the examination, obtain written confirmation that there have been no material changes to the date of inquiry.
Inquire of officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

a. whether the principal items in the latest interim financial statements mentioned in (2) above were treated in conformity with generally accepted accounting principles and practices applied on a basis consistent with that of the latest period reported on by the auditor

b. whether all adjustments necessary for a fair presentation of the financial position at the interim date and the results of operations for the interim period have been made and reflected in such interim financial statements

c. whether any adjustments other than for normal recurring items had been made during the interim period or to the date of inquiry

d. whether any substantial contingent liabilities or commitments existed at the date of the interim financial statement or at the date of inquiry; where appropriate, this inquiry should also be directed to legal counsel

e. whether there was any material adverse change in the financial position or results of operations subsequent to the date of the financial statements covered by the report of the auditor, or any change in the capital stock or long-term debt, to the date of inquiry

f. the current status of items which were accounted for on the basis of tentative, preliminary or inconclusive data.

REPORTS BY PREDECESSOR AUDITORS

It is not unusual for a registration statement filed with the Securities and Exchange Commission to contain the reports of two or more independent auditors on their examinations of different periods included in the summary of earnings or the statements of income and retained earnings. An auditor who has not examined the financial statements for the most recent audited period included in the registration statement has a responsibility for events subsequent to the date of the financial statements on which he is reporting which continues to the effective date. This responsibility is discharged by:

(1) Reading the entire prospectus and reviewing other pertinent portions of the registration statement.
(2) Obtaining a letter of representation from the successor independent auditor as to whether or not his examination (including his procedures with respect to subsequent events) disclosed any subsequent events which, in his opinion, might have a material effect on the financial statements reported on by the prior auditor or would require mention in the notes thereto.

DATING THE REPORT

15. In general, the date of completion of all important audit procedures should be used as the date of the independent auditor’s report. In most cases this date will coincide with the completion of his work in the client’s office.

16. In those cases in which the independent auditor’s report is dated substantially later than the date of completion of all important audit procedures, the independent auditor may find it desirable to state that his report is based on an examination which was completed at an earlier date. However, he may find it practicable and consider it preferable to continue inquiry (but not examination) up to the date of his report and avoid the necessity of a special comment as to the date.

17. Long-form reports are often prepared at a date subsequent to the issuance of the short-form report from data obtained during the examination which was the basis for the issuance of his short-form report or opinion. It is the practice of many independent auditors to give the long-form report a date the same as the date of the short-form report for the purpose of removing any intimation that further audit work has been done. In some cases the report is dated at the time of issuance and such date with the added words “as of ................................” which latter date is the date of the first delivered report or opinion.

18. If these dating practices are not observed, care should be taken that the comments in the long-form report contain reference to the issuance of the earlier-dated short-form report with proper notation that the subsequent report is based on the work then performed. The independent auditor has no duty to make further investigation or inquiry as to events which may have occurred during the period between the times of issuance of his two reports provided the second report does not contain any indication of such subsequent examination.

19. The independent auditor has usually issued his report on the financial statements for the year at a date prior to the filing of an annual report (e.g., Form 10-K) with the Securities and Exchange Commission.
It is customary and proper for the auditor to use the same date on his report included in the Securities and Exchange Commission filing as he used in reporting on the financial statements previously released. Use of the original date removes any implication that records, transactions or events after this date have been examined or reviewed. The independent auditor in such a situation has no responsibility to make a further investigation or inquiry as to events which may have occurred between the time of issuance of his report on the financial statements initially released and the issuance of his report on the financial statements included in the annual report to the Securities and Exchange Commission.

20. In case a subsequent event of the first type discussed previously (one requiring recognition in the financial statements) occurs between the date of first release of the report of financial statements and the filing date of the annual report and comes to the attention of the auditor, appropriate adjustments should be made in the financial statements with disclosure of their effect. The report of the independent auditor may then bear a current date, in which case the independent auditor has the same responsibility with respect to all subsequent events up to the revised date as he had up to the date of his original report. Alternatively, the report may continue to bear the original date supplemented by a current date limited specifically to the event requiring the adjustment, thus eliminating responsibility for other subsequent events.

21. In case a subsequent event of the second type (one whose disclosure is advisable) occurs during the above-mentioned period and comes to the attention of the auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

\[\text{Events Subsequent to the Date of the Report of Independent Public Accountants}\]

Under these circumstances the report of the independent auditor would carry the same date used in reporting on the financial statements previously released.

REQUESTS FOR ADDITIONAL COPIES OF PREVIOUSLY ISSUED REPORTS

22. For various reasons, it is not unusual that an independent auditor is requested by his client to furnish additional copies of a previously issued report. Generally, an effort will be made by the independent
To have these reports identical in appearance and date, and, therefore, in the same condition as if the additional copies had been initially requested and furnished at the same time as the first copies were delivered. Under such circumstances, additional report copies may be delivered without further investigation or inquiry as to events which may have occurred between the date of issuance of the initial report and the request for additional copies.

23. In some unusual cases, it may not be desirable to deliver additional copies of a report as there may have been a change in the company's circumstances which has come to the attention of the independent auditor, subsequent to the issuance of the original report. In such cases it may be appropriate to issue a revised report stating that it is currently submitted under the circumstances or conditions existing at the time of first issuance but with an accompanying disclosure relating to the subsequent change.
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Price-Level Changes

Status of Statements Reporting Financial Effects of Price-Level Changes

American Accounting Association Committee Statement—1951

The committee on concepts and standards underlying corporate financial statements of the American Accounting Association studied the effects of price-level changes on financial statements. In order to clarify the problem and to suggest a course of action, the committee considered these questions:

(1) Is modification of the conventional accounting approach to net income determination to give explicit recognition to changes in the value of the dollar a desirable development?

(2) If so, what methods are most appropriate for measuring variations in the value of the dollar and for giving effect to such variation in financial reports?

(3) If such modification is desirable, how is disclosure best to be accomplished?

The committee reached the following conclusions:

(1) In periodic reports to stockholders, the primary financial statements, prepared by management and verified by an inde-
pendent accountant, should, at the present stage of accounting development, continue to reflect historical dollar costs.

(2) There is reason for believing that knowledge of the effects of the changing value of the dollar upon financial position and operating results may be useful information, if a practical and substantially uniform method of measurement and disclosure can be developed.

(3) The accounting effects of the changing value of the dollar should be made the subject of intensive research and experimentation; the specific significance of the basic problem should be determined with as much accuracy as possible; the means of its solution, if its significance warrants, should be thoroughly investigated.

(4) The effects of price fluctuations upon financial reports should be measured in terms of the overall purchasing power of the dollar — that is, changes in the general price level as measured by a GENERAL price index. For this purpose, adjustments should not be based on either the current value or the replacement costs of specific types of capital consumed.

(5) The measurement of price level changes should be all-inclusive; all statement items affected should be adjusted in a consistent manner.

(6) Management may properly include in periodic reports to stockholders comprehensive supplementary statements which present the effects of the fluctuation in the value of the dollar upon net income and upon financial position.

(a) Such supplementary statements should be internally consistent; the income statement and the balance sheet should both be adjusted by the same procedures, so that the figures in such complementary statements are coordinate and have the same relative significance.

(b) Such supplementary statements should be reconciled in detail with the primary statements reflecting unadjusted original dollar costs, and should be regarded as an extension or elaboration of the primary statements rather than as a departure therefrom.

(c) Such supplementary statements should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the adjusted data.

The several pages of discussion by the committee of the foregoing conclusions have been omitted. Readers who may be interested in this discussion are referred to the pamphlet entitled "Price Level
Changes and Financial Statements — Supplementary Statement No. 2,” published by the American Accounting Association.

**AICPA Committee on Accounting Procedure Statement—1953**

The committee on accounting procedure of the American Institute of CPAs dealt with price-level changes in Chapter 9, Section A of *ARB No. 43*. This section of the Chapter is reproduced below.

**ARB No. 43**
**Chapter 9**
**Section A**

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1. In December, 1947, the committee issued Accounting Research Bulletin No. 33, dealing with the subject of depreciation and high costs. In October, 1948, it published a letter to the membership re-affirming the opinion expressed in the bulletin.

2. The subject is one of continuing importance. The committee once more expresses its approval of the basic conclusions asserted in both publications, but in view of the many requests received for further consideration of various aspects of the problem has placed the subject on its agenda for further study.

3. Accounting Research Bulletin No. 33 read as follows:

4. “The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.

5. “The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of "inflated" dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management
must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.

6. “When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

7. “It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

8. “It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

9. “The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness.”

10. The letter of October 14, 1948, was addressed to the members of the Institute and read as follows:

11. “The committee on accounting procedure has reached the conclusion that no basic change in the accounting treatment or deprecia-
tion of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar.

12. "The committee has given intensive study to this problem and has examined and discussed various suggestions which have been made to meet it. It has solicited and considered hundreds of opinions on this subject expressed by businessmen, bankers, economists, labor leaders, and others. While there are differences of opinion, the prevailing sentiment in these groups is against any basic change in present accounting procedures. The committee believes that such a change would confuse readers of financial statements and nullify many of the gains that have been made toward clearer presentation of corporate finances.

13. "Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries. But it does not seem to the committee that such action should be recommended now if financial statements are to have maximum usefulness to the greatest number of users.


15. "Any basic change in the accounting treatment of depreciation should await further study of the nature and concept of business income.

16. "The immediate problem can and should be met by financial management. The committee recognizes that the common forms of financial statements may permit misunderstanding as to the amount which a corporation has available for distribution in the form of dividends, higher wages, or lower prices for the company’s products. When prices have risen appreciably since original investments in plant and facilities were made, a substantial proportion of net income as currently reported must be reinvested in the business in order to maintain assets at the same level of productivity at the end of a year as at the beginning.

17. "Stockholders, employees, and the general public should be informed that a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business. The committee therefore gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings."
Six members of the committee, Messrs. Andrews, Peloubet, Peoples, Smith, Wellington, and Williams, dissented to adoption of section (a) of chapter 9.

The six dissenting members object to the reprinting, in this section, of Bulletin No. 33 of December, 1947, and the reaffirming letter of October 14, 1948. That Bulletin was issued to check the extension of certain then-emerging practices and it was successful in that purpose. However, Bulletin No. 33 contains assertions which are not now appropriate and should be eliminated, notably:

(a) An attempt to recognize current prices in providing depreciation . . . would require the serious step of formally recording appraised current values . . . and consistent depreciation charges based on the new values (par. 7 of this section).

Those dissenting believe this is not the only method which may be followed — a conclusion also reached by the Study Group on Business Income.1

(b) ... consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time. (par. 8)

This statement virtually precludes changes in accounting practice in so far as the monetary unit is concerned and is inconsistent with the paragraphs on Accounting and the Corporate System in the introduction to this volume.

(c) The warnings (in paragraphs 5, 6, 16 and 17) to management as to the use of profits.

Such warnings are irrelevant; it is no part of the accountant's function to tell management what it may or may not properly do with income after it has been determined.

Those dissenting believe that acceptable accounting practices should comprehend financial statements to stockholders, employees, and the public designed to reflect those concepts of cost and net income which are recommended in paragraph 5 to management in determining product costs, prices, and business policies. They question whether net income can properly be so designated if appropriations therefrom, as suggested in paragraph 6, are needed to preserve capital invested in plant.

They believe that plant may continue to be carried in the balance sheet at historical cost with deduction for depreciation based thereon.
In addition to historical depreciation, a supplementary annual charge to income should be permitted with corresponding credit to an account for property replacements and substitutions, to be classified with the stockholders’ equity. This supplementary charge should be in such amount as to make the total charge for depreciation express in current dollars the exhaustion of plant allocable to the period. The supplementary charge would be calculated by use of a generally accepted price index applied to the expenditures in the years when the plant was acquired. The last sentence of paragraph 7 would then be no longer valid; the usefulness of financial statements would be enhanced without sacrifice of presently existing comparability.


Resolution of Accounting Principles Board—1961

The price-level problem remained on the agenda of the committee on accounting procedure until the fall of 1959, when its responsibilities were assumed by the Accounting Principles Board. The APB discussed the matter from time to time and on April 28, 1961 passed the resolution shown in the following excerpts from minutes of the meeting:

The possibility of recognizing the effect of price-level changes in financial statements was discussed at some length. While no definite decisions were reached, those present appeared to react most favorably to supplementary disclosure of the complete effect of price-level changes upon both the income statement and the balance sheet.

At the conclusion of the discussion, the Board, by a vote of 15 to 0 (one member not voting), agreed that the assumption in accounting that fluctuations in the value of the dollar may be ignored is unrealistic, and that therefore the Director of Accounting Research should be instructed to set up a research project to study the problem and to prepare a report in which recommendations are made for the disclosure of the effect of price-level changes upon the financial statements. In this study, special attention should be paid to the use of supplementary statements as a means of disclosure.

Accounting Research Study No. 6—1963

The accounting research division carried out the study as instructed by the Board. The study was published in 1963 as Accounting Re-
search Study No. 6, "Reporting the Financial Effects of Price-Level Changes." The study is necessarily an extensive one since it deals with all aspects of the problem and includes extensive sections on index numbers, demonstration of adjustment technique, gains and losses on monetary items, examples of methods of disclosure and annotated bibliography of cases.

In regard to the most suitable price index and to a practicable cutoff date for translation of historical costs to current dollar costs, the study reaches the following conclusions:

As a result of our investigation we are convinced that the GNP Implicit Price Deflators are reliable enough for accounting purposes. However, since the precision of the measure of change is open to serious question when the goods and services available in the two periods being compared are dissimilar, and because so many of the goods and services currently available resulted from wartime (World War II) and postwar technology, it would probably be desirable to select a cutoff date instead of using prewar or even wartime index numbers for the adjustment of the applicable data in financial statements.

The earliest point in time that seems to offer reasonable comparability of goods and services is no earlier than 1945. If 1945 were selected as a cutoff date, all assets acquired and liabilities incurred prior to 1945 would be treated as if they had originated during that year. For most industries, the resulting inaccuracies would probably not be material.

The study confirmed the views favored in the APB resolution that disclosure should be made of the complete effect of price-level changes upon both the income statement and the balance sheet and that supplementary statements be used as the means of disclosure. The following comments on these matters are taken from pages 53 and 54 of ARS No. 6:

If price-level effects are to be recognized in financial statements, the most practicable procedure in the foreseeable future is to present the adjusted data as supplementary to the unadjusted (conventional) statements. The presentation of completely adjusted financial statements, either as supplementary exhibits or in extra columns in the primary exhibits, should be particularly effective in a period of experimentation during which the reader of the reports would become familiar with the nature and significance of the adjusted figures. To guide the readers of the annual reports when presented with two versions of the results of operation or of financial position, an explanation of the meaning and significance of the adjusted amounts would be needed.
In the preparation of these supplementary but completely adjusted financial statements, the necessary adjustments would usually be recorded at the end of the accounting period, and these statements would ordinarily be expressed in terms of the dollar at the end of the period. (The index for the last month or quarter would be used unless the price level was changing very rapidly.) All nonmonetary items would be restated and brought up to date, the monetary items would appear unchanged, and the gain or loss in purchasing power of the monetary items would be recorded in the financial statements as a separate item.

