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Accounts of a Corporation

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In this day business is conducted more than ever before by trusts, and particularly by that species of trust which is the relation subsistent between a corporation and its stockholders. The essential features of this relationship are three in number:

(1) The investment of legal title to properties in the corporation as an artificial person.
(2) The investment of the equitable estate in the stockholders, they being the beneficiaries of the trust.
(3) Management of the corporate estate by a directorate responsible and accountable to the stockholders.

The corporate balance-sheet and operating account were, with the evolution in England of the limited liability company, conceived to be essentially an accounting of stewardship rendered by the management to the stockholders, and were, in their nature as such, made subject to audit by an appointee of the stockholders (shareholders).

With the subsequent rapid development of accounting as an essential aid to management, and more particularly the balance-sheet as a basis for the extension of credit, there has been evident a tendency to overlook and obscure the character of the balance-sheet as in part purely a statement of trust moneys received and expended. There have been adopted, in fact, certain accounting processes which render the balance-sheet in some cases quite unintelligible as an accounting for invested capital funds.

The attempted development of the balance-sheet as a measure of wealth has been founded, it seems, on two fallacies:

(1) That it is possible to measure absolutely the use value of capital goods.
(2) That periodical net profit as determined by accounting methods is or should be coincident with true economic profit.

It has been my contention that capital assets represent properly a functional classification of expenditures of capital moneys, with deductions for the reimbursements shown to have been effected out of revenue. The net figures do not constitute valuations of wealth or capital goods. It is true that the most substantial expenditures of capital are often made in acquisition of intangibles, which, though in many cases the most valuable of properties, can by no stretch of the imagination be described as wealth in the economic sense.

Depreciation (in the sense of all amortizations of capital assets) has been so widely conceived as a measurement of expired capital value that an understanding of its true nature is a prerequisite to a logical conception of the nature of the revenue account and balance-sheet. The word "depreciation" in accounting terminology comprehends, not only physical deterioration, but also obsolescence, inadequacy and supersession. These latter factors are in this age often more potent than physical deterioration in accelerating the retirement of a property.

It should be well known that physical decay is not uniform and constant. It is quite possible that a plant may be, at the end of a period, in a more efficient working condition than at the beginning of the same period. The other factors named above are also inconstant and variable in their action. The truth is not thereby altered, however, that depreciation, being progress toward the ultimate retirement of a property, is continuous, uniform and in direct proportion to effluxion of time.

It is clear, nevertheless, that utility value is not reduced in the same ratio, that is, uniformly and continuously. Plant, as a matter of fact, is ordinarily maintained at an approximately uniform level of efficiency. It is not possible moreover to measure practically the progressive effect of those conditions producing obsolescence and inadequacy. And finally use value (as productive of profit) may be favorably or adversely affected by social, political and economic conditions having no direct relation to those forces already mentioned which produce depreciation.

Depreciation provision is based therefore on the expected time of retirement of a property. Since the latter is, as has been shown, determined by the operation of a variety of forces, the trend of which is not subject to definite prediction, the reserve provided may be to any degree more or less than sufficient when retirement becomes desirable or imperative. The resultant book profit or loss is not of a capital nature but is to be given effect as an adjustment of prior earnings.

It is required only that depreciation provision be made in good faith on some equitable basis, in practice, ordinarily, by equal periodical instalments. The result is to effect, not the periodical preservation of capital values, but the ultimate recovery of capital moneys expended. Is it supposed that provision for depreciation on the library of a professional firm measures a decline in use value of that library? Can it be held that, in the case of a municipal undertaking, the depreciation provided in respect of, say, a road (often the amount of periodical retirement of the relative debt or of the sinking-fund provision for its ultimate retirement) measures the reduction in its capital value. The road, as a matter of fact, is not capital. Is the value of a leasehold reduced because a premium paid for it is amortized in the accounts of the lessee? Depreciation provision bears no relation to value. The object is the recovery of money expended, the provision for replacement of those properties which will require to be replaced—in short, the maintenance of the enterprise as a going concern.

