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Review and resume; Accounting Terminology Bulletins, no. 1

American Institute of Certified Public Accountants. Committee on Terminology

ACCOUNTING TERMINOLOGY BULLETINS

Number 1

Review and Résumé

Prepared by Committee on Terminology
AMERICAN INSTITUTE OF ACCOUNTANTS
270 Madison Avenue • New York 16, N. Y.

Prepared by the committee on terminology and published by authority of the committee on accounting procedure, American Institute of Accountants. The granting of such authority by that committee connotes its general agreement with opinions expressed herein as to the meaning of established terminology in accounting usage. As to any recommendation made herein for modifying established terminology, authority for publication indicates that the committee on accounting procedure regards such modification as a desirable objective not in conflict with generally accepted accounting principles.

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Foreword

BETWEEN NOVEMBER, 1940, and October, 1949, the series of Accounting Research Bulletins issued by the committee on accounting procedure included eight (Nos. 7, 9, 12, 16, 20, 22, 34, and 39) which had been developed by the committee on terminology. Although approved generally by the committee on accounting procedure, they were not issued as its formal pronouncements, and have been omitted from the restatement of Accounting Research Bulletins Nos. 1 to 42, which has been published as Bulletin No. 43. The paragraphs which follow are almost wholly excerpts from these eight terminology bulletins; there has been no intentional change in the conclusions reached or in the substance of the views expressed in the committee's earlier utterances. The purpose is to initiate, with a review of what has gone before, a series of bulletins on terminology separate from those on accounting procedure. The committee believes that the field of terminology will afford stimulating subjects for future bulletins as the practice of the art of accounting is kept abreast of the times.

No. 1—Review and Résumé

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 *debits* 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 business men 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 practising 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 pro-

cedure, 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 defini-

tions 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.

INCOME—INCOME STATEMENT
PROFIT—PROFIT AND LOSS STATEMENT
UNDISTRIBUTED PROFITS—EARNED SURPLUS

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 dicussion 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 deduction 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 (see page 28).

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

[1] Other than gains from transactions in its own shares, and losses therefrom chargeable to capital surplus; see chapter 10(b) of Accounting Research Bulletin No. 43, paragraphs 7 and 8.

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 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[2] 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 propetry 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.).

[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. . . . "

(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 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 measurement, 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 captial, 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,[3] 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

[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.

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 combination 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

(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

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