In completely adjusted financial statements, all the amounts would be based on the same standard measuring unit and would therefore be comparable. As a result, the rate of return on the "adjusted" investment would be more accurate, the depreciation and related asset amounts would recognize price-level changes (but not necessarily current replacement costs), dividends could be interpreted in relation to more meaningful earnings, the proportion of earnings actually being taken by income taxes would be more apparent, the gains and losses from holding or maintaining monetary items would be disclosed, and so on.

Among the advantages of the use of supplementary financial statements is the fact that bond indentures and other such contracts often contain references and restrictions as to net income, dividends, working capital, etc., which in equity should probably be interpreted in the light of the accounting principles and procedures in use at the date of the agreement. The unadjusted primary statements will supply this information. Similarly, in the field of business law, there are many references to accounting terms and concepts such as net profit, earned surplus, dividends, etc., which will no doubt continue to be interpreted for an indefinite period in terms of unadjusted accounting data.

Credit grantors have through experience established more or less standard financial ratios. The supplementary data, recognizing price-level changes, will give them an opportunity to re-examine these ratios and develop new standards based on the adjusted figures.

**Present Status**

The major objections to reporting financial effects of price-level changes in the past have been related to the alleged limitations of price-index numbers and to a fear that statements based on historical costs were to be abandoned. As to the first point, ARS No. 6 includes a comprehensive study and evaluation of index numbers available in
the United States and concludes that the GNP Implicit Price Deflators are a reliable measure of the financial effects of price-level changes since 1945, the suggested cutoff date. In regard to the second point, no suggestion is made to dispense with historical statements. In fact, historical accounting is necessary as a basis for applying the price-level adjustments and historical dollar, and current dollar statements are complementary to each other. ARS No. 6 also furnishes adequate guidance to business and to the CPA on how to translate historical dollar costs to current dollar costs.

The APB has already agreed in the 1961 resolution that, under prevailing conditions, the assumption in accounting that fluctuations in the value of the dollar may be ignored is unrealistic. If the Board agrees with the findings in ARS No. 6 that a reliable index number series is available, at least, since 1945, it would seem that the only remaining question is whether business entities have an accountability for changes in capital resources and results of operations in terms of current purchasing power dollars as well as in historical or nominal dollars.

If the APB agrees that business entities have such accountability, the degree of future inflation will probably determine whether and when this accountability becomes mandatory. In the view of the author, reporting the financial effects of price-level changes, in addition to historical statements, is essential to a fair and comprehensive presentation of financial position and results of operations. It follows that when the rate of inflation is substantial, such as in several of the South American nations, financial statements reflecting only historical costs should require qualifications as to the fair presentation in the report of the CPA.
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Alternative Methods and Significant Points

Alternative Methods of Implementing
Generally Accepted Accounting Principles

The following list of alternative methods does not purport to be all inclusive. The methods listed are not all of the same nature, some are truly “either-or” choices of management while others are applicable or not applicable depending on the circumstances. The latter illustrate the versatility of accounting to meet different conditions and to prevent financial and accounting abuses.

Revenue is recognized in the sale of products or services at the time of

1. Sale
2. Collection of sales price
3. Completion of product

Revenue is recognized in long-term contracting operations

1. At the time the contract is completed
2. Proportionately over performance

Cash discounts taken by customers on sales affect income

1. At the time of sale
2. At the time of collection
Excise taxes are

1. Included in sales and cost of sales
2. Excluded from the income statement

Pension payments made directly to retired employees are charged to expense

1. When payment is made
2. On an accrual basis over the period of service of the employees. There are several accepted actuarial cost methods which may be used as the basis for the accruals.

Pension payments made indirectly to retired employees through the medium of a fund are charged to expense

1. When payments are made to the fund
2. Normal or current cost on an accrual basis over the period of service of the employees. There are several accepted actuarial cost methods which may be used as the basis for the accruals.
3. So-called past service credits at time of adoption of plan—
   (a) Not provided for, except as to interest
   (b) Accrued over period permitted in Income Tax Code, over remaining service life of employees or over longer period such as total average service life of employees. Again, any one of several accepted actuarial cost methods of computation may be used.

Real and personal property taxes are charged against income of various periods

1. Year in which paid
2. Year ending on assessment (or lien) date
3. Year beginning on assessment (or lien) date
4. Calendar or fiscal year of taxpayer prior to assessment date
5. Calendar or fiscal year of taxpayer including assessment date
6. Calendar or fiscal year of taxpayer prior to payment date
7. Fiscal year of governing body levying the tax
8. Year appearing on tax bill
When items affecting taxable income are reported in financial statements and income tax returns in different periods

1. The tax effect is allocated between periods in the financial statements
2. The tax effect is not allocated between periods
3. The tax effect is allocated for some items but not for others

The investment income tax credit is

1. Spread over lives of the properties
2. Reflected as a reduction in income taxes currently

The following methods of depreciation are used to charge off the cost of depreciable assets over their estimated lives (which also vary considerably from company to company)

1. Straight-line
2. Decreasing charge (declining balance, sum-of-years' digits)
3. Increasing charge (annuity, sinking fund)
4. Production or "use" methods are also used by some companies.

Rates may be composite, group or by individual classes of assets, which introduce further variety in depreciation estimates.

Depletion provisions, designed to amortize the portion of development costs capitalized by extractive enterprises over future production of the developed resources, are determined by

1. A single composite rate
2. Group composite rates for major areas
3. Separate rates for individual tracts or leases

The estimates of the quantities of economically recoverable resources, obviously, are subject to substantial variations and uncertainties.

Extraordinary gains and losses are reported in

1. The income statement
2. The statement of retained earnings

Common stock dividends payable in common shares, the amount chargeable to retained earnings is

1. The fair market value if dividend is less than, say, 20 per cent of stock outstanding
2. Nothing if dividend is at a higher rate. It is then considered a stock split.

When property is distributed as a dividend to stockholders, the amount charged to retained earnings is

1. The book value of the property, or
2. The fair market value of the property

Inventory cost is determined under

1. Fifo
2. Lifo
3. Average cost
4. Base stock, and
5. Various combinations of these methods

In addition to the foregoing cost methods, standard costs are acceptable, if they approximate actual costs, and a zone of tolerance is permitted in undercapitalization of overhead costs; for example, some companies omit depreciation. Cost is reduced to market, where lower, and market means current replacement cost, except that (1) it should not exceed net realizable value, and (2) should not be less than net realizable value reduced by a normal profit margin. Market may be applied on an over-all basis or by individual items. Some companies in metal mining and meat packing carry inventories at market rather than cost.

Investments in unconsolidated subsidiaries are carried at

1. Cost
2. Cost, plus equity in undistributed earnings

Unlimited term intangibles, such as goodwill, not necessarily expected to have value over the entire life of the enterprise, are

1. Not amortized, but charged off when there is clearly no remaining value
2. Amortized over an arbitrary period

Research, development, and experimentation costs are

1. Accumulated as deferred charges and then amortized over an arbitrary, but relatively short period
2. Charged to expense as incurred

Unamortized discount and expense on bonds refunded is

1. Written off to income or retained earnings in the year of refunding
2. Amortized over the remaining life of original issue

Liabilities to trade creditors are recorded at

1. Gross invoice price not reduced for anticipated cash discount
2. Gross invoice price reduced for anticipated cash discount

Fixed assets. Properties acquired are recorded at (1) cost, (2) appraisal amounts, (3) original cost to first owner using them for utility purposes, in case of public utilities, (4) book value of previous owner in case of poolings.

Properties constructed are recorded at (1) direct costs only, (2) direct costs plus partial overhead costs, (3) direct costs plus all overhead costs, including interest on all funds used in the construction (funds from equity sources as well as debt).

Property retirement units are subject to selection or definition by each business entity. This establishes the boundary line between items to be capitalized and those to be charged to expense. Items to be capitalized may also be determined or affected by minimum dollar amounts. A company choosing larger retirement units, as compared with one choosing smaller units, over a period of years would have a larger part of its fixed assets reflected at older vintage dollar costs, and would therefore have relatively smaller depreciation charges and larger maintenance costs.

The “replacement and betterment” method used by railroads for roadway items (ties, rails and ballast) is closely related to selection of retirement units. The new costs of replacements equivalent in character to the old are charged to expense; betterments, such as heavier rail, etc., are capitalized only to the extent of the betterment, and the carrying amounts of the roadway items are not depreciated. The method is also used by other utilities and industrials where parts of existing units are replaced with parts having greater capacity or versatility.
Property conversion and abandonment losses are

1. Charged to expense or retained earnings, if substantial, by industrial entities
2. Often deferred and amortized over future periods by utilities, if permitted by the regulatory commissions

Containers are

1. Capitalized and depreciated over estimated life
2. Capitalized to extent of customer deposits and excess of cost over deposit charged immediately to expense

Spare parts of machinery are

1. Carried in fixed assets
2. Included, by some companies, in inventories

Patterns, jigs and small tools are

1. Capitalized and depreciated over estimated lives
2. Carried at estimated depreciated values as determined by inspection from time to time
3. Charged to expense as purchased

Development costs of extractive industries are

1. Capitalized and allocated to future production through depletion charges
2. Capitalized but not charged to future income statements through depletion (certain mining enterprises)
3. Capitalized in part and the remaining part charged to expense currently; the portion capitalized is allocated to future production through depletion charges

Material leases of properties in the accounts of the lessee are

1. Capitalized and depreciated if they are, in substance, installment purchases
2. Other lease rentals are charged to expense with suitable disclosure of lease commitments
CHAPTER 10: ALTERNATIVE METHODS OF IMPLEMENTING GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Repair and renewal costs are

1. Charged to expense when incurred
2. Periodically accrued in advance of expenditures to "normalize" charges between periods

Fire losses, when the enterprise carries no fire insurance, are

1. Charged as a loss when incurred
2. Periodically accrued in advance of actual losses

Business combinations are treated as

1. Poolings, in which book values of assets of constituent companies are carried forward
2. Purchases, thereby establishing a new cost or fair market value for the assets acquired by the dominant and continuing corporation

Reference is made to the memorandum prepared by the Office of the Chief Accountant of the SEC, which is reproduced as Appendix A to this chapter.

Some Significant Points to Be Drawn From the Variety of Alternative Methods and the Contents of the Preceding Chapters

The foregoing listed variety of possibilities in accounting, if viewed in the aggregate mathematical scale of combinations, would be an astronomical figure. Such a mathematical exercise would be useless because it would merely confirm that accounting is not an exact science (if such a thing exists), but is rather a discipline in practical findings of fact and judgment of business affairs.

The mere listing of the alternative methods might be somewhat sterile without setting forth some points of significance in relation to the variety of accounting methods and the contents of the preceding chapters. It is recognized that this is an area of judgment in which different accountants would draw different conclusions. For whatever they may be worth, the following points are regarded as significant by the author:
1. The basic accounting concept of "Diversity in accounting among independent entities" is fully supported by the variety of methods. It is evident that variety of applications causes the major share of the differences in accounting among entities, rather than differences among the broader accounting principles listed in the summary of this Inventory.

Recognition of the foregoing fact in no way diminishes the problem of "narrowing the areas of difference" in accounting and financial reporting, because methods of applying the broader principles of accounting must be considered an integral part of the whole fabric of generally accepted accounting principles. This is particularly true in observance of the standard of consistency between periods for the reporting entity. On this point the Securities and Exchange Commission has held, in Rule 3-07 of Regulation S-X, that:

(a) Any change in accounting principle or practice, or in the method of applying any accounting principle or practice, made during any period for which financial statements are filed which affects comparability of such financial statements with those of prior or future periods, and the effect thereof upon the net income for each period for which financial statements are filed, shall be disclosed in a note to the appropriate financial statement.

2. General agreement should be possible on "basic concepts" and on the broader generally accepted accounting principles, as reflected in the summary of this Inventory. It is believed that consideration of the applicability of the basic concepts and broad principles in future Opinions by the APB should bring about a better understanding of the interrelationship of concepts, broad principles and methods of application. Further progress should be made by eliminating methods which have outlived their usefulness. We should, however, carefully avoid false promises that all diversity in accounting can or should be eliminated in the investor-owned competitive enterprise system in the United States.

3. In the case of "either-or" alternatives which management may choose, the Institute and stock exchange correspondence in the early nineteen thirties pointed out that if the significant practices were adequately disclosed and consistently followed, the effect of differing methods on periodic income would soon be unimportant, although there might be considerable difference in balance-sheet items carried forward to future periods. The position stated in the foregoing correspondence remains generally valid today.
4. Adherence to the consistency and disclosure standards of generally accepted auditing standards permits comparability of financial statements from year to year for the same entity. What about comparability among different entities? The investors now have the "qualitative standard of comparability" that the management and directors of each enterprise adopt and apply the accounting principles and methods, which, in their judgment, will fairly present the financial position and results of operations of that enterprise. They also have the assurance inherent in the independent opinion of the certified public accountant that the statements are fairly presented in accordance with generally accepted accounting principles, which have substantial authoritative support and have been consistently applied, unless there are specific and clearly stated qualifications. Also, it should be borne in mind that no independent CPA accepts accounting methods and estimates merely because a company has adopted them. He recognizes that, while he does not substitute his judgment for that of the management on an item by item basis, he has the responsibility of accumulating the possible adjustments and of judging whether the aggregate impact of them permits an unqualified opinion. In most instances, the management and the directors will adopt the recommended adjustments in order to avoid a qualified opinion.

As stated in point 3, differences in accounting practices if consistently applied, tend to diminish their effect on income determination over a period of years. The effects of such matters as income tax allocation between periods and the handling of extraordinary gains and losses are usually disclosed so that certainly the sophisticated investor may make useful and practical comparisons between the earnings of different entities. Therefore, it can be stated that a broad basis of comparison and differentiation of income statements does exist. In this connection, it should be noted that the several articles in newspapers and financial periodicals, criticizing lack of comparability of financial statements of different entities, found the differences they were talking about in the body or notes to the financial statements.

5. The accounting profession can take encouragement from the fact that the leading financial and business executives and financial analysts fully understand the value of the qualitative standard of comparability previously referred to. They realize, also, that the Institute's program of gradually eliminating unjustified "areas of difference" and of continuing to lead in the evolutionary process of improvement in accounting and reporting is the sound course to follow, even though it falls...
short of satisfying the type of person who yearns for simple and certain answers which are usually inapplicable to the complex problems of business.

6. The greatest single step toward providing financial statements, having a relatively high degree of comparability, would be the presentation of statements fully translated into dollars of current purchasing power, in addition to the historical statements. Such statements would overcome the differences caused by different inventory methods and by the different vintages of dollars reflected in property accounts. This problem, of course, remains for future decision. In addition to improving comparability of financial statements substantially, investors would be informed of the effects of inflation on the resources and results of operations of the business. These effects, which vary greatly among different entities, cannot be determined from historical reports by the most sophisticated investor.