As long as a business is operated there subsists constantly a condition wherein some capital expenditures have not been recovered by application of revenues. Should liquidation take place, there will be realized in respect of these unamortized expenditures the scrap or sale value of the tenements or chattels in acquisition of which the expenditures were made. A substantial loss is often sustained, a loss which, being extraordinary and of a capital nature from the standpoint of accounting on a periodical basis, is none the less an actual business loss, inasmuch as the profit accruing from any enterprise is ultimately the excess of moneys received over moneys expended, all properties having been liquidated and all obligations discharged.

This potential and latent loss need not be provided against for the accounting purposes of a going concern. It may be advanced as a general proposition that, in the case of a going concern, there need be written off only those capital expenditures which will be recurrent. Such a write-off effects a reservation of funds for a definite purpose. Such a reservation of revenue funds is otherwise a question of financial expediency to be determined by the management. Loss of value, either exchange or utility, does not in itself justify the write-off.

It follows that periodical net profit, as measured by accounting processes, is of quite a different nature from true economic profit and that a revenue surplus appearing in the balance-sheet must be interpreted, not as a measured excess of resources over liabilities (including capital stock), but as an undistributed surplus of revenues over expenditures (including estimated depreciation). It is quite possible, with such a revenue surplus shown, that there may exist at the same time a latent, but none the less actual, deficiency from an economic viewpoint. Consider the balance-sheet summarized as follows.

Assets			Liabilities	
Current assets		$100,000	Current liabilities	$50,000
Fixed assets—at cost	$110,000			
Less—depreciation	10,000	100,000	Revenue surplus	10,000
Organization expenses		5,000	Capital stock	145,000
		$205,000		$205,000

This corporation has been operating for three years. During the first there was earned a net profit of $20,000. A loss of $5,000 was sustained in each of the two ensuing years. The balance-sheet reflects the condition at the end of the third year. The scrap value of fixed assets is estimated to be $15,000. Depreciation provision has been made in reasonable amounts. On a going-concern basis the value of the fixed assets, which under existing conditions and management yield no profit, is less than nil. Current assets being assumed to be properly valued, the deficiency on a going-concern basis is $95,000. If there be introduced the market value of the fixed assets in liquidation, the deficiency is reduced to $80,000. It is to be observed, however, that the revenue surplus of $10,000 is actual and properly shown as such. It is moreover available for dividend, the business being obviously solvent with a current ratio of 2.

The above demonstrated truth was recognized in originally formulating the principles governing the measurement of corporate profits available for dividend. In requiring that dividends should not be paid out of capital the intent was, not to attempt the impracticable, that is, the periodical preservation intact of capital values, but to forbid the improper employment and disposition of capital funds. It was admitted that the measurement of periodical net profit by the accounting process is conventional and arbitrary and that true ultimate profit may not be determined until the liquidation or sale of the enterprise takes place. It was required only that revenues should be applied to the recoupment of all current operating expenditures (including, probably, estimated depreciation) before a dividend might be paid. Fixed capital might be sunk and lost, but the excess of current revenues over current expenditures would be available for distribution, provided, of course, that solvency would not thereby be jeopardized. There was made, in fact, a very practical, if arbitrary, distinction between capital funds and revenue funds.

This latter fundamental difference is not obvious in the form of balance-sheet ordinarily adopted for a commercial enterprise. It is true, of course, that a distinction is made between fixed assets and current assets and that the bases of valuation are dissimilar. It is not emphasized, however, that the figure representing total assets is non-significant, being constituted both of conventional figures reflecting capital funds expended and real figures representing an actual valuation of resources which will or can be liquidated in the ordinary course of business operations.

The general misconstruction of the nature of assets and profits has in many cases been adopted by the courts of law, and in some cases it is evident in company legislation. Section 58 of the New York stock corporation law, as amended by chapter 787, laws of 1923, provided as follows:

"No stock corporation shall . . . declare or pay any dividend . . . unless the value of its assets remaining after payment of such dividend . . . shall be at least equal to the aggregate amount of its debts and liabilities, including capital or capital stock as the case may be."

That is to say, surplus available for dividend is determined by deducting from total assets the sum of liabilities including capital stock.

From an economic standpoint the process is ideal. It ensures the preservation of capital value through the periodical measurement of it, any surplus over invested capital being designated as a revenue accretion available for dividends. Though proper in theory, the implied measurement of wealth is not the function nor the object of accounting processes. Such a procedure is not only impracticable but in many cases undesirable.

