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H. G. Kimball

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Accounting for Capital Assets

By H. G. Kimball

Accounting procedures and the related methods of verifying financial statements are constantly being judged in the light of events that affect business, especially those that affect it adversely. Accounting for capital assets and verification of the accounting so far, in spite of their enormous importance to an industrial society such as ours, have seemed to escape their share of criticism. However, it is too much to hope that they will escape it altogether or, if substantial business recovery does not soon develop, for long.

Criticism of accounting for capital assets and a wide-spread drive for more adequate information concerning them than is presently available will almost surely be a result of extensive failures in heavy industries financed principally by long-term loans secured by liens on plant and equipment as, for example, the impending bankruptcy and reorganization of the railroads. It has been alleged with respect to the railroads that a substantial portion of their funded debt has been incurred on account of capital assets with a considerably shorter life than the life of the debt, and that the debt is or will be outstanding after the assets have been worn out and discarded. Debt is then pyramided through borrowing to replace discarded equipment, and financial problems are increased and complicated by the effort to service a loan no longer supported by income producing assets. Moreover, it is said that separate funded obligations have been inadvertently secured by overlapping liens so that the debts are not secured to the extent or in the manner that they are represented to be. If these allegations are supported by future findings, and if the implications as to the possible conditions in other heavy industries are insistently exposed—and it appears that they will be—questions that may easily be embarrassing will be addressed to accountants, especially to public accountants, and they should think how to answer them.

Answers to questions concerning such matters will always turn on basic conceptions of accounting and accounts. Accounting is simply a technique for describing business transactions. Ac-

counts are the descriptions prepared by means of the technique. Unhappily the descriptions are not clean cut because they present a bewildering mixture of fact and opinion in which opinion probably predominates; and they are not complete because they can not include descriptions of general economic conditions and tendencies necessary if the matters they do reflect are to be fully understood. However, barring differences of opinion as to the facts in a case, they are meant to be a complete record of the transactions of an enterprise and of the management's judgment of their effect. Judgments as to the effect of transactions acquire, so far as the transactions are common to all business or to all of a branch of business, the status of accepted principles of accounting when there is any general concurrence in them. By these steps we come to conceive of accounts as technical descriptions of the transactions of an enterprise, based on and coupled with expressions of opinion as to their immediate and direct effect on the enterprise, and of good accounts as complete records of relevant facts and accepted opinions.

Before proceeding to a discussion of the particular subject of this paper, I think we ought to consider the significance of the concept "an accepted principle of accounting." It seems to me that if the concept is significant of anything more than merely a limit which an individual accountant sets on the responsibility which he is willing to take in regard to a set of accounts, it is significant because it means that, in the judgment of accountants generally, a principle which has been accepted has proved to be correct, to lead ordinarily to successful business practice. For example, the practice of paying dividends out of profits computed by including stock dividends at the quoted value of the stock received has proved disastrous, and the method of computing income which underlies it is not an accepted principle of accounting. On the other hand, the practice of paying dividends out of profits computed by including profits on account of such dividends only to the extent of the excess of the amount received over the cost of shares sold (determined by dividing the amount of the investment in the stock by the total number of shares owned after the receipt of the dividends) has proved to be reasonably safe, and the method of computing income which underlies it has been accepted. This significance must be kept in mind in judging any principle of accounting, especially in unique or original cases in which there are no accepted principles to guide the accountant. In

such cases the accountant must be ready to judge for himself whether the accounting is acceptable or not and to assume his share of the responsibility for whatever results follow from acting on the principle adopted. With this consideration in mind, let us return to accounting for capital assets.

Accounting for capital assets is expected to be based on the essentially simple principle that all increases and decreases in plant and equipment will be reflected in the accounts on an acceptable basis, and that an inventory of the items of plant and equipment stated at the amounts at which they are carried in the accounts will agree with the balances thereof.

The public accountant, reporting upon an examination of financial statements, generally includes in his report a statement of his opinion as to whether or not the accounts are stated, as they are expected to be stated, on the basis of accepted principles of accounting. He bases his opinion in part upon an examination of his client's accounting methods, including, presumably, the methods of accounting for capital assets. If he finds that those methods do not provide a satisfactory means of regularly comparing the balance of the capital-asset accounts with an inventory of the items comprising the plant and equipment—the only possible way of clearly and indisputably establishing the accuracy of the accounts—it seems that he must necessarily regard the methods as unsatisfactory and qualify his opinion with respect to them.

It is my experience that only negligible numbers of businesses have accounting systems which provide a means of satisfactorily verifying their capital asset accounts, and that the accounts of most are deficient in this respect. On the basis of such experience, I would expect to see numerous qualifications in accountants' reports pointing to such deficiencies; but I seldom do. The reason appears to be the accountant's disposition to regard the matter lightly and to depend upon the method of accounting for depreciation eventually to clean up any amount carried in capital-asset accounts of which no other disposition had been made. However, the matter is not unimportant, as the example of the railroads will illustrate, and the accountant is not justified in so regarding it.

Eventually, in order to correct this almost universal deficiency in accounts, it will be necessary for business to adopt satisfactory methods of accounting for capital assets. Business should be

able to obtain for itself, and to furnish to others with a right to it, such information as the following:

1. What assets have been acquired? How?
2. What assets have been disposed of? How?
3. What assets are left? Where are they?
4. Are the assets left serviceable? Have they been producing?
5. How are they held? Are they subject to any lien?
6. What basis has been used in determining the amount at which they are stated? Is it an acceptable basis and has it been consistently maintained?

Determining and reporting the acquisition and disposition of assets, their location, utilization and physical condition will fall to the lot of the engineer. Matters involving questions of title will need to be determined by the attorney. Designing, installing and, in coöperation with the others, operating a system of recording the information will be the accountant's job.

Immediately, where it is necessary, public accountants should include a more forthright discussion of the matter in their reports, renouncing their question-begging dependence on the practice of accounting for depreciation. Such discussion would attract attention to the defective accounting and lead to its correction.