7. In suggesting that an inventory and particularly a summary of generally accepted accounting principles be prepared, the author used the following quotations from Justice Holmes:

... the whole outline of the law, as it stands today, is the resultant of a conflict between logic and good sense—the one striving to carry fictions out to consistent results, the other restraining and at last overcoming that effort when the results become too manifestly unjust.

... the logical method and form flatter that longing for certainty and for repose which is in every human mind. But certainty is illusion, and repose is not the destiny of man.

Justice Holmes was dealing with a rational study of law but his comments apply perhaps to an even greater degree to a study of accounting. He also stated on page 181 of his Collected Legal Papers that:

... We do not realize how large a part of our law is open to reconsideration upon a slight change in the habit of the public mind.

Similarly, it may be said that a large part of accounting rests upon judgment related to particular circumstances and, therefore, prior determinations are open to reconsideration with changes in circumstances and with changes in business environment. The foregoing

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applies to judgments made by individual practitioners and firms and also to the collective judgments reflected in pronouncements by the Accounting Principles Board.

8. This entire Inventory, including the chapters on responsibility and authority, basic concepts, the meaning and summary of generally accepted accounting principles, income and expense, equity, assets and liabilities, financial statements and status of reporting on price-level changes, is presented to aid the thinking processes of the certified public accountants in making the findings of facts and judgments which are inherent and inescapable responsibilities underlying the expression of his independent opinion as an auditing and accounting expert. Stated another way, this Inventory is not a rule book to avoid individual thought, innovation and responsibility (see excerpts from address of Commissioner Woodside in Appendix B to this chapter). If it should ever become a rule book, that would mark the beginning of the fall of accounting as an independent and learned profession.

The summary of generally accepted accounting principles is arranged in broad terms in relation to the four primary objectives of fiduciary accountability in the presentation of financial statements. The author has dared to hope this summary might serve the same purpose in accounting that the summary of generally accepted auditing standards served in auditing. When the auditing study was undertaken twenty years ago, there was a considerable demand in the accounting profession and elsewhere for a definitive rule book on auditing procedures. The tentative statement of generally accepted auditing standards issued in 1947 raised the thinking of the profession from the level of detailed auditing procedures to the higher level of quality standards. If our hopes for the Inventory and particularly the summary are fulfilled, the need for further detailed opinions by the APB might diminish in rate rather than increase over the years. There is, of course, and always will be a need for revision, consolidation or repeal of bulletins and opinions outstanding and for new opinions required for the fulfillment of the responsibilities for accounting leadership delegated by the Council in the Charter document. In this connection the following statement of purpose taken from the Charter, is an appropriate conclusion:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others. This means something
more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues.
Appendix A to Chapter 10

Memorandum Prepared by the Office of the Chief Accountant, Securities and Exchange Commission, in Response To Request of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, on H.R. 6789 and H.R. 6793

At page 1289 of the stenographic report of proceedings of the Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, on February 19, 1964, Hon. Harley O. Staggers (chairman of the subcommittee) made the following request of Chairman Cary: “Can you file with this committee setting forth what you understand to be the areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles?” and “If you would, with your conclusions as to the significance of each such area and with the reasons why you consider that investors who are considering and comparing various companies are adequately protected by your acceptance of these alternative practices.”

Some general observations appear to be in order as a basis for listing areas of alternative practices in accounting and for discussing the significance of each for investors. The Commission’s authority for dealing with accounting matters under the Securities Exchange Act of 1934 is found in sections 13 and 15(d).

Section 13(b) of the act gives the Commission authority to prescribe the form and the items or details to be shown in the financial statements, the methods to be followed in the preparations of reports and accounting for assets and liabilities and income and expenses.¹

The authority contained in the act has been implemented by the adoption of forms and regulations of which regulation S-X prescribes the form and content of financial statements. The preface of this regulation as presently in effect states: “This regulation (together with
the accounting series releases) states the requirements applicable to the form and content of financial statements. The instructions as to what financial statements are required to be filed are contained in the form prescribed for the respective registration statement, application for registration, or report. * * * ” The last comprehensive amendment of this regulation was adopted pursuant to the requirements of the Administrative Procedure Act and was published December 20, 1950, as Accounting Series Release No. 70. A copy of this release, the regulation, and four more recent releases (Nos. 85, 86, 95, and 96) of continuing current interest are attached to this memorandum.

With the exception of banks, insurance companies, and railroads, as to which exemption is provided in the forms, financial statements filed for registrants under the act must be certified by independent public accountants. Rules 2-02 (c) and (d) prescribe the opinions and exceptions to be expressed as follows:

(c) Opinions to be expressed.—The accountant’s certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (ii) the opinion of the accountant as to any material changes in accounting principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and (iii) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(d) Exceptions.—Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

Rule 3-07 referred to above reads:

“Changes in accounting principles and practices and retroactive adjustments of accounts.

(a) Any change in accounting principle or practice, or in the method of applying any accounting principle or practice, made during any period for which financial statements are filed which affects comparability of such financial statements with those of prior or future periods, and the effect thereof upon the net income for each period for which financial statements are filed, shall be disclosed in a note to the appropriate financial statement.
(b) Any material retroactive adjustment made during any period for which financial statements are filed, and the effect thereof upon net income of prior periods shall be disclosed in a note to the appropriate financial statement.

Also pertinent to the discussion to follow is Rule 3-06: Additional Information:

The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies.

Early in the Commission's administration of the act it was argued by representatives of registrants that a change in accounting could not be required when full supplemental disclosure was made of alternative practices deemed by the Commission to be preferable to those reflected in the financial statements. The Commission dealt with this problem by issuing the following statement of its administrative policy in Accounting Series Release No. 4 on April 25, 1938:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

This policy was reaffirmed and clarified in Accounting Series Release No. 96 issued on January 10, 1963.

The requirement for certification of financial statements to be filed with the Commission was introduced in the Securities Act of 1933.
Recognizing that this placed a heavy responsibility upon the accounting profession, which some of its leaders expressed a willingness to assume, the Commission has encouraged the profession to exercise leadership in accounting and auditing matters. At the same time the Commission has not hesitated to criticize and prod, to take exception to accounting presentations, and to discipline members of the profession when circumstances warranted.

The Commission is well aware of the controversial nature of many accounting issues and over the years has authorized its chief accountants to participate in the work of the American Institute of Certified Public Accountants and other organizations in their efforts to narrow the areas of differences in accounting. Such efforts are clearly in the interest of investors. This is an unending process for as uniformity of practice is achieved in some areas new problems arise in others because of changing economic conditions and business practices. Much improvement in financial reporting practices has occurred since the enactment of the first Federal securities law in 1933. The Commission believes that its policy of working with and supporting the accounting profession in the development of accounting principles has directly influenced this progress and is the best means of assuring continuing improvement of accounting practices.

I

Some areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles are discussed in the following paragraphs:

1. Valuation of inventories

It is readily recognized that a single method of valuation is not suitable for all industries or for all companies within the same industry. The best known alternatives perhaps are "first in, first out" (Fifo) and "last in, first out" (Lifo). It took some time and litigation for the latter to be widely accepted for income tax purposes. This method affords a tax benefit but one of the conditions of its use is that the Lifo inventory be reflected in the books. As the use of Lifo was extended it attained the status of general acceptance while Fifo retained that status.

Consistent application of either method is considered appropriate in reporting the results of operations. Failure to disclose the method used deprives the investor of significant information; hence, rule 5-02-6(b) of regulation S-X requires the disclosure. Continued use
of Lifo in periods of rising price levels results in an increasingly con­servative valuation of the inventory in the balance sheet which analysts should recognize when making comparisons between companies which have adopted life at widely different times or between Lifo and Fifo companies. The accounting staff of the Commission and some public accountants encourage companies using Lifo to disclose in footnotes the inventory values on a current basis.

2. Depreciation and depletion

The basis for determining depreciation, depletion, and amortization of fixed assets vary by industries and by companies within industries. Even in regulated utilities different methods have been approved by authorities having jurisdiction — both straightline and accelerated methods are acceptable. Perhaps here more than in some other areas of accounting, managerial judgment, subject to critical review by independent accountants, is a significant factor. An assumption of precise comparability between companies may not be warranted, even though the methods followed appear to be the same, because of variations in amounts depending on whether the management is conservative or liberal in making provisions for depreciation and amortization. Recognition of this problem is found in regulation S-X in rules 3-12 and 3-20(c) which require disclosure of the basis of valuation, methods of depreciation, depletion and amortization, and of the related accounting for maintenance, repairs, renewals, and betterments as well as the method of accounting for properties retired or sold. The Commission’s staff challenges the methods followed when the facts warrant.

3. Income tax allocation

Accounting for income taxes is a problem when items of income and deductions are reported in different periods for tax purposes than for corporate reporting purposes. The problem has been dealt with in publications of the American Institute of Certified Public Accountants for the guidance of the profession and in accounting series releases by this Commission. The most recent of the latter are release Nos. 85, 86, and 96. In release No. 96, which deals with the “investment credit,” the Commission found authoritative support for an alternative solution to the problem although the majority of the Accounting Principles Board of the AICPA in its Opinion No. 2 found only one solution to be acceptable. This problem aroused extensive and intensive discussion among public accountants, businessmen, and
regulatory agencies. Experience so far shows that in most cases the amounts involved in the credit are not significant. The recent amendment of the Internal Revenue Code will require a re-examination of this problem.

4. Pensions

The variety of plans in this area and the many factors that enter into the determination of the amounts involved make uniformity among companies and even consistency in application year by year in the same company difficult to attain. Various aspects of the problem have been dealt with by the Commission from the earliest days, and the AICPA has issued statements for the guidance of the profession. Differences in accounting result from the methods of providing for past service costs and for current costs of accruing pensions not yet vested. These problems are currently under study by the research staff of the AICPA and by our staff. SEC disclosure requirements as to pensions are specified in rule 3-10(e) of regulation S-X.

5. Research and development costs

In the post-World War II period proper accounting for the vast expenditures on research and development has been a highly significant factor in the financial reporting of many companies. Two principal methods of accounting are generally accepted. It is common practice for large, well-established companies to expense such outlays as they are incurred on the theory that this is a regularly recurring cost of maintaining the position of the company in its industry.

New companies organized to develop and exploit new products are more prone to capitalize these costs and amortize them as the product is produced and sold. However, when failure of the project is evident the loss must be recognized.

An intermediate position can be sustained for the company which maintains a research staff and allocates part of its cost to specific ventures and the remainder as current expense for sustaining the activity.

It is clear that the propriety of any of these methods depends upon the facts. The Commission's practice in this area is to make appropriate inquiries, challenge the method of accounting if this seems necessary, and to require pertinent disclosure of the company's policy. It is believed that this practice provides the necessary information for the protection of investors.
6. Goodwill

Goodwill, which usually arises from the acquisition of another business, under generally accepted accounting practice may be retained on the balance sheet as an asset until there is evidence of loss in value, or it may be amortized by charges to income even though there is no evidence of loss in value. An often-quoted author, Charles B. Couchman, in commenting on this situation, said 40 years ago: "To put it briefly, if you can write it down, you need not; if you cannot, you should."

In Accounting Series Release No. 50, published January 20, 1945, the then Chief Accountant of the Commission expressed a preference for the writeoff of goodwill through timely charges to income rather than in a lump sum when it became worthless. This is the staff's preference today but businessmen are reluctant to make charges of this kind against income when they are not deductible for income tax purposes and the activity with which the goodwill is associated continues to be prosperous. This is an area in which a clear disclosure of the method followed is required (by rule 3-20(c)(2) of regulation S-X) so that the investor may apply his own judgment for purposes of comparison.

7. When is income realized?

The proper assignment of revenues and related costs to accounting periods is one of the most important (some would say the most important) problems in financial reporting. Carman C. Blough, the first Chief Accountant of the Commission and from 1944 to 1961 director of research of the AICPA, stated this problem in one sentence in an article in the Journal of Accountancy for December 1959 when he said, "While it is generally understood that income should be recognized when services are rendered or goods delivered, in practice the time of taking it up ranges all the way from the time of production, as in the case of some mining enterprises, to the time the cash is received, as is sometimes done in the case of installment sales." As this quotation indicates, the solution of the problem depends upon a careful consideration of the facts in each situation. A single rule of practice in this area would not necessarily result in a proper reporting of realized income in all circumstances. The Commission and staff are alert to the difficulties that may be encountered in this area and request explanations and supporting data from registrants where necessary to reach a conclusion as to the propriety of the accounting.
Examples of problems of this nature encountered in the real estate business are set forth in Accounting Series Release No. 95. Alternative practices are appropriate here, as elsewhere, only if the result is to attain a fair determination of income in each case.

8. "All-inclusive" versus "current operating performance" profit and loss or income statement

This is one of the classic controversial issues in accounting. The Commission over the years has supported the view that all items of profit or loss given recognition in the accounts during the period covered by a profit and loss or income statement should be included in the statement, whereas some accountants advocate the exclusion of items not related to current operating performance. The former view may be designated as the "clean" surplus theory whereas the latter (the so-called operating performance theory) permits direct debits and credits to surplus for items material in amount not deemed to be related to current operations. The issue came to a head in the 1950 revision of regulation S-X and was compromised by the introduction of a provision for "special items" to be reported on the profit and loss or income statement after the caption "Net Income or Loss." In reports to stockholders such items are often shown as direct debits or credits to earned surplus in accordance with the "current operating performance" theory. The AICPA considers both theories acceptable and accordingly accountants certify to both presentations as being in accordance with generally accepted accounting principles. While this solved the problem for financial statements required to be filed with the Commission, examination of reports to stockholders reveals that some companies have a tendency to report favorable items in the income statement and unfavorable items as direct charges to earned surplus without adequate comment elsewhere. This practice has resulted in de-emphasis of significant adverse situations in some cases that have come to the attention of the Commission. While a careful reading of all the financial statements usually reveals the facts, this matter warrants re-examination by the accounting profession and the Commission.

The items above are discussed as being illustrative of areas in which alternative accounting practices exist which could materially affect comparability as between companies and as between periods for the same company if a change in practice is made. It would be impractical to attempt to list all such areas. However, additional alternative accounting practices exist in other major areas such as
intercorporate investments, long-term leases, principles of consolidation, business combinations, income measurement in finance and small loan companies, and intangible costs in the oil and gas industries. As indicated in the general discussion at the beginning of this memorandum, all changes in accounting in areas such as these and the effect thereof, if material, must be disclosed in financial statements filed with the Commission in the interest of adequate financial reporting for the protection of investors. These disclosures also afford the Commission and its staff an opportunity to challenge the accounting if it seems inappropriate in the circumstances. When financial statements are considered misleading as presented, the Commission recognizes its responsibility to require that changes be made.

