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HICKS ON ACCOUNTING

Abstract: Whenever income and capital maintenance concepts are discussed at the conceptual level, a reference to Hicks is likely to be found. These references are misleading since Hicks himself believed that the proper basis of valuation in the financial statements of a firm is historical cost. He also argued that accountants should not make price-level adjustments. Hicks' views on accounting, which are scattered in his writings over a period of 35 years, are reviewed in this paper.

J. R. Hicks viewed accounting from a statistician's perspective and he emphasized the need for objective accounting data. Hicks also was concerned with the principles of account classification which he once called "the canons of orderliness."[1] The need for objectivity and order, together with a very strict interpretation of how accounts should be framed to monitor management, led this 1972 Nobel Prize economist to defend the practice of valuing assets at historical cost and to argue, as a corollary, that accountants should not make price-level adjustments.

This short description of Hicks on accounting differs sharply from the popular view. The misconception is due to the pervasive influence on accounting thought of Hicks' definition of a man's income as "the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning."[2] This income concept was introduced into accounting literature by Alexander in 1950 and, by the early 1960s, Zeff reported that the definition "recurs with remarkable frequency in economic and (especially) accounting writings."[3] Today, whenever the income concept is discussed at a conceptual level, a reference to Hicks is likely to be found.

Hicks himself warned that income and related concepts are "bad tools, which break in your hands."[4] However, with few exceptions, most theorists have not only ignored this admonition, but they also have overlooked other work by Hicks which is more directly related to accounting practice.

Hicks' interest in accounting was signalled in 1942 with the publication of *The Social Framework.* This book is a text on "Social

Accounting," which the author contends should be a first course in economics. Social Accounting is defined as "the accounting of the whole community or nation, just as Private Accounting is the accounting of the individual firm."[5] In the second edition (1952), Hicks commented that "when I wrote in 1942, I knew very little of the practice of accountants, and I am afraid professional accountants who read my book were often bothered by needless unorthodoxy in the use of terms." Among others, F. Sewell Bray is thanked for some "excellent coaching in accounting usages."[6]

Interesting ideas on accounting also are contained in *The Problem of Budgetary Reform* (1948) and noteworthy opinions are expressed in a review of a book by Bray that was published in the *Economic Journal,* also in 1948. Other works which have special significance for accountants include: "The Measurement of Capital" (1969), *Capital and Time* (1973) and "Capital Controversies: Ancient and Modern" (1974).

The purpose of this paper is to review Hicks' main thoughts on accounting practice. They concern the need for objectivity, the principles of account classification and the traditional questions of depreciation and asset valuation. These ideas, which are scattered in books and articles written over a period of 35 years, make it evident that Hicks' actual influence on accounting was the opposite of what he intended.

Objectivity of Accounting Measurements

In a 1948 review of a book by Bray, Hicks emphasized the need for objectivity and then defended the cost principle. He used the following argument to reach this conclusion.

The function of accounting, on the lowest level, is to make a record of business transactions. On a higher level, accountants devise a means to distill from the record of transactions summaries which "enable the meaning of the record to be grasped, as well as it can be grasped."[7] These summaries should be constructed using rules which do not introduce outside elements. But since no set of rules will produce summaries "which are equally meaningful on all occasions,"[8] the user of financial statements must exercise judgment in interpreting them.

Although the interpretation of financial statements is considered the highest part of the accountant's function, it should not get "mixed up" with the lower part because the accounts must be "as objective as possible."[9] "This demand is so exactly parallel to the demand that statisticians have had to make of their investigators . . . that its sense is readily acceptable, once we see it . . . ."[10]

The consequence of this position led to the conclusion that the justification for valuation at historical cost is "simply that the original purchase price is the one objective valuation of the asset . . . . Any other valuation must be a matter of judgment, and therefore belongs to the stage of interpretation, not to the stage of the compilation of the basic summaries."[11]

The need for objectivity is the central issue in accounting and it has two further implications. First,

> It reproves those economists who have demanded from the basic accounts information which those accounts cannot properly give. And it also reproves those accounting practices (such as the practice of valuing stocks at cost or market price, *whichever is the lower)* which edge a little interpretation into the work of summarising, and therefore diminish the objectivity of the basic tables.[12]

