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Correspondence: Classification of Assets

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CLASSIFICATION OF ASSETS

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SIR: There are many lessons, mostly unpleasant, which may be learned from the course of security prices in the last three years, but there is one which, while it seems clear, has not been, so far as I am aware, discussed by writers on accounting theory.

It is generally conceded that whatever else it may indicate the course of security prices does show the majority opinion of the business and financial world and that, right or wrong, this opinion is expressed with complete sincerity, for the average man may put forward and maintain opinions on many subjects for sentimental reasons but he does not often make his investments on that basis. If he invests in a common stock at prices which past earnings do not justify and the most optimistic anticipation of future profits would hardly warrant, he does so because he really believes that these things will come about, not that he thinks they should come about or that it is right for them to come about. Similarly when the price of a share has been reduced to less than what has been previously paid in dividends in one year the price goes down because investors believe, let us hope wrongly, that profits will not be made for a considerable length of time and that the payment of dividends will be deferred for a still longer period. As a result of this attitude we have the spectacle of stocks selling at only a fraction of their conservative book value.

In these cases it has been the fashion to say that a certain stock selling for $10 a share has $9.50 of current assets behind it and that therefore the fixed assets are valued by the market at only fifty cents a share, while the book value of the fixed assets is, say, $20 a share. Such a statement seems to me to be a misinterpretation of the attitude of the investor or trader. The investor does not buy stocks on a liquidation basis. If he did, the calculation of so much current assets per share and the ascribing of the rest of the market value to the plant might be logical, but the investor knows intuitively or by the application of sound business principles that he has no more chance of getting his proportion per share of the current assets than he has of receiving a wheelbarrow load of bricks from the building or a few cogwheels from the machinery. He knows that the company in which he buys stock will continue in business even though it should go into receivership and that he is buying, not a share in certain assets, but a share in a deferred and at present uncertain future income.

This action of the market seems to justify the position taken in my article "Current assets in the going concern" published in THE JOURNAL OF ACCOUNTANCY in July, 1928, in which it was pointed out that the real division of assets was between those which are necessary for the conduct of the business and those which are free for disbursement to stockholders without affecting the conduct of the business. Of those assets which must be retained in the business, some, such as plant and buildings, are retained in their original form until they are worn out. Others, such as raw materials, cash and accounts receivable, constantly change their form, although the investment remains substantially the same. This makes our present balance-sheet division into fixed and current assets thoroughly illogical and at times misleading, but this is forced upon us by the attitude of the banker who insists on looking toward liquidation rather than at the business as a going concern. To drop the illogical distinctions between fixed and current assets does not imply losing any of the advantages of the attempted distinction. A logical separation of assets would be into fixed and circulating, the test for inclusion in the one or the other being the convertibility of the asset and its forming a part of the cycle starting with the purchase of raw materials and the payment of wages and closing with the collection of the accounts receivable. It is, of course, interesting from every point of view to know that the circulating assets of a company are sufficient to take care of the quick liabilities which provide those assets. What is objectionable is the assumption that circulating assets are not as fixed and permanent an investment in the business as those assets the physical form of which does not change. A necessary cash balance can no more be distributed than can the land on which a plant is built. When conditions warrant, another group might cover assets not necessary to the conduct of the business, and it could be made perfectly clear that the circulating and fixed assets are merely divisions of one group which together represent the investment without which the business could not function.

The attitude of investors in the stock market is based, consciously or not, on the theory expressed in the article mentioned. They know that there are no more current assets, so-called, in the companies in which they are investing than are needed for the conduct of the business; they know that in most cases these so-called current assets are insufficient and that with continued losses this condition will become aggravated and that regardless of excess of current assets over current liabilities their position as stockholders and potential receivers of dividends will not be improved until those companies accumulate, through earnings, assets which are in excess of those required to operate the business.

It was somewhat disappointing to read in the January, 1932, number of THE JOURNAL an article by Anson Herrick in which he seems to range himself on the side of the banker by agreeing to the anomalous distinction between fixed and current assets, while suggesting a few revisions of the theory as to what is usually included in current assets. It is surely time for us to attempt to break away from the impossible and illogical situation into which we are forced by applying liquidation principles to going concerns and to come out boldly and say that assets are either invested in the business or are unnecessary to the conduct of the business. Merely to say that they might be turned into cash without stating whether that cash must be immediately reinvested or may be disbursed to stockholders is an evasion of an issue which present conditions emphasize.

Yours truly,

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