II

In order to place the financial reporting problems in proper perspective, particularly with respect to the part the judgment factor plays in adequate financial reporting and the Commission's policy in dealing with these problems, a further outline of the development of the Commission's present policies and practices is provided. It is believed that this background data will be of value to the committee in appraising these problems.

After the stock market debacle of 1929, when the New York Stock Exchange began to reconstitute itself, it set about to see what could be done to improve accounting reports furnished to stockholders by listed companies in order to prevent excessive abuses in the future growing out of inadequate information regarding companies listed on that exchange. In this endeavor exchange representatives solicited the cooperation of the listed companies, the Controllers Institute of America, and the American Institute of Accountants (now the American Institute of Certified Public Accountants). The AIA created a special committee composed of distinguished accountants from nine leading accounting firms to cooperate with the New York Stock Exchange in this endeavor. The results of this endeavor as set forth in correspondence between the AIA Special Committee on Cooperation with Stock Exchanges and the Committee on Stock List of the New York Stock Exchange was published in 1934 by the AIA in a pamphlet titled "Audits of Corporate Accounts." One of these letters, dated September 22, 1932, from the special committee to the committee on stock list, carried a note in this pamphlet stating that it "was placed in evidence by the chairman of that committee in a hearing on exchange practice before a subcommittee of the U.S. Senate Com-
mittee on Banking and Currency January 12, 1933, and is now circu-
culated for the information of the members of the Institute and others
interested."

Reference to this early document is not made in order to bypass
progress in financial reporting since that date but because it is a succinct
statement of the problems of financial reporting and was developed
by the best minds of the profession and industry under almost ideal
conditions of objectivity. It has a special relevance to the SEC in
that it was a basic document used in the drafting of the Commission's
original financial reporting and certification requirements, which are
basically the same as those in effect today although they have been
extended and expanded in the light of experience and of changing
economic conditions and business practices.

The letter summarizes the problems of financial reporting and
demonstrates the importance of the judgment factor, based on integrity,
competence, and experience, in accounting decisions and in financial
reporting and concludes that:

The purpose of furnishing accounts to shareholders must be not
only to afford them information in regard to the results being
achieved by those to whom they have entrusted the management
of the business, but to aid them in taking appropriate action to
give effect to the conclusions which they reach regarding such
accomplishments. In an earlier day, stockholders who were dis-
satisfied with the results secured by the management could per-
haps move effectively to bring about a change of policy, or,
failing that, a change of management. With the growth in mag-
nitude of corporations, and the present wide diffusion of stock
holdings, any such attempt is ordinarily impracticable because
of the effort and expenditure that it would entail. The only
practical way in which an investor can today give expression to
his conclusions in regard to the management of a corporation
in which he is interested is by retaining, increasing, or disposing
of his investment, and accounts are mainly valuable to him inso-
far as they afford guidance in determining which of these
courses he shall pursue.

There is no need to revolutionize, or even to change materially,
corporate accounting; but, there is room for great improvement
in the presentation of the conclusions to which accounts lead.
The aim should be so satisfy (so far as is possible and prudent)
the investor's need for knowledge, rather than the accountant's
sense of form and respect for tradition, and to make very clear
the basis on which accounts are prepared.

The AIA special committee in this letter recommended to the com-
mittee on stock list certain objectives which included a recommendation “to make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance (five examples were listed in an exhibit) and, within the limits of such broad principles, to make no attempt to restrict the right of corporations to select detailed methods of accounting deemed by them to be most adapted to the requirements of their business.” The recommendation also urged the exchange: (a) to ask each listed corporation to cause a statement of the methods of accounting and reporting employed by it to be formulated in sufficient detail to be a guide to its accounting department; (b) to secure assurance that the methods so formulated will be followed consistently from year to year and that, if any change is made in the principles, or any material change in the manner of application, the stockholders and the exchange shall be so advised; and (c) to endeavor to bring about a change in the form-of-audit certificates so that the auditors would specifically report to shareholders whether the accounts as presented were properly prepared in accordance with the accounting methods regularly employed by the company.

The Commission at its inception was faced with the problem of whether it should prescribe detailed uniform accounting instructions, and came to the conclusion early in its deliberations that it would require full disclosure of financial facts and accounting practices, but that it was not desirable to prescribe accounting methods, or even reporting methods, in detail. On the recommendation of a committee composed of prominent accountants and distinguished university professors, who were engaged in helping the Commission draft its requirements, it adopted a rule which was incorporated in the original form 10 (for listed companies) and in subsequent financial statement requirements. It is now stated in rule 3-01(a) of regulation S-X as follows:

Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto.

The adoption of detailed rules on accounting methods has been strongly advocated and strongly opposed by various groups since that time, but the Commission has followed the principle and the congressional philosophy that, basically, the securities acts are disclosure statutes, and that it is the fairness of financial statements, taken as
a whole, which is more important to investors in carrying out the purposes of these statutes. In 1937, at the American Institute of Accountants’ 50th anniversary celebration, the then Chief Accountant of SEC, Mr. Carman G. Blough, made the following statement on the subject of generally accepted accounting principles:

The expressions of opinion that have come from my office have been expressions of opinion as to what we considered to be the most generally accepted accounting practice among the better accountants in the country, and not a promulgation of any new ideas or anything that had not been followed by accountants rather generally.

If the time comes when the Commission is convinced that a procedure which is not generally accepted in the profession is a procedure that should nevertheless be followed, the matter will be handled not through a release of an opinion by the chief accountant but through a rule or regulation of the Commission requiring that such procedure be followed.

The procedure indicated in the last paragraph quoted above is consistent with the authority provided in section 13(b) of the Securities Exchange Act, as discussed previously. Accounting series release No. 96 contained, in addition to the statement of policy on the question of uniformity of accounting practice with respect to the treatment to be accorded the “investment credit,” the following statement in regard to the Commission’s general policy on financial reporting and its development:

In accounting series release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting series release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant’s certificate and footnotes will be accepted in lieu of conformance to the Commission’s views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free
to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance.

As stated previously, and alluded to in this release, the Commission has cooperated throughout the years of its existence with representatives of the American Institute of Certified Public Accountants, and others, in an endeavor to develop and promote better financial reporting, and a more general acceptance of sound accounting practices. Experience has borne out that the investor, and the public, are best served by this practice, and by the policy of requiring a certificate of independent accountants which expresses an opinion as to the overall fairness of the financial position and operating results reported upon, and the avoidance of prescribing detailed regulations as to accounting methods, practices, or principles. No legislative endorsement of this policy is considered necessary.

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1 "The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; ** **
In other words, there are a lot of people working in one way or another at various activities which are aimed at or collaterally affect the better working of our securities markets.

This leads me to observe that the Special Study [of the security markets] did less than it might well have done in the matter of assessing the role of your profession in our business. I believe I am correct in saying that there is no specific reference or comment directed at the accountants. But in a real sense there is high praise in the report for the corporate financial officers and the independent public accountants, if you know where to look. The report made no particular effort to praise anyone. I think on this occasion I am permitted a freedom of expression above and beyond that usually found in "official" reports, and accordingly I will interpret.

In Chapter IX, the Special Study observes that "Disclosure is the cornerstone of Federal securities regulation; it is the great safeguard that governs the conduct of corporate managements in many of their activities; it is the best bulwark against reckless corporate publicity and irresponsible recommendation and sale of securities." In Chapter XII, the Special Study notes the Commission's "marked success" in administering the disclosure provisions for issuers.

Fair, adequate, understandable disclosures under these acts begin with the corporate accounting records and the financial statements synthesized from them. Almost everything else to be said about a company and its securities either affects or explains — finds cause or effect in the profit and loss statement and the statement of condition.
In a very real sense the accountants are the unsung heroes of many a corporate drama and many an actor on the corporate stage cannot play his more dramatic part until the less spectacular work of the financial officer and accountant has arranged the scenery and perhaps established the basic theme.

Only we who live with these statutes can fully appreciate the extent to which, in the evolution of our regulatory scheme, we have relied upon the accounting profession to establish standards and to apply them or the extent to which the accountants' work has influenced administrative policies generally. This reliance furthermore has been at the profession's invitation.

With statutory authority reposing in the Commission to prescribe — to require — to dictate by rule how financial statements should be prepared and presented, the Commission very early in its life, at the request of the profession, stood aside and not only withheld governmental action but actively encouraged the full self-development of the initiative sought to be exercised. The wisdom of that regulatory decision and the soundness of the administrative trust thus demonstrated really have never been seriously questioned. For twenty-five years it has been the exceptional situation which prompted the Commission to speak directly by rule on matters of accounting principles.

The profession thus has performed an important role as a self-regulatory institution. Although it is not the holder of delegated governmental power, as is the NASD or the stock exchanges, its accomplishments are a credit to volunteer activity — shaped by general statutory principles — which achieve a species of compulsion without the customary trappings of the compulsory process.

We have a continuing interest in the viability of this effort — this process, or however it should be described. Speaking for myself, it is better, I think, to have some of the looseness — the creaking joint, if you will — some sacrifice of the ultimate in consistency and uniformity and acceptability under such a system than to seek the rule — government or industry inspired — which either binds people to a rigid conformity or sets up a standard from which departures multiply in achieving solutions to problems. How many remember the two dozen or more exceptions from the rule for the use of old Form A-2 under the Securities Act which evolved over a period of time until the form itself was abolished?

We thought the dismay with which our reaction to the investment credit episode seems to have been greeted, in some quarters, most unfortunate. We intended no rebuff to the profession or the Account-
ing Principles Board. On the contrary, we have encouraged and con-
tinue to encourage them in their work. We would caution, however,
against the profession undertaking to do what you have always
pleaded that we not do.

We know from long experience that even a relatively simple matter
such as our Rule 14a-3, which in effect says a company's financial
statements in its annual report to its stockholders should not be incon-
sistent in any material way with the financial statements filed with
us, becomes an extremely difficult and protracted exercise in rule-
making and in fact somewhat contentious. The task you set your-
selves to force conformity on matters of accounting principle when
there is not in fact acceptability of conformity, I think, is an impossible
one. In any event, such a step calls for full exploration of problems
and procedures. But this view in no sense reflects upon the efforts
of those dedicated, highly intelligent and articulate public-minded
members of the profession who vigorously urge more, and more
penetrating, research and who constantly seek to narrow differences
and, where possible, broaden the scope of that which is truly "the
acceptable" of the profession. We salute them and their efforts.

Those who wish to compel conformity — or rather seek to have us
compel conformity — for only we in the final analysis have the tools to
enforce the law or to set enforcement in motion — will no doubt be
less than happy with this approach. What then are we left with, say
they, except education and persuasion?

The short answer in our field of activity, I think, is that these have
been the principal tools by which so much has been and continues to
be accomplished. They have been the genius of the administration
of the disclosure provisions of the '33 and '34 Acts. With your con-
tinued assistance, I think they are likely, in major respects, to remain
so.
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402
1. The Committee on Terminology was constituted in 1920 and assigned the task of compiling a vocabulary of words and expressions used peculiarly in accounting and of gradually preparing definitions thereof. In 1931 definitions which had been formulated were brought together in a volume published by the Institute under the title Accounting Terminology, but without official approval and with emphasis on its tentative character. In the years that have since elapsed, events have forced accountants to give more careful consideration to the use of words, as the responsibilities that may flow from careless or inaccurate usage have become more serious and manifest. Since 1939 the members of the committee on terminology have (with rare exceptions) been chosen from the membership of the committee on accounting procedure.

2. As a field of activity or thought extends, and a need for new modes of expression arises, the need may be met by the development of new words, or by expanding the meaning of words already in use. Either course has its dangers; in the one case that of not being understood, in the other that of being misunderstood. Where, as in the case of accounting, the need arises from the growth of an old activity, the second alternative is likely to be adopted more freely than the first and the resulting danger of being misunderstood is very real.
3. Illustrations may be noted from the uses in accounting of the words *value*, *assets*, and *liabilities*. A correct understanding of these uses is fundamental to the understanding of many other accounting terms.

4. The term *value* is used in accounting to signify some attribute of an asset (or other accounting factor); this attribute is expressed in terms of money, which may or may not reflect intrinsic worth, and is normally indicated by a qualifying adjective (e.g., *book value*, *replacement value*, etc.). Furthermore in accounting, *values* as thus broadly viewed, although not homogeneous, may be aggregated or deducted from one another. Thus, it is a universally accepted practice to add the cost value of one asset to the market value of another, and to deduct from the sum the amount of a liability to arrive at a net figure. This procedure, although open to obvious criticism of its mathematical propriety, possesses so many practical advantages and is so well established that it is not likely to be abandoned.

5. The words *assets* and *liabilities* are in accounting usage often no more than substitutes for *debts* and *credits* as headings for the two sides of a balance sheet. Not all the items carried under these headings are assets or liabilities in the ordinary sense of those words, nor are all the items that are assets or liabilities in the ordinary sense commonly included under these headings. Thus in one case unamortized discount on bonds (not an asset) may be found under the heading of assets, while in another case goodwill (possibly the most valuable of assets) may not be found at all.

6. The failure of accountants to emphasize and explain their conventional uses of these and other terms has given rise to criticism of accounting statements and of the profession. Students from other fields are apt to regard as revelations and as grounds for adverse criticisms what are really truisms accepted with respect to accounts not only by accountants but by businessmen and by regulatory bodies generally.

ACCOUNTING—ACCOUNTANCY

7. No words are employed more commonly than these, either in the practice or in the teaching of the subject; yet many differences arising in accounting writings have their roots in different conceptions of these basic terms. A careful consideration of these words will therefore add to understanding, not only among accountants
themselves, but also among those outside the profession who have to do with accounting.

8. That publishers of general dictionaries had not, before the committee on terminology first expressed itself publicly, given adequate attention to the special uses of accounting terms was very evident from what the committee found with respect to their treatment of the words here under consideration. One dictionary consulted contained no definition of *accounting*, though it used the word in defining the verb *account* as "To furnish or receive an accounting." For the noun *accounting*, the more formal *accountancy* was made to serve, and was defined as "The work or art of an accountant." Turning therefore to *accountant*, hoping to find a definition which did not use the word to be defined, the committee found only that he is "one who keeps, examines, or is skilled in accounts; one whose business is to keep or examine books of a mercantile or banking house or in a public office."

9. After extensive consultation and careful consideration, the committee in 1941 formulated the following definition:

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

10. Public accounting is the practice of this art by one whose services are available to the public for compensation. It may consist in the performance of original work, in the examination and revision of the original work of others, or in the rendering of collateral services for which a knowledge of the art and experience in its practice create a special fitness.

11. If accounting were called a science, attention would be directed (and perhaps limited) to the ordered classifications used as the accountant's framework, and to the known body of facts which in a given case are fitted into this framework. These aspects of accounting cannot be ignored, but it is more important to emphasize the creative skill and ability with which the accountant applies his knowledge to a given problem. Dictionaries agree that in part art is science, and that art adds the skill and experience of the artist to science; it is in this sense that accounting is an art.