Second,

> Every statistical table needs to be annotated, and in a similar way the full meaning of an accounting statement can only be expected to emerge in the accompanying report. But the accountant's report goes to the directors, while his figures go to the shareholders; he has thus some public obligation to pack into his figures the maximum of information, even if he can only do this, within the limits prescribed, by some sacrifice of objectivity. How ought this difficulty to be got over? Should it be laid down that companies must publish an audited report as well as audited accounts? Or would this make the accountant, more than ever, master of the destinies of us all?[13]

Ordering of Accounts

In 1948 Hicks also wrote a short monograph, *The Problem of Budgetary Reform,* and it dealt with the classification problem. The importance he accorded this problem is evident in the initial discussion of the accounting and economic aspects of the definition of a budget surplus. The accounting aspect concerned maintaining order in government accounts and the economic dimension related to the relationship between government accounts and the rest of the economy. Although Hicks explicitly states that he writes as an economist, he strongly contended that the accounting aspect is the most important consideration.

> If we can agree upon the principles by which the government's accounts should be ordered, the accounts of National Income and Expenditure could be adjusted to fit; but if we start from the other end, beginning from the economic requirements, we may easily be endeavoring to fit the government accounts into a framework with which it is difficult, and from their own point of view may be undesirable, for them to conform.[14]

For Hicks the principles of account classification had to do with problems like whether a distinction ought to be made between current and capital items. The main issue was not a matter of economics but rather a question of purpose. Different systems of account classification were needed for different purposes. Hicks repeatedly stressed the point of view that purpose is the critical determinant of accounting practice.

The possibility of putting government finances on a business accounting basis also was mentioned, but this "drastic" remedy was rejected even though

> It would provide a new and authoritative set of canons for orderliness; it would enlist the experience and influence of the accountancy profession in maintaining those standards; and it would facilitate the integration of the government's accounts with those of the rest of the economy in national income calculations, with all that implies for the smooth working of rational employment policy.[15]

A similar statement was made in the second edition of *The Social Framework* (1952) and it was repeated in the fourth edition (1971).

> The first thing that has to be done is to prepare the bricks out of which the structure is to be built, by constructing a standard set of accounts for the individual units out of which the national economy is composed. Much of this task has already been performed by professional accountants, and we can draw heavily upon their work at this stage of the argument.[16]

Hicks often referred to the accountant's positive contributions as well as his influential position. He even once discussed the influence of accounting practice on the history of economic thought.[17]

Depreciation Accounting

In 1939 Hicks and Hicks remarked that the calculation of depreciation presents "awkward problems."[18] This statement was often repeated. Hicks also called depreciation an "artificial" item that does not correspond to actual cash payments. It is "less solid" than other items in an income statement and there is "some room for judgment" about the precise sum to be put down, though accountants are generally guided by conventional rules about this "most uncertain" item.[19] Over a quarter of a century later similar comments are made.

> There are items, of which depreciation and stock accumulation are the most important, which do not reflect actual transactions but are estimates (by the accountant, not by the statistician) of changes in the value of assets which have not, or not yet, been sold.[20]

Exactly the same views were expressed in *Capital and Time* where the meaning of these estimates was elaborated on.

> These are estimates in a different sense from that previously mentioned. They are not statistician's estimates of a true figure, which happens to be unavailable; there is no sure figure to which they correspond. They are estimates that are relative to a purpose; for different purposes they may be made in different ways.[21]

Hicks never criticized the accountant's method of calculating depreciation. He simply observed that there was no firm economic solution to the depreciation problem and that the methods developed by accountants as soon as they were confronted with the problem "were probably what they had to do . . . . It is what they still do, even in this day."[22]

All English editions of *The Social Framework* (1942, 1952, 1960, and 1971) and the American editions (1945 and 1955) contained an Appendix on depreciation. The main point was that different people might estimate depreciation in different ways and the same person might have different estimates for different purposes. Again, the focus is on purpose.

Two particular estimates for the depreciation of a firms' fixed capital are discussed. The first is for the purpose of determining profits available for dividends and the second is made for the purpose of taxation. Conservative principles govern the calculation on which dividends are paid, whereas tax laws are based on a concept of fairness.