Let us suppose, by way of illustration, that a business corporation has sustained heavy operating losses and in addition substantial capital losses as a result of fire. The business is now, nevertheless, quite solvent and is moreover earning money, though at a reduced rate on the old capitalization. No one, neither creditor nor stockholder, is injured by the payment of a dividend, since the liquid condition is good. Such a step may be, in fact, very advisable if it is intended to secure in the market additional capital to replace the plant destroyed by fire. The operating and capital losses already sustained are probably best taken care of by capital reconstruction. There is not a single logical reason why a business should be crippled perhaps for years by reserving out of net revenues amounts intended to replace capital which has been lost. If the capital is not required, then, why should the reservations be made? If the capital is required it is needed at once to restore crippled plant, and not in the course of years. These are financial matters and the subject of opinion. It is the function of the law, in the case of the particular matters under discussion, to prohibit the fraudulent distribution of capital moneys, not to prescribe what may or may not be financial prudence.

The capital section of the balance-sheet is properly interpreted as, not so much the reflection of a static condition, but the cross section of a dynamic condition. Since the same statement applies also to the current section it is perhaps clearer to say that while there is an essential interest in the static liquid condition as indicating the state of solvency, the interest in the capital section should be, not in wealth and values, but in the allocation of capital funds to various functions, in the flow thereof and the process of their recovery out of revenue. There must be a mental dissociation of capital assets (representing unrecovered capital funds expended) and the physical wealth, if any, acquired by such expenditures. The useful life of a property and the provision of funds for replacement is therefore the major interest, and present value (not reflected in the accounts) a matter of secondary concern.

It should be possible, indeed, to deduce from the balance-sheet of a concern the essential features of its financial history. The process may be illustrated by reference to the balance-sheet already presented. Of the sum of $145,000 shown to have been contributed by the stockholders $5,000 has been expended in organization. To date a total of $110,000 has been invested in plant, leaving, out of subscribed moneys, a balance of $30,000 to be used as working capital. Through depreciation provision and net earnings there has been an accretion of $20,000 to current funds. This sum, together with the original working capital, is represented in the indicated excess of current resources over current liabilities. While the balance-sheet submitted is simple and devoid of complicating features, the analytical process described should be generally applicable in any case.

It has been demonstrated that the balance-sheet is, as regards the statement of fixed assets at least, simply an accounting for the administration of money. An actual process of valuation is applied only in the case of the current resources. Proper interpretation of the balance-sheet, and consequently of the operating account, might be assisted by its division into the two dissimilar parts of which it is composed, that is, a statement of current resources and obligations and a statement of capital moneys received and expended.

The balance-sheet, constructed on the basis of the theories advanced, is necessary so long as the nation's business, owned in equity by millions of stockholders, is administered in trust by corporations, the management of which is in the hands of relatively few persons. It is perhaps not impertinent to express the opinion here that an independent audit of corporate accounts and balance-sheets should be made obligatory. Incidentally, the public practitioner need then no longer fear the encroachment of internal audit staffs. The protection of funds and assurance of accuracy through internal check is one proposition; independent verification of the management's accounts by a representative of the owner's is another.

While it is most important that the historical and trust aspects of corporate accounts as developed in this paper should be considered as by no means of secondary significance, it is my opinion that the great future of accounting lies in the development of its relationship to management, as quite distinct from its function in respect to stockholders. For purposes of financial control, and particularly in the field of costing we shall without doubt have occasion to use present values. New forms of financial statements may have to be devised to meet new requirements.

There is, however, no object in adulterating the balance-sheet and rendering it unintelligible for any purpose. It is, in its nature as described in this paper, of far more value to management than the erroneously conceived statement of net wealth, which it usually purports to be. Management is most interested, not in the value of wealth, but in the profitable employment of money.

Capital must not be deified. Maintenance of a going concern on a profitable basis, so long as stockholders are acquainted with the condition and the rights of creditors are not prejudiced, is the lawful object of business enterprise.

We accountants must be more practical. It is not our mission to measure the wealth of the nations.