12. Except as in the two preceding paragraphs, the committee
chose not to amplify the definition which it put forth. It rejected suggestions that the definition be made more explicit by mention of other details of accounting, because it questioned the desirability of writing its definition in terms which, while perhaps sharpening its presentation, might also unduly limit its scope. After the passage of more than ten years, this choice of broad but significant language continues to seem wise, and the definition to appear comprehensive as well as succinct.

13. From the establishment of the Interstate Commerce Commission and of other regulatory commissions, accounting has served these bodies and the railroads and other utilities under their jurisdiction in the solution of rate-fixing and related problems. Following the adoption of the income-tax amendment, it quickly became and has ever since remained apparent that in the implementation of that amendment accounting is a sine qua non for ascertaining the income to be taxed. The complexities of modern business have brought to management some problems which only accounting can solve, and others on which accounting throws necessary and helpful light. With the widening of corporate ownership, accounting was found both necessary to and capable of an intelligible presentation, within reasonable compass, of the financial data required to be furnished by management to investors. Although all of these facets of accounting, and many others, had long been well known to the business world, the committee included in its definition no specific mention of any of them; but careful attention to such phrases as “summarizing in a significant manner,” “transactions and events . . . of a financial character,” and “interpreting the results thereof,” will reveal that the definition is in fact broad enough to cover them all.

14. Similar careful attention to the significant words, “the art of recording, classifying, and summarizing,” will rule out any interpretation that no more is indicated than bookkeeping. The recording and classifying of data in account books constitute an accounting function, but so also and on a higher level do the summarizing and interpreting of such data in a significant manner, whether in reports to management, to stockholders, or to credit grantors, or in income tax returns, or in reports for renegotiation or other regulatory purposes.

ACCOUNTING PRINCIPLES

15. It is desirable that the accountant conceive of his work as a complex problem to be solved and of his statements as creative works
of art, and that he reserve to himself the freedom to do his work with the canons of the art constantly in mind and as his skill, knowledge, and experience best enable him. Every art must work according to a body of applicable rules, but it also must reserve the right to depart from the rules whenever it can thereby achieve a better result.

16. Dictionaries agree in giving at least three orders of definitions of *principle*. The first is: "source, origin, or cause," which is of little help to accountants except as it emphasizes the primary character of some principles. The second is: "A fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths." The third is: "A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice. . . ."

17. This third definition comes nearest to describing what most accountants, especially practicing public accountants, mean by the word *principle*. Initially, accounting postulates are derived from experience and reason; after postulates so derived have proved useful, they become accepted as principles of accounting. When this acceptance is sufficiently widespread, they become a part of the "generally accepted accounting principles" which constitute for accountants the canons of their art. It is not convenient, either in conversation or in writing on accounting subjects, to add "(meaning number three)" each time the word *principle* is used, though that essentially is understood.

18. Care should be taken to make it clear that, as applied to accounting practice, the word *principle* does not connote a rule from which there can be no deviation. An accounting principle is not a principle in the sense that it admits of no conflict with other principles. In many cases the question is which of several partially relevant principles has determining applicability.

**BALANCE SHEET—ASSETS—LIABILITIES**

19. Since the committee's mid-year report in 1941, and consistently with what was said in that report, there has been marked progress toward greater logic and usefulness in what nevertheless still are referred to as balance-sheet presentations. It may be that at some future date the term *balance sheet* will cease to be used to designate a presentation of financial position and will instead be deemed to refer (as the term *trial balance* already refers) to a mere step, or point of arrival-and-departure, in preparing such a presentation. This possibility the committee leaves for future exploration.
20. The terms balance sheet, assets, and liabilities are so closely related that the three can best be considered together. Indeed, the procedure is often adopted of first defining a balance sheet as a statement of assets and liabilities (or of assets, liabilities, and capital) and then undertaking the definition of assets and liabilities. This procedure, however, overlooks the fact that a balance sheet is historically a summary of balances prepared from books of account kept by double-entry methods, while a statement of assets and liabilities may be prepared for an organization for which no such books are kept; moreover such a summary may fall short of being an adequate statement of assets and liabilities. Since balance sheet is a distinctly technical accounting term while assets and liabilities are less so, the committee feels that balance sheet should be defined with reference to the origin (that is, the origin in the accounts) of its constituent parts, and that the relation of assets and liabilities to the concept of the balance sheet should be considered subsequently.

21. In this view a balance sheet may be defined as:

A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept according to principles of accounting.

22. For purposes of contrast, the definition in the Century Dictionary (taken from Bouvier's Law Dictionary, 1934) is worthy of analysis. It reads as follows:

A statement made by merchants and others to show the true state of a particular business. A balance sheet should exhibit all the balances of debits and credits, also the value of the merchandise, and the result of the whole.

The use of the word true in the first sentence is regrettable since it adds nothing to the definition but suggests a possibility of certainty that does not exist. The second sentence recognizes the nature of the balance sheet as a statement of balances. From the reference to merchandise, one might infer that the definition originated in a day when the inventory was a figure introduced into the books only as a part of the final closing. The use here of the term value is characterized by the looseness noted in the discussion below (see paragraph 35) of the meanings of that term when used in accounting.

23. The committee once said that the term balance sheet had too often been construed in a mood of wishful thinking to describe what
the writer would like a balance sheet to be; perhaps the definition just cited reflected such a mood. With the passing of time and with the greater development and more widespread understanding of accounting principles, the committee now feels that commercial and industrial usage has tended toward the reconciling of these two definitions so that in those fields a balance sheet as contemplated in the first may indeed be the statement of assets and liabilities which appears to be contemplated in the second.

24. Accounting analysis frequently requires that two accounts be carried, with balances on opposite sides, in respect to the same thing (e.g., a building account, and a building-depreciation account). In the balance sheet, however, the net amount of such balances is usually though not invariably shown.

25. Those things which are reflected in the net debit balances that are or would be properly carried forward are termed assets, and those reflected in net credit balances, liabilities. Hence the expression statement of assets and liabilities is frequently used as synonymous with balance sheet, though as already pointed out not every statement of assets and liabilities is a balance sheet.

26. The word asset is not synonymous with or limited to property but includes also that part of any cost or expense incurred which is properly carried forward upon a closing of books at a given date. Consistently with the definition of balance sheet previously suggested, the term asset, as used in balance sheets, may be defined as follows:

Something represented by a debit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting (provided such debit balance is not in effect a negative balance applicable to a liability), on the basis that it represents either a property right or value acquired, or an expenditure made which has created a property right or is properly applicable to the future. Thus, plant, accounts receivable, inventory, and a deferred charge are all assets in balance-sheet classification.

The last named is not an asset in the popular sense, but if it may be carried forward as a proper charge against future income, then in an accounting sense, and particularly in a balance-sheet classification, it is an asset.

27. Similarly, in relation to a balance sheet, liability may be defined as follows:
Something represented by a credit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock and related or similar elements of proprietorship are balance-sheet liabilities in that they represent balances to be accounted for, though these are not liabilities in the ordinary sense of debts owed to legal creditors.

Consideration of the facts noted in the last sentence of this definition has led some accountants to the view that the aggregate of liabilities as contemplated in this definition should be referred to as the aggregate of liabilities and capital, and that the balance sheet consists of an asset section, a liability section, and a proprietary or capital section, with the monetary amounts represented by the first shown as equal to the sum of those represented by the other two. The committee feels that there is no inconsistency between this view and the suggested definition.

28. Although the term income account continues to be used somewhat to designate a financial statement prepared from accounts and designed to show the several elements entering into the computation of net income for a given period, the more modern practice is to use instead the term income statement; one of the effects of this practice is to restrict the use of the term account to the technical running record in the ledger, from the aggregate of which the financial statements are prepared.

29. The terms profit and profit and loss account (or profit and loss statement) are older, and perhaps more inclusive and more informative, expressions to be applied to industrial and mercantile enterprises and their results than are the terms income and income account (or income statement). The term profit and loss seems to have been in use before Paciolo's work was published in 1494, and what was perhaps the earliest
bookkeeping text in England (A *Briefe Instruction*, by John Mellis, published in 1588) contained a chapter treating “Of the famous accompt called profite and losse, or otherwise Lucrum and Damnum, and how to order it in the Leager.” This is the earliest work cited by *A New English Dictionary of Historical Principles*, 1888-1928, as having used the phrase *profit and loss*, which the dictionary defines as “an inclusive expression for the gain and loss made in a series of commercial transactions”; it also defines *profit and loss account* as “an account in book-keeping to which all gains are credited and losses are debited, so as to strike a balance between them, and ascertain the net gain or loss at any time.” The same dictionary shows 1601 as the issue-date of the earliest work discussing *income*, which term it defines as meaning the periodical produce of one’s work, business, lands, or investments; it seems significant that the dictionary does not define or otherwise mention the *income account*.

30. Clearly, an opportunity existed for distinctive uses of the terms *earnings*, *income*, and *profits*, and of the corresponding *accounts* or *statements*. Not too long ago, usage applied *earnings* to concerns rendering services, *profits* to manufacturing and mercantile concerns, and *income* to the compensation or revenue received by an individual. In recent years, there has been an increasing tendency to substitute the term *income statement* for the term *profit and loss statement*, and to regard these two terms as equally inclusive.

31. It is important that accountants keep in the forefront of any discussion of *income*, its composite nature as the resultant of positive (credit) and negative (debit) elements. The income statement can be informative only as it discloses such of these positive and negative elements as are significant.

32. The cumulative balance of *profit and loss* (or *income*) after deductions of dividends was long called *undivided profits*, but later came to be more commonly called *earned surplus*. The change brought no increase of accuracy or lucidity but rather the reverse. It is difficult to see why the word *surplus* was used at all, and the introduction of the challenging and often unwarranted word *earned* seems to be wholly regrettable. In 1949, this committee secured the approval of the committee on accounting procedure for its recommendation that the use of the term *surplus* in balance-sheet presentations be discontinued.

33. As early as 1924 the Institute appointed a special committee whose task was merely to define *earned surplus*; it was not directed
to consider alternatives. That special committee, after an extensive inquiry, in 1930 submitted to the Council of the Institute a report suggesting a definition which the Council duly received but on which it took no action.

34. By that definition only slightly modified, the term *earned surplus* (or *undistributed profits* or *retained income*) means:

The balance of net profits, income, gains and losses of a corporation\(^1\) from the date of incorporation (or from the latest date when a deficit was eliminated in a quasi-reorganization) after deducting distributions therefrom to shareholders and transfers therefrom to capital stock or capital surplus accounts.

**VALUE AND ITS DERIVATIVES**

35. *Value* is a word of many meanings. Just as beauty is said to lie in the eye of the beholder, so worth may lie in the mind of the appraiser. There is often no unique standard of worth which is both realistic and objectively applicable. The fact that there are different criteria of worth is strikingly illustrated in Supreme Court decisions which have applied different methods of determining value in connection with the regulation, taxation, and reorganization, respectively, of railroads. But apart from the difficulty of measuring value when the word is used to connote worth, it is evident that in the literature of business, economics, and accounting, *value* is used in varying significances, not all of which have any definite connotation of worth. The word is commonly employed in accounting to describe the figure at which an asset or liability is carried in the accounts, even though the amount may be determined by a process which is not one of valuation in any ordinary sense.

36. Since accounting is predominantly based on cost, the proper uses of the word *value* in accounting are largely restricted to the statement of items at cost, or at modifications of cost. In accounting, the term *market value* is used in senses differing somewhat from those attaching to the expression in law. As applied to securities, it means a sum computed on the assumption that value is measurable by market quotations; as applied to inventories, it is compiled from a variety of considerations, including market quotations, cost of replacement, and probable sales price. In the case of so-called fixed assets the *value* shown in accounts is the balance of their cost (actual or modified) after deducting recorded depreciation. Thus the following definition would seem to be appropriate:
Value as used in accounts signifies the amount at which an item is stated, in accordance with the accounting principles related to that item. Using the word value in this sense, it may be said that balance-sheet values generally represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

37. The word value should seldom if ever be used in accounting statements without a qualifying adjective.

AUDIT AND ITS DERIVATIVES

38. The origin of the word audit relates it to hearing, and traces of this early usage, signifying the hearing by proper authorities of accounts rendered by word of mouth, still linger in such phrases as hearing witnesses and examine witnesses included in some dictionary definitions of audit. From this to the modern applications of the word is, however, a considerable distance.

39. The use of the term audit has been extended to include the examination of any records to ascertain whether they correctly record the facts purported to be recorded. The next step extended the usage to statements prepared as summaries of records, so that an audit was concerned not only with the truth of the records, but also with the question whether or not the statements were faithfully prepared from those records.

40. But the most notable development in the use of the term is that which has to do with the preparation of statements “in conformity with generally accepted accounting principles,” signifying that the auditor’s concern is not restricted to the technical accuracy of the records, but goes also to the principles which have governed the accounting allocations entering into the results shown in the statements.

41. It thus becomes clear that the end result of the audit is in many cases the expression of an opinion by the auditor to the effect that the statements are what they purport to be. But such general terms as that could not satisfy the requirements of the situation, since they would leave it open to the reader to supply his own standards or definitions of what the statements are intended to mean. Hence the reference, in the standard short form of accountant’s report recommended by the Institute’s committee on auditing procedure, to “conformity with
generally accepted accounting principles.” Only in the light of these principles is it proper to interpret and judge the statement.

42. The word *opinion* is also important. In the circumstances described it is not possible for the auditor to state as a literal fact that the statements are true, or that they have been prepared “in conformity with generally accepted accounting principles.” All that the circumstances warrant is an expression of opinion; and although it is true that the auditor is expected to have qualified himself to express an opinion, both by his general training and by his examination in the particular case, yet his audit properly results in a statement of opinion, not of fact.

43. These considerations suggest definitions of *audit* as follows:

In general, an examination of an accounting document and of supporting evidence for the purpose of reaching an informed opinion concerning its propriety. Specifically:

(1) An examination of a claim for payment or credit and of supporting evidence for the purpose of determining whether the expenditure is properly authorized, has been or should be duly made, and how it should be treated in the accounts of the payor — hence, *audited voucher*.

(2) An examination of similar character and purpose of an account purporting to deal with actual transactions only, such as receipts and payments.

(3) By extension, an examination of accounts which purport to reflect not only actual transactions but valuations, estimates, and opinions, for the purpose of determining whether the accounts are properly stated and fairly reflect the matters with which they purport to deal.

(4) An examination intended to serve as a basis for an expression of opinion regarding the fairness, consistency, and conformity with accepted accounting principles, of statements prepared by a corporation or other entity for submission to the public or to other interested parties.