Hicks also pointed out that these depreciation estimates are not satisfactory for the purpose of determining national income when prices are unstable. Under inflationary conditions it is the task of the economists to work out methods to compute real depreciation. However, "although it is necessary, in the interest of fairness, to go back to the original purchase price (for that is firm ground, not somebody's guess), to do this is not economically satisfactory."[23] But Hicks never suggested that accountants ought to make this computation.

Asset Valuation

The idea that "the fixed capital used by a manufacturing firm may have half a dozen different values that can be plausibly put upon it"[24] often was repeated. Purpose was paramount.

> The measurement of capital is one of the nastiest jobs that economists have set to statisticians. Finding that it is so nasty, the working satistician very naturally asks for guidance. Will the economist please explain just what it is that he wants?[25]

The 1969 paper explicitly analyzes the accountant's practice of valuing assets at original cost and two reasons are given for making corrections to this valuation—price-level changes and technical progress.

It is significant that Hicks did not think that accountants should be the ones to make price-level adjustments. He concluded that the task of making price-level adjustments would be a formidable one and implied that on a cost-benefit basis, it would not be worthwhile to have accountants correct the accounts for inflation. Hicks put it this way.

> To correct balance-sheets of companies, one by one, so as to make them conform to the principle I have been outlining would obviously be a formidable undertaking. One could not expect that it should be done by the accountants, the purpose of whose calculations (as we have seen) is quite different.[26]

What was the purpose of the accountant's calculations? Hicks believed that "the first object of commercial accounting is to watch over the capital of the business . . . ."[27] Thus, accountants could not be expected to make price-level adjustments because

> If one asks why the company needs a balance-sheet the answer must surely be given in terms of its obligation to its shareholders and to other creditors. It has to show, periodically, what it has done with their money.[28]

This emphasis on stewardship led to the conclusion that

> The balance-sheet of the company, as explained, is designed to show shareholders what has been done with their money. If it is this which has to be shown, the original cost of the actual assets held is the magnitude that is relevant.[29]

The other reason for adjusting original cost is technical progress. However, from an accounting viewpoint, technical progress is part of obsolescence and is taken into account in choosing the method of depreciation. But from an economic viewpoint, Hicks argues the accountant is too pessimistic because "he does not allow (and from his own point of view is quite right not to allow) for the increase in the productivity of new investments that come from technical progress."[30] Therefore, the accountant's measure of depreciation normally overstates the gross investment needed to maintain capital since real capital increases faster than it appears to do on financial statements since the reinvestment of depreciation allowances is made on continually more favorable terms.

There is no ambiguity about Hicks thoughts on the accountant's responsibility for asset valuation. Financial statements should be based on historical costs and adjustments for price-level changes should be made by the user, not the accountant.

Concluding Comment

At the 1969 meeting of the International Statistical Institute where Hicks presented the paper, "The Measurement of Capital," another paper on the same subject was given. The opening remarks are jocular, but the message captures Hicks' attitude towards the valuation problem which accountants face.

> Without the threat of thumbscrew, and indeed with no urging at all, an economist may often be found to declare that his idea of a measure for a stock of capital is to equate it to the present discounted value of the future stream of

> earnings that the stock of capital will generate. This is so inherently unmeasurable that it will amuse a statistician until he perceives that the suggestion is offered somewhat more than half-seriously.[31]

When it came to practical problems of measurement, Hicks sought to avoid the kind of definitions that are more "at home in those simplified models beloved of economic theorists" than in a world of "flesh and blood."[32]

Hicks' emphasis on the need for objectivity and his conception of the meaning of stewardship led him to defend the traditional practice of valuing assets at original cost less depreciation and to argue that accountants should not make price-level adjustments. These views will surprise those (and there are many) who have used the Hicksian income concept to develop a conceptual framework in accounting.