**AUDITOR’S REPORT (OR CERTIFICATE)**

44. The Securities Act of 1933 repeatedly speaks of statements “certified” by accountants, and this usage was followed in the regulations of the Securities and Exchange Commission. Before 1933, however, question had been raised as to the propriety and usefulness in this connection of the words to *certify* and *certificate*; it was pointed out that they were misleading to the extent that they conveyed to ordinary readers an impression of greater certainty or accuracy than
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the statements could possess, or that they represented that the auditor was expressing more than his opinion about the statements. In a letter dated December 21, 1933, the Institute's special committee on cooperation with stock exchanges wrote: "To this end, we think it desirable that the document signed by the accountants should be in the form of a report, as in England, rather than a certificate, and that the words 'in our (my) opinion' should always be embodied therein." But one of the notes to the form recommended with that letter spoke of the "certificate," and other committees have frequently found themselves obliged to use report and certificate interchangeably. In these circumstances the continued use of both terms can scarcely be avoided, and the important thing is to emphasize the fact that the choice of one term or the other implies no difference of scope or purport, and to make that purport clear. This might be done by the following definition:

The report (or certificate) of an independent accountant (or auditor) is a document in which he indicates the nature and scope of the examination (or audit) which he has made and expresses the opinion which he has formed in respect of the financial statements.

45. The word report as synonymous with certificate (sometimes also called "short form of report") is used primarily in connection with audits of the kind covered by the fourth of the specific definitions suggested above. In relation to other kinds of audits the report may take varying forms according to the nature and scope of the work undertaken.

DEPRECIATION

46. The word depreciation is an outstanding example of a term used in accounting in specialized senses. The sense in which accountants use this term differs not only from its colloquial sense but also from the sense in which it is used in engineering; and it is far removed from the root-meaning (diminution in price or value) of the word itself. The committee therefore feels that there rests on the profession an obligation to clarify the meaning of the word when used as a term of art in accounting. This is the more desirable since the accounting concept of the term has in recent years won increasing acceptance from courts and regulatory commissions.

Definitions from other sources

47. Before formulating its own definition in 1944, the committee considered a number of earlier definitions from other sources, some of which are quoted below:
(1) Webster’s *New International Dictionary* (1934):

(a) Depreciation: (Accounting). Decline in value of an asset due to such causes as wear and tear, action of the elements, obsolescence, and inadequacy.

(b) Depreciation charge: (Accounting). An annual charge to cover depreciation and obsolescence, usually in the form of a percentage, fixed in advance, of the cost of the property depreciated.

(2) United States Supreme Court, in *Lindheimer v. Illinois Bell Telephone Company*, 292 U.S. 151 (1934):

Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence. Annual depreciation is the loss which takes place in a year.

(3) National Association of Railroad and Utilities Commissioners, *Report of Special Committee on Depreciation*, “Depreciation Principles and Methods” (1938), pp. 8-10:

... depreciation, as applied to depreciable utility plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of utility plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in some cases, the exhaustion of natural resources.

(4) United States Treasury Department, Bureau of Internal Revenue, *Regulations 103 relating to the Income Tax* (1940):

Sec. 19.23(1) — 1. Depreciation: A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property
in the business, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep.

NOTE. The foregoing language is substantially identical with that on the same subject in Regulation 62 (1922), Regulations 65 (1924), Regulations 74 (1928), Regulations 77 (1933), Regulations 86 (1935), Regulations 94 (1936), Regulations 101 (1939), and Regulations 111 (1943 et subs.).

(5) Montgomery, Auditing Theory and Practice:

(a) First Edition (1912), page 317:

Entirely extraneous influences may cause fluctuation in the value of assets. . . . Depreciation, however, is a decline in the value of property such as may reasonably be expected to occur as a result of wear and tear and gradual obsolescence. It is due to the possession and use of the assets, and therefore is a part of the cost of operation.

(b) Sixth Edition (1940), page 477:

To accountants fixed assets represent an investment in physical property, the cost of which, less salvage, must be charged to operations over the period of the useful life of such property. Hence, fixed assets are really in the nature of special deferred charges of relatively long service life, the absorption of which is called by the distinctive name ‘depreciation.’

(6) Paton, Essentials of Accounting (1938), page 530:

‘Depreciation’ has come to be used particularly to designate the expiration of the cost or value of buildings and equipment in the course of business operation . . .

48. These definitions view depreciation, broadly speaking, as describing not downward changes of value regardless of their causes but a money cost incident to exhaustion of usefulness. The term is sometimes applied to the exhaustion itself, but the committee considers it desirable to emphasize the cost concept as the primary if not the sole accounting meaning of the term: thus, depreciation means the cost of such exhaustion, as wages means the cost of labor.

49. It is recognized by some if not all of these definitions that the whole cost of exhaustion of usefulness is not included within the accounting concept of depreciation, but there is not complete unanimity as to what should be excluded. Exhaustion is constantly being both retarded and in part restored by current maintenance and, in
defining *depreciation*, costs chargeable to maintenance must be excluded from the cost incident to exhaustion. Immediately, a question arises as to whether the exclusion should be (a) the cost of exhaustion which is in fact restored by current maintenance or (b) the cost of exhaustion which would be restored by adherence to an established standard of maintenance. The above-quoted definitions by the Court (2) and the Commissioners (3) accept the former alternative and that by the Treasury (4), while not explicit, appears similar in intent. However, depreciation accounting is normally based on assumed standards of maintenance, and depreciation charges are not as a rule varied as maintenance cost rises or falls. It is probably correct to say that if in a single and exceptional period maintenance cost is either materially above or materially below the assumed standards, the excess or deficiency should be treated as outside the scope of depreciation, but that a change in maintenance policy or in a classification of maintenance charges would call for a reconsideration of the system of depreciation accounting.

50. Exhaustion of usefulness may result from causes of materially different character, some physical, others functional and others possibly financial, some operating gradually, others suddenly. The Supreme Court’s definition (2) of depreciation includes the words “all the factors causing the ultimate retirement of the property,” but it also gives a list of such factors and those mentioned are all gradual in operation. The Treasury’s definition (4) likewise gives a list of factors which is similarly restricted. The definition by the Commissioners (3) is in terms more comprehensive but introduces a new exception: it includes “causes which are known to be in current operation and against which the utility is not protected by insurance.” Certain of the causes specifically enumerated in these three definitions — wear and tear, decay (exhaustion), inadequacy, and obsolescence — are included in all three; the Court and the Treasury recognize no other causes, but the Commissioners add “action of the elements,” “changes in the art,” “changes in demand,” and “requirements of public authorities.”

51. “Action of the elements” may be either gradual or sudden, and including as *depreciation* losses due to storms, fires, and floods if not covered by insurance, seems clearly to extend the concept of depreciation from one of a long-term deferred charge (see definition 5) to something more in the nature of self-insurance. Such an extension might be justifiable if application of the term is restricted to large
groups of properties collectively as against relatively small separate units, because as to a large group the losses from such causes over a period of years may be reasonably foreseeable, while in the case of single units they are not. However, application of the term *depreciation* to losses due to sudden and violent action of the elements may be questioned, especially by those who oppose attempts to smooth out reported profits artificially. “Changes in the art” may be regarded as one cause of obsolescence, and the inclusion of these words in the definition as a redundancy. “Changes in demand” is more inclusive than “inadequacy”; it would presumably cover the losses due to superfluity of capacity, which in some circumstances may become of even greater importance than inadequacy. “Requirements of public authorities” may perhaps be regarded as an inclusion deemed particularly applicable to utilities and not necessarily relevant to unregulated enterprises.

52. In industrial accounting, the meaning of *depreciation* conforms more closely to the definitions of the Court and the Treasury than to that of the Commissioners; in this field depreciation provisions are generally limited to costs or losses which are not restorable by current maintenance and are (a) gradual in their nature, (b) due to physical or functional causes, and (c) reasonably foreseeable.

**Committee definition**

53. The committee regards it as a good procedure first to define *depreciation accounting*, and then to describe the various senses in which the words *depreciate* and *depreciation* are used in connection with such accounting.

54. Depreciation accounting is clearly a special technique (like cost accounting or accrual accounting). It can be sharply distinguished from the replacement system, the retirement system, the retirement reserve system, and the appraisal system, all of which have at times been employed in dealing with the same subject matter in accounting. Depreciation accounting may take one of a number of different forms. The term is broadly descriptive of a type of process, not of an individual process, and only the characteristics which are common to all processes of the type can properly be reflected in a definition thereof. These common characteristics are that a cost or other basic value is allocated to accounting periods by a rational and systematic method and that this method does not attempt to determine the sum allocated to an accounting period solely by relation to
occurrences within that period which affect either the length of life or the monetary value of the property. Definitions are unacceptable which imply that *depreciation for the year* is a measurement, expressed in monetary terms, of the physical deterioration within the year, or of the decline in monetary value within the year, or, indeed, of anything that actually occurs within the year. True, an occurrence within the year may justify or require a revision of prior estimates as to the length of useful life, but the annual charge remains an allocation to the year of a proportionate part of a total cost or loss estimated with reference to a longer period.

55. Obviously, the term *depreciation* as here contemplated has a meaning different from that given it in the engineering field. The broad distinction between the senses in which the word is used in the two professions is that the accounting concept is one of systematic amortization of cost (or other appropriate basis) over the period of useful life, while the engineering approach is one of evaluating present usefulness.

56. After long consideration the committee on terminology formulated the following definition and comments:

*Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

**NOTE.** This method of accounting may be contrasted with such systems as the replacement, the retirement, the retirement reserve, and the appraisal methods of recognizing the fact that the life of certain fixed assets is limited.

The words *depreciate* and *depreciation* are used in various ways in connection with depreciation accounting. The verb is used in a transitive as well as in an intransitive sense (cf., the use of accrue in accrual accounting). The noun is used to describe not only the process but also a charge resulting from the process or the accumulated balance of such charges; it is also used to describe the exhaustion of life which gives rise to the method of accounting.

In all these uses, the meaning of the word is sharply distinguished
from the sense of "fall in value" in which the word is employed in common usage and in respect to some assets (e.g., marketable securities) in accounting.

USE OF THE TERM "RESERVE"

57. The committee observed some years ago that the term reserve was being used in accounting in a variety of different and somewhat conflicting senses. As a result clarity of thought and accuracy of expression were impaired and an adequate understanding of financial statements on the part of users was made more difficult than necessary. In addition the variations in balance-sheet classification and presentation of the so-called reserves contributed to the confusion and made comparisons difficult.

58. The dictionaries define the term generally as something held or retained for a purpose, frequently for emergencies. In dealing with financial matters the term is commonly used to describe specific assets which are held or retained for a specific purpose. This is the sense in which the term is employed, for instance, in our banking system, which derives its name from the fact that member banks are required to maintain deposits with the central or reserve banks. The term is also used to indicate such assets as oil and gas properties which are held for future development. In accounting, such assets are described according to their nature or referred to as funds or deposits for specific purposes, generally without using the term reserve.

59. In accounting practice the term has been used in at least four senses, namely:

(1) To describe a deduction which is made (a) from the face amount of an asset in order to arrive at the amount expected to be realized, as in the case of a reserve for uncollectible accounts, or (b) from the cost or other basic value of an asset, representing the portion of the cost which has been amortized or allocated to income, in order to arrive at the amount properly chargeable to future operations, as in the case of a reserve for depreciation. In this sense the term has been said to refer to valuation reserves, reflected in the asset section of the balance sheet.

(2) To indicate an estimate of (a) an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) the probable amount of a disputed claim, as in the case
of a reserve for additional taxes, or (c) a liability or loss which is not certain to occur but is so likely to do so as to require recognition, as in the case of a reserve for self-insurance. These reserves have been included in the liability section of the balance sheet, or in a section immediately below the ordinary liabilities, or in the proprietary section. In the insurance field the term is used in this sense as referring to the portion of the total assets derived from premiums which is expected to be required to meet future payments under policies.

(3) To indicate that an undivided or unidentified portion of the net assets, in a stated amount, is being held or retained for a special purpose, as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacement of property, or (c) for possible future inventory losses, or (d) for general contingencies. In this sense a reserve is frequently referred to as an appropriation of retained income.

(4) In the income statement, to indicate a variety of charges, including losses estimated as likely to be sustained because of uncollectible accounts, depreciation, depletion, amortization, and general or specific contingencies. It is to be noted here that the term refers to the charge by means of which a reserve (in any of the three preceding senses) is created.

60. The committee in 1948 recommended that in accounting practice the use of the term reserve be limited to the third of the four senses set forth above, i.e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes, and that the use of the term in the income statement or to describe in the balance sheet deductions from assets or provisions for particular liabilities should be avoided. There appears to be increasing recognition of the soundness of this recommendation.

61. The first and second accounting usages of the term set forth above seem not only clearly contrary to its commonly accepted meaning but also lacking in technical justification. As to the first, a so-called reserve for bad debts or for depreciation does not in itself involve a retention or holding of assets, identified or otherwise, for any purpose. Its function is rather a part of a process of measure-
ment, to indicate a diminution or decrease in an asset due to a specified cause. Nor is the suggested substitution of the term *provision* acceptable as an improvement, because any provision must of necessity and in the final analysis be made by the allocation or segregation of assets. The term *less reserve* in this area has been increasingly replaced by terms which indicate the measurement process, such as *less estimated losses in collection, less accrued depreciation*, etc.

62. As to the second of these four usages, it may be argued that the showing of any liability in the balance sheet is an indication that a portion of the assets will be required for its discharge, and that in this sense the showing may be regarded as a provision or reserve; however, it is clearly preferable to regard the showing as indicating the obligation itself, which is a deduction necessary to arrive at proprietary investment or net assets. The items in this area which have been described as reserves are therefore better designated in some such way as *estimated liabilities* or *liabilities of estimated amount*.

63. The use of the term *reserve* to describe charges in the income statement involves different considerations. It may be said that a charge of this nature, e.g., a charge for depreciation, indicates that cash or some other thing received by way of revenue has, to the extent indicated, been reserved or set aside for a special purpose, and therefore represents a reserve. However, the basic purpose in the making of these charges is one of income measurement, and the designation of such charges as costs, expenses, or losses, i.e., negative elements in determining income, is more understandable than their designation as *reserves*.

64. The generally accepted meaning of the term *reserve* corresponds fairly closely to the accounting usage which indicates an amount of unidentified or unsegregated assets held or retained for a specific purpose. This is the use to which the committee feels it should be restricted, and it is interesting to note that in the 1947 revision of the British Companies Act the use of the term was limited to this area.

**USE OF THE TERM “SURPLUS”**

65. In 1941 the committee suggested a general discontinuance of the use of the term *surplus* in corporate accounting, and a substitution therefor in the proprietorship section of the balance sheet of designations which would emphasize the distinction between (a) legal capital, (b) capital in excess of legal capital, and (c) undivided
profits. Extensive discussions of the proposal followed, and in 1949 it was approved “as an objective” by the committee on accounting procedure.

66. A factor of primary importance in the balance-sheet presentation of the stockholders’ equity is the status of ownership at the balance-sheet date. Where two or more classes of stockholders are involved, the interests of each must be presented as clearly as possible. These interests include the entire proprietary capital of the enterprise, frequently divided further, largely on the basis of source, as follows:

1. Capital stock, representing the par or stated value of the shares.
2. Capital surplus, representing (a) capital contributed for shares in excess of their par or stated value, or (b) capital contributed other than for shares.
3. Earned surplus, representing accumulated income or the remainder thereof at the balance-sheet date.

67. While the terms capital surplus and earned surplus have been widely used, they are open to serious objection.

1. The term surplus has a connotation of excess, overplus, residue, or “that which remains when use or need is satisfied” (Webster), whereas no such meaning is intended where the term is used in accounting.

2. The terms capital and surplus have established meanings in other fields, such as economics and law, which are not in accordance with the concepts the accountant seeks to express in using those terms.

3. The use of the term capital surplus (or, as it is sometimes called, paid-in surplus) gives rise to confusion. If the word surplus is intended to indicate capital accumulated by the retention of earnings, i.e., retained income, it is not properly used in the term capital surplus; and if it is intended to indicate a portion of the capital, there is an element of redundancy in the term capital surplus.

4. If the term capital stock (and in some states the term capital surplus) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication
in the terms **surplus** or **earned surplus** of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, available for dividends.

68. In seeking terms more nearly connotative of the ideas sought to be expressed, consideration should be given primarily to the sources from which the proprietary capital was derived. In addition, regard should be had for certain types of events which may have occurred in the history of the corporation. Thus, a quasi-reorganization in which a “new start” has been made may be said to have put the entire net assets, as restated at the time, into the status of contributed capital, so that in subsequent balance-sheet presentations that part of proprietary capital sometimes described as **earned surplus** would include only income retained after the quasi-reorganization and would be “dated” accordingly. Likewise a stock dividend, or a transfer by resolution of the board of directors, must for purposes of subsequent balance-sheet presentation be dealt with as a transfer of capital accumulated by retention of income to the category of restricted capital. Finally, the classification of proprietary capital involves a consideration of present status in such matters as contractual commitments, dividend restrictions and appropriations of various kinds.

69. In view of the foregoing the committee in 1949 particularized the proposal which had been so long under consideration by recommending that, in the balance-sheet presentation of stockholders’ equity:

(1) The use of the term **surplus** (whether standing alone or in such combinations as **capital surplus**, **paid-in surplus**, **earned surplus**, **appraisal surplus**, etc.) be discontinued.

(2) The contributed portion of proprietary capital be shown as:

(a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.

(b)(i) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value, or of a reduction in par or stated value
(ii) Capital received other than for shares whether from shareholders or from others.

(3) The term earned surplus be replaced by terms which will indicate source, such as retained income, retained earnings, accumulated earnings, or earnings retained for use in the business. In the case of a deficit, the amount should be shown as a deduction from contributed capital with appropriate description.

(4) In connection with 2(b) and 3 there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal. Retained income appropriated to some specific purpose nevertheless remains part of retained income, and any so-called "reserves" which are clearly appropriations or segregations of retained income, such as those for general contingencies, possible future inventory losses, sinking fund, etc., should be included as part of the stockholders' equity.

(5) Where there has been a quasi-reorganization, retained income should be "dated" for a reasonable time thereafter; and where the amount of retained income has been reduced as a result of a stock dividend or a transfer by resolution of the board of directors from unrestricted to restricted capital, the presentation should, until the fact loses significance, indicate that the amount shown as retained income is the remainder after such transfers.

(6) Any appreciation included in the stockholders' equity other than as a result of a quasi-reorganization should be designated by such terms as excess of appraised or fair value of fixed assets over cost or appreciation of fixed assets.

70. As already noted, this proposal was approved "as an objective" by the committee on accounting procedure although it has subsequently used the term surplus in certain of its pronouncements where it felt that the avoidance of such usage might seem to border on pedantry. The cogency of the reasons adduced for discontinuing the use of the term in balance-sheet presentations of the stockholders'
equity seems obvious, and that the proposal is winning general acceptance appears from analyses made by the Institute's research department of numerous published corporate financial statements: the proportion of such statements in which the term *surplus* was not used was 10 per cent for 1947 and 18 per cent for 1948, but for 1949, 1950, and 1951, after the recommendation was published, it was 32 per cent, 41 per cent, and 44 per cent, respectively.

Committee on Terminology (1952-53)
Frederick B. Andrews, Chairman
John W. Queenan
C. Aubrey Smith

August, 1953

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1 Other than gains from transactions in its own shares, and losses therefrom chargeable to capital surplus; see chapter 1(b) of *Accounting Research Bulletin No. 43*, paragraphs 7 and 8.

2 Elsewhere in the same report, *service value* is defined as “the difference between the original cost and the net salvage value of utility plants. . .”

3 This classification includes such items as capital transferred from capital stock account as a result of the reduction of par or stated value, and credits resulting from transactions in the corporation's own stock.
mendations are made for the use of these terms in connection with business operations and financial statements. The term proceeds also is included in the list of terms considered.

DEFINITIONS AND RECOMMENDATIONS

**Proceeds**

3. Definition:

   *Proceeds* is a very general term used to designate the total amount realized or received in any transaction, whether it be a sale, an issue of stock, the collection of receivables, or the borrowing of money.

4. Recommendation:

   This term is not ordinarily used as a caption in the principal financial statements and generally should be used only in discussions of transactions.

**Revenue**

5. Definition:

   *Revenue* results from the sale of goods and the rendering of services and is measured by the charge made to customers, clients, or tenants for goods and services furnished to them. It also includes gains from the sale or exchange of assets (other than stock in trade), interest and dividends earned on investments, and other increases in the owners' equity except those arising from capital contributions and capital adjustments.

6. Revenue, like proceeds, is a gross concept but revenue, unlike proceeds, does not include items such as amounts received from loans, owners' investments, and collection of receivables. In the case of ordinary sales, revenue is generally stated after deducting returns, allowances, discounts, freight, and other similar items; and in the case of sales of assets other than stock in trade, it is generally stated after deducting the cost of the assets sold. The revenue for a period less the cost of goods sold, other expenses, and losses will give the net results of business operations for the period. Revenue from ordinary sales or from other transactions in the ordinary course of business is sometimes described as operating revenue.

7. Recommendation:

   It is recommended that this meaning of the term revenue
be adopted and that the term be more widely used in the preparation of financial statements and for other accounting purposes.

Income and Profit

8. Definition:
Income and profit involve net or partially net concepts and refer to amounts resulting from the deduction from revenues, or from operating revenues, of cost of goods sold, other expenses, and losses, or some of them. The terms are often used interchangeably and are generally preceded by an appropriate qualifying adjective or term such as "gross," "operating," "net . . . before income taxes," and "net." The terms are also used in titles of statements showing results of operations, such as "income statement" or "statement of profit and loss," or, sometimes, "profit and loss account."

9. The term gross income is often used as the equivalent of revenue; in public utility practice it is commonly used in referring to net income before deducting interest and other income charges. The term gross profit is frequently used to describe operating revenue less the cost of goods sold. The terms operating income or operating profit are generally used to denote "gross profit" less ordinary expenses. The terms net income or net profit refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period. These deductions do not include dividends or comparable withdrawals.

10. Recommendation:
The committee recommends that when the terms are used in financial statements, they be preceded by the appropriate qualifying adjective. When referring to items covered by the term "revenue," the term "gross income" should be avoided. The excess of operating revenue over the cost of goods sold may be described as "gross profit" but such terms as "gross profit on sales" or "gross margin" are preferable. It also is recommended that the terms "operating income," "net income," and "income statement" be used instead of the related terms, "operating profit," "net profit" and "statement of profit and loss." It is, however, proper to use the term "profit" in describing a specific item such as "profit on sale of fixed assets."
CHAPTER 11: TERMINOLOGY BULLETINS OF THE AICPA

Earnings

11. Definition:
The term earnings is not used uniformly but it is generally employed as a synonym for “net income,” particularly over a period of years. In the singular the term is often combined with another word in the expression “earning power,” referring to the demonstrated ability of an enterprise to earn net income.

12. Recommendation:
The committee is hopeful that eventually there will be a single term, uniformly used, to designate the net results of business operations. In recent years there has been a trend toward the term “earnings,” although a majority of published financial statements employ the term “net income.” Until one or the other of these terms achieves pronounced preference, the committee makes no recommendation as between them. It approves the use of the term in accounting language in connection with the concept of ability to realize net income.

Committee on Terminology (1954-1955)
Edward B. Wilcox, Chairman
Almand R. Coleman
Clifford V. Heimbucher

ATB No. 3 | BOOK VALUE

1. The term book value is one of several widely used expressions in which the word value appears with a particular qualifying adjective to denote a particular concept of value. Book value is to be distinguished from such terms as fair or market value or liquidating value, in that it refers to amounts reflected on accounting records and in financial statements.

2. The term book value is seldom if ever used in the body of financial statements, either as an indication of the basis of stating an item therein
or in connection with owners' equities. To do so would involve a pointless truism and such use is therefore not recommended.

INDIVIDUAL ITEMS

3. In Accounting Terminology Bulletin No. 1, the term *value* is defined as follows:

   *Value* as used in accounts signifies the amount at which an item is stated, in accordance with the accounting principles related to that item. Using the word *value* in this sense, it may be said that balance-sheet values generally represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

4. This use of the word *value* does not involve the concept of current worth, but rather refers to a particular method of quantitative determination.

5. The following slight rephrasing of the first sentence of the definition quoted in paragraph 3 above gives the clue to the meaning which some have adopted for book value as applied to individual items in books of account or in financial statements:

   *Book value* signifies the amount at which an item is stated in accordance with the accounting principles related to the item.

6. Thus one might refer to the "book value" or "net book value" of fixed assets, or the "book value of investments." More specific terms, however, can be used in describing the kind of value at which individual items are stated; as, for example, *cost less depreciation, lower of cost or current replacement cost, or lower of cost or selling price.* Similarly the term *ledger balance* or a term such as *the amount shown in published financial statements* would more clearly and accurately convey an exact meaning. The committee believes that any reference to a quantitative determination of a specific item can be more clearly and specifically described by terms other than the general and relatively vague term *book value.*

7. *Recommendation:* The committee recommends that the use of the term *book value* in referring to amounts at which individual items are stated in books of account or in financial statements, be avoided, and that, instead, the basis of amounts intended to apply to individual items be described specifically and precisely.
OWNERS’ EQUITY

8. The committee recognizes that the term book value is also used in various business arrangements such as partnership agreements, contracts for sale of a business interest, and wills and trusts. For example, partnership agreements sometimes contain a provision that a deceased partner’s interest may be acquired by surviving partners for an amount which is based at least in part on the “book value” of the interest. Contracts for the sale of going business concerns sometimes specify a price based on the “book value” of either the capital stock or the net assets. When used in such documents, the meaning to be ascribed to the term is a question of legal interpretation of the document and appears to depend primarily on the intent of the contracting or other parties rather than on any accounting definition of such term. While such uses of the term are common, they have given rise to misunderstandings and can easily develop into controversies when the intention of the parties is not clear. One typical difficulty arises when there is a change in circumstances between the time when an agreement regarding “book value” was reached and the time when that agreement must be interpreted. For example, a change from the Fifo to Lifo inventory basis between those two dates would affect the equities involved. Similar situations would arise with respect to any changes in accounting policies or from business combinations, divisive reorganizations, and other comparable events. Even in the absence of such changes, questions arise as to whether “book value” was intended to mean literally amounts shown on ledger accounts or amounts so shown after correction for (a) errors, (b) departures from consistently maintained practices of the enterprise, (c) departures from established practices of the type of organization, or (d) departures from generally accepted accounting principles, or any combination of such corrections.

9. When the intent of the parties is not clear as to the use of the term book value in reference to owners’ equity, the committee suggests the following definition:

Book value is the amount shown on accounting records or related financial statements at or as of the date when determination is made, after adjustments necessary to reflect (1) corrections of errors, and (2) the application of accounting practices which have been consistently followed.

10. Recommendation: In view of the fact that the intent of the parties to arrangements involving sale or transfer of business interests should govern, and the foregoing definition may not reflect such intent,
the committee recommends that the term *book value* be avoided. Instead of this term it is recommended that any agreement involving the general concept of book value should contain a clearly defined understanding in specific and detailed terms, particularly as to such matters as are referred to in paragraph 8 of this bulletin.

Committee on Terminology (1955-1956)
Edward B. Wilcox, Chairman
John K. McClare
William W. Werntz

**CHAPTER 11: ATB NO. 3**

**INTRODUCTION**

1. In Accounting Terminology Bulletin No. 2 the terms proceeds, revenue, income, profit, and earnings were defined. This bulletin defines the correlative terms *cost*, *expense*, and *loss*. While ascertainment of cost sometimes involves processes of valuation and allocation, the techniques of ascertainment are not discussed here.

**DEFINITIONS AND RECOMMENDATIONS**

**Definitions**

2. *Cost* is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received. Costs can be classified as unexpired or expired. Unexpired costs (assets) are those which are applicable to the production of future revenues. Examples of such unexpired costs are inventories, prepaid expenses, plant, investments, and deferred charges. Expired costs are those which are not applicable to the production of future revenues, and for that reason are treated as deductions from current revenues or are charged against retained earnings. Examples of such expired costs are costs of products or other assets sold or disposed of, and current expenses. Unexpired costs may be transferred from one
classification to another before becoming expired costs as above defined, e.g., depreciation or insurance on plant may be included in unexpired costs ascribed to inventories.

3. Expense in its broadest sense includes all expired costs which are deductible from revenues. In income statements, distinctions are often made between various types of expired costs by captions or titles including such terms as cost, expense, or loss, e.g., cost of goods or services sold, operating expenses, selling and administrative expenses, and loss on sale of property. These distinctions seem generally useful, and indicate that the narrower use of the term expense refers to such items as operating, selling or administrative expenses, interest, and taxes.

4. Loss is (1) the excess of all expenses, in the broad sense of that word, over revenues for a period, or (2) the excess of all or the appropriate portion of the cost of assets over related proceeds, if any, when the items are sold, abandoned, or either wholly or partially destroyed by casualty or otherwise written off. When losses such as those described in (2) above are deducted from revenues, they are expenses in the broad sense of that term.

Recommendations

5. The term cost should be used when appropriate in describing the basis of assets as displayed in balance sheets, and properly should be used in income statements to describe such items as cost of goods sold, or costs of other properties or investments sold or abandoned.

6. While the term expense is useful in its broad and generic sense in discussions of transactions and as a general caption in income statements, its use in financial statements is often appropriately limited to the narrower sense of the term as indicated in paragraph 3. In any event, items entering into the computation of cost of manufacturing, such as material, labor, and overhead, should be described as costs and not as expenses.

7. The term loss should be used in financial statements in reference to net or partially net results when appropriate in place of the term income or profit as described in para-
graphs 8, 9, and 10 of Accounting Terminology Bulletin No. 2. In such cases the term should generally be used with appropriate qualifying adjectives. It should also be used in describing results of specific transactions, generally those that deal with disposition of assets. The use of the term in the latter type of cases is believed desirable since it distinguishes them from more normal expenses of a recurring type which are generally shown in gross amounts.