POSTSCRIPT

After this article went into production the author received a letter from Sir John Hicks. Although Hicks indicated that he did not have time to do more than glance at a copy of the article, he commented that "I had no idea when I wrote that chapter in *Value and Capital* that it would be taken up by accountants; and The Social Accounts as I first envisaged them, were a pure economist's construction. By the time of the later editions of that book [1952, 1960, and 1971] I had this further experience, and the same applies to all my later writings." The experience Hicks is making reference to is a 1949 meeting (which was referred to in the 2nd edition of *The Social Framework*) with, among others, Richard Stone and F. Sewell Bray. This meeting led to the publication of *Some Accounting Terms and Concepts* (Cambridge: Cambridge University Press, 1951). I have not seen this book. Hicks then went on to say that "it is perhaps in the IIPF paper ["The Concept of Income in Relation to Taxation and to Business Management," Proceedings of the 35th Congress of the International Institute of Public Finance, Taormina, 10-14 September, 1979, Detroit, Michigan 1981] which I sent to you that this becomes clearest."

The 1979 paper compares the accountant's depreciation with "true" depreciation. Its basic conclusions are consistent with his earlier work. Hicks once again stressed that "The accountant's conventional way of measuring income, though (as we have seen) it has elements in it that are arbitrary, is largely based upon actual transactions . . . . It would not be an improvement to replace this relatively firm assessment by one that in practice must be even more, even much more arbitrary." He also emphasized that "when it is proposed to make corrections to the conventional allowances, to adjust to inflation, the question of whether the conventional allowances were appropriate, even in absence of inflation, is bound to be raised. So one comes back to the subjective assessments—how much can be *safely* taken out of the business—from which the accountant's procedure had been thought to be an escape."

Both the 1974 paper delivered at the annual meetings of the American Economic Association and the paper given at the IIPF meeting in 1979 should interest the accounting historian for another reason. In these papers, Hicks directly addresses questions involving the history of accounting. In addition, in his letter Hicks also remarked that "I see that the journal in which you are publishing is on the history of accounting. I wonder if it is known to your friends that one of the most remarkable contributions of accounting to civilization is the beginning of the year on the first of January. The Florentine merchants in the fifteenth century found this sense of orderliness (as you rightly call it) vexed by the practice then and in other places long after common of beginning on March 25. They wanted to have their yearly accounts made up of a tidy number of monthly accounts, so they looked for a feast of the Church which fell on the first day of the month, and found it on the first of January." The reference Hicks provides is to a French economic historian, Yves Renoüard, who in 1969 published a book of essays which I have not yet seen.

I am grateful to Sir John Hicks for his thoughtful comments. I also thank Professor Edward Stamp for suggesting that I communicate with Hicks.

FOOTNOTES

[1]*The Problem of Budgetary Reform*, p. 14.
[2]*Value and Capital*, p. 172.
[3]Zeff, p. 620.
[4]*Value and Capital*, p. 177.
[5]*The Social Framework* (1942), p. vi.
[6]*The Social Framework* (1952), p. vii.
[7]Review, p. 562.
[8]Review, p. 563.
[9]Review, p. 563.
[10]Review, p. 563.
[11]Review, p. 563.
[12]Review, pp. 563-564.

[13]Review, p. 564.
[14]*The Problem of Budgetary Reform,* p. 6.
[15]*The Problem of Budgetary Reform,* p. 14.
[16]*The Social Framework* (1952), p. 224; (1971), p. 260.
[17]"Capital Controversies: Ancient and Modern," p. 310.
[18]"Pubiic Finance in National Income," p. 147.
[19]*The Social Framework* (1942), p. 225.
[20]"The Measurement of Capital," p. 254.
[21]Capital and Time, p. 155.
[22]"Capital Controversies: Ancient and Modern," p. 312.
[23]*The Social Framework* (1942), p. 275. A similar statement is made in the fourth edition (1971), pp. 301-302.
[24]*The Social Framework* (1942), p. 102.
[25]"The Measurement of Capital," p. 254.
[26]"The Measurement of Capital," p. 259.
[27]*The Problem of Budgetary Reform,* p. 15.
[28]"The Measurement of Capital," p. 253.
[29]"The Measurement of Capital," p. 258.
[30]"The Measurement of Capital," p. 261.
[31]Evans, "Some Comments on Measures of Changes in Capital Stock Aggregates," p. 265.
[32]"Maintaining Capital Intact: A Further Suggestion," pp. 132-133.

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