Committee on Terminology (1956-1957)
Edward B. Wilcox, Chairman
John K. McClare
Herbert E. Miller
Comments by Members of Project Advisory Committee

In the accounting research program, a project advisory committee is appointed by the Director of Accounting Research, with the consent of the chairman of the Accounting Principles Board, in the early stage of each research study. In this way, the members of the committee are available for consultation during the progress of the work. Their valuable consultative service includes (a) suggestions regarding the plan for the study and sources of information, (b) review of drafts of studies for the purpose of suggesting wording changes to the authors, and (c) ultimately advising the Director of Accounting Research as to the suitability of the work for publication as an accounting research study. Approval of the publication of a research study does not imply that members of the advisory committee have a responsibility for the contents of the study or that they necessarily agree with the author’s conclusions or recommendations, and they may express disagreement if they wish to do so.

All of the members of the project advisory committee have recommended publication of the “Inventory of Generally Accepted Accounting Principles,” by Paul Grady, as Accounting Research Study No. 7. Ten members of the committee, including the chairman, do not have comments which they wish to have published. Three members have comments, relating principally to the concept of “Diversity in Accounting Among Independent Entities,” and one member suggests several changes in wording. All of such comments are presented in the following pages.
Comments of Thomas J. Cogan

The preparation of the “Inventory of Generally Accepted Accounting Principles” is an important contribution to the existing body of professional literature and its author is to be congratulated upon his substantial accomplishment.

I believe, however, that some comments are called for concerning the discussion, in Chapter 2, of “Diversity in Accounting Among Independent Entities,” listed in the Inventory as a basic concept underlying accounting.

A considerable part of this discussion centers about a report by a special committee of the American Institute of Certified Public Accountants on co-operation with stock exchanges issued in 1934, particularly a letter dated September 22, 1932 from that committee to the New York Stock Exchange which was incorporated in the report. The Inventory notes that the special committee recognized the existence of diversity in accounting among independent entities and concluded that an attempt to bring about uniformity of accounting in the sense that uniformity was prescribed for regulated industries was impractical.

The Inventory goes on to conclude that diversity in accounting is “a basic fact of business life,” and then refers to a minority view which urges uniformity indicating that this is regarded as a “panacea.”

This discussion as it stands, appears to be a statement of the problem of diverse accounting in terms of two extremes—the diversity which existed in 1932 versus a degree of uniformity which would extend into all details of accounting determinations.

In my opinion, the Inventory should have pointed out that there is a substantial body of accountants, and others possessing interest in financial statements, which believes that diversity to the extent possibly deemed acceptable in 1934 is clearly undesirable under present conditions if accounting is to function effectively as a means of communicating financial information. This group does not propose that the determination of accounting policies by reporting entities should be put into a straight jacket of uniformity such as would be represented by the degree of detail referred to in the Inventory. It does believe, however, that corporate managements must accept some discipline in their choice of accounting principles and that alternatives stemming from conclusions that are logically incompatible when applied to the same set of facts, should be done away with or, in any event, kept at a minimum. While the Inventory may have intended to recognize this
view when it referred to placing within realistic limits the efforts of the Accounting Principles Board's effort to narrow areas of differences in accounting, it has not, I believe, made the point clear.

It is recognized that there will always be some differences in the manner in which accounting determinations are made. Some of these, referred to in the Inventory, arise out of differences in circumstances and probably should not be categorized as differences for purpose of deciding upon the extent of existent diversity. Moreover, differences in detailed methods of applying governing accounting principles will probably continue to exist and, as the Inventory indicates, individual judgments and estimates can lead to diversity. These factors however, do not, in my opinion, justify abandoning a continuing endeavor to narrow differences in the controlling accounting principles; nor would these factors in my opinion, be of major concern in the majority of instances if that endeavor is successful.

I believe that the Inventory should also have pointed out that in recognizing the freedom of corporations to choose their own methods of accounting, the 1934 report contemplated that companies would prepare, and have available to any shareholder upon request, written statements of the accounting and reporting practices used in their financial statements. This recommendation was not effectively implemented. However, in view of the need that present more widespread interest in corporate financial information has created for a greater degree of comparability of financial statements, as between one company and another, I doubt that enumeration of accounting practices followed by particular entities would, today, be an adequate substitute for a narrowing of differences in accounting.

In my opinion, the environment in which the 1934 report was prepared should be considered as having some bearing on the weight which it is currently to be accorded. At that time, there were no generally recognized accounting principles, other than the five "broad" principles referred to in the report. Nor, was there any effective mechanism for developing and enunciating further and more precise principles. Thus, as a very practical matter, it would have been difficult for the Special Committee to have arrived at a different conclusion than it did. The extent to which the practicality of the situation influenced the acceptance, by members of the special committee, of the conclusions expressed in the September 22, 1932 letter is, of course, conjectural. Some may have felt that they represented what "ought to be." Others may have believed that they were the best that could then be sought.
It is, however, an historical fact that in 1933, the American Institute of Certified Public Accountants appointed a special committee on the development of accounting principles. The purpose of this committee, as stated in letters of appointment to proposed members, was "to consider how far it may be possible to formulate principles so generally acceptable that any deviation from them would require explanation." There is, thus, some evidence that the then status quo was not considered to be entirely satisfactory. The Institute subsequently appointed other special committees whose purposes seemed to have some relation to the objectives of the 1933 committee.

In 1937, it organized the committee on accounting procedure that was the predecessor of the present Accounting Principles Board and which during its existence issued 51 statements on specific accounting matters. During this period, also, the Securities and Exchange Commission began its policy of issuing "Accounting Series Releases" to enunciate its views of accepted accounting principles in specific areas. Other groups were also addressing themselves to the problem of narrowing differences in accounting. Thus, there appears to be ample evidence that strong efforts were being made, and that much was being accomplished, toward overcoming any practical limitations which may have influenced the position taken by the special committee in its 1932 letter.

Comments of Arnold W. Johnson

Page 24—Item No. 4 "Monetary expression in accounts" and the side heading, page 30, "Monetary Expression in Accounts."

The phrase "monetary expression in accounts" is a poorly stated principle-of-accounting. The "principle of valuation at cost" (see also references to the cost principle on pages 30, 36, 228, 245, 253) is generally accepted—why not, therefore, state specifically that the recording of transactions at their "historical cost" is a generally accepted "principle of accounting?"

Page 24—Item No. 5 would be better if it read as follows:

Consistency between time periods for the same entity.
Page 24—Item No. 9 would be better if it read as follows:

Materiality and full disclosure.

Page 57—Objective A would be better if it read as follows:

Account for sales, revenues, income, cost of sales, expenses, gains and losses in such manner as to present fairly the results of operations and income history for the period or periods of time covered.

Page 59—Re: Principle A-7

Income statements are *not* misleading when they include all items of profit and loss of a given period—fully disclosed and properly titled.

Page 63—Re: Principle C-2, line 14

“Depreciation reserve” should be “allowance-for-depreciation.” (The AICPA should use language consistent with its own recommendations as to the use of the word “reserve.”)

Page 74—Re: Principle A-1

The three italicized lines would be better if they read as follows:

“Sales, revenues and income should be fairly stated; these values should not be anticipated and the amounts of overstatement or understatement should be minimal, i.e., *not* significant.”

Page 76

First paragraph on this page fails to include comment to the effect that revenue to be recognized must be realized by verifiable objective evidence.

Page 101—Re: last paragraph, lines 33-40

The implication of this paragraph is that the warranty-or-service guarantee is an expense of the period in which the sale is made. Actually, the payment of the liability is a cost of the period of expenditure; it is *not* an expense of the date on which the sale happens to be made. A transaction of this kind should be recorded by a debit to Cash (or Accounts Receivable) and credits to Sales and to Liability for “Free Service.”
Pages 113-114

Mention should be made of still another view: that many accountants believe that the only charge for income taxes on a given statement of income is the actual amount of income taxes assessable for a given period (i.e., the amount actually paid to the U.S. Treasury).

(These pages bypass the question: What is the classification for deferred income taxes on the balance sheet?)

Page 148 Re: Principle A-3

The two italicized lines should emphasize that the cost of fixed assets (subject to depreciation and depletion) should be written off over the accounting periods in which these assets are revenue-producing.

Page 156

In the third paragraph, word should be “allowance” not “reserve.”

Page 198 Re: 2nd paragraph under side heading

This paragraph should also include the strongly held view to the effect that subscriptions receivable to capital stock are not accounting assets; they are deductions from capital stock subscribed on the balance sheet. The remainder value is the amount of capital paid in on partly paid subscriptions to capital stock.

Page 228

Definition of “liability” is poor.

Comments of D. F. MacEachern

Mr. Grady is to be congratulated on his truly monumental work of inventorying the existing generally accepted accounting principles. This compendium should be an extremely valuable addition to accounting literature and will, I am sure, be long regarded as a most significant milestone in accounting. In an effort of such wide scope it is hardly
surprising that there would be areas where differences of opinion arise. I find such an area in Chapter 2 under the heading “Diversity in Accounting Among Independent Entities.” The conclusion under this heading would be acceptable to me if it were not for the tone of the five preceding paragraphs. The conclusion reads:

“Recognition of the concept of diversity in accounting among independent entities, as a fact of business life, in no way imperils the objective of the Accounting Principles Board to ‘narrow the areas of difference in accounting’ and to promote continuous improvement and greater comparability in financial statements. It does, however, place the objective within realistic limits which fall considerably short of uniformity.”

But the preceding paragraphs seem to discourage any hope of narrowing such differences.

As I read the first of these paragraphs the impression received is that since judgment and estimates play such a substantial role in accrual accounting and since this leads to diffusion in decision-making, there is bound to be diversity in accounting results. It seems to me, however, that the judgments and estimates required by accrual accounting should not in themselves lead to diversities in accounting principles. For example, the judgments and estimates required for depreciation accruals are simply the necessary steps required to effectuate the principle that depreciation must be “systematic and rational.” The fact that two entities with similar physical plant may select somewhat different estimates of life and salvage does not interfere with the principle involved and as long as both estimates are reasonable, as implied by the certification of the public accountants involved, reasonable comparability will be retained.

On this same subject of depreciation, the third paragraph gives the impression that someone is attempting to achieve such a substantial degree of uniformity that among other things, “rates of depreciation by classes of property” would have to be prescribed. I doubt that any substantial number of accountants have seriously advocated such a degree of uniformity.

As for the diversity in accounting for regulated industry, mentioned in the fifth paragraph, I believe that such diversity has gone much too far. Rather than citing such diversity as a reason why divergencies cannot be narrowed, I should cite it as a reason for narrowing them. When divergencies in accounting principles come to be founded on forecasts of what action specific regulatory bodies may take in the future, sound accounting has been badly strained. In my opinion,
recognition of costs by public utilities should depend on sound account-
ing principles rather than on whether such costs are allowed for rate-
making purposes.

Taken altogether, these five paragraphs seem to present as the only possible choices either complete uniformity or complete flexibility, whereas I believe that it is perfectly feasible and highly desirable to restrict flexibility to those situations where circumstances are really different.

My feelings with respect to Chapter 10, “Alternative Methods and Significant Points,” are much the same. In this case my disagreement runs to some of the conclusions reached. It seems to me that the listing of the “alternative methods” should serve as a useful step in determin-
ing which are really necessary for a fair statement of conditions, but one of the author’s conclusions is that the listing supports the basic accounting concept of “diversity in accounting among independent entities.”

Another conclusion is that “further progress should be made by eliminating methods which have outlived their usefulness.” I should have preferred rather that the goal set be the elimination of alternative methods which are not justified by differing circumstances.

I find little comfort in the idea reiterated here that the effect of differences in practices tends to level off in the long run. With the ever widening use of financial statements for making, buy, sell, or hold dec-
cisions, it is more and more important to avoid large swings in year-to-
year earnings caused by accounting divergencies not based on differ-
ences in circumstances.

Comments of Leonard Spacek

The basic concepts and broad principles of accounting set forth in this study represent the conventional type of approach which ac-
countants have made in the past; and in that sense, these matters do belong in this “Inventory.” However, it should be understood that there is considerable need for developing new and improved concepts and principles which will better serve the needs of our society today.

The section on “Diversity in Accounting Among Independent Enti-
ties" (pages 32-35) is an inadequate and misleading discussion of that subject. No serious attempt is made to point out the need or desirability of accounting principles that will result in comparable financial statements for the use of investors. One of the primary objectives of Congress in adopting the various Securities Acts and in establishing the Securities and Exchange Commission was to inform investors and to make available to them understandable and useful financial statements and related data on a comparable basis.

This research study should serve to highlight the basic issues involved in the controversy between (1) those persons who believe that Congress and the public want and will demand more uniformity in accounting principles and more comparability in financial statements and (2) those persons who publicly advocate progress but actually work for maintenance of the status quo. "Uniformity in accounting" is improperly characterized in this study as a "panacea," and the manner in which desirable uniformity would be achieved is not accurately described.

In my opinion, the determination and adoption of sound principles must be preceded by analysis, study, and discussion of the various conflicting viewpoints; and, then, a uniform approach can be achieved. Until these conflicts are eliminated, there cannot be agreement on a statement of the principles which is sought. The comparison in this study of uniform accounting principles with a "uniform code of accounts" is confusing the detailed mechanics of bookkeeping with the necessary basic concepts and standards.

Opinions Nos. 2 and 4 of the Accounting Principles Board relating to the investment credit are cited (page 33) as an example of the recognition by the Board members that alternative practices are inevitable as a "basic fact of life." While there are arguments in favor of each of the two divergent practices in accounting for the investment credit, it is inconceivable that anyone could contend that such diversity is logical, necessary or desirable. These two Opinions show that the Accounting Principles Board did not have the strength to uphold a principle. The Board, in issuing Opinion No. 4 and not cancelling Opinion No. 2, voluntarily endorsed conflicting practices which ignored principle as applied to a new area where alternatives had not previously existed and where there could be no significant differences in circumstances; and, thus, expediency was permitted to overshadow principle, and the interests of investors again suffered as they have so many times in the past.

The section on "Some Significant Points to be Drawn from the
Variety of Alternative Methods and the Contents of the Preceding Chapters" (pages 379-384) attempts to defend and justify the present undesirable situation. This study, if it was not to be limited to a description of what exists today, should have given (1) more emphasis to the need for the elimination of the existing double standards created by alternative accounting practices and (2) less emphasis to the need for continuing the present undesirable state of affairs.

If this study is used as a base point for improvement and as an aid for a better understanding of the problems involved in achieving real progress toward improved accounting principles, then it will serve a useful purpose. On the other hand, if this study is used as authoritative support for the resistance of progress and as an excuse for perpetuating present accounting practices, some of which are not “sound” even though they are “generally accepted,” then it will serve a detrimental purpose. It is important for the accounting profession to take stock of where it stands today, but it is even more important for the profession to understand what is needed and to decide what should be done about correcting the situation.
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