

3-1920

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Recommended Citation

Hawkins, Lester G. (1920) "Appraisals and Their Relation to Accounts," *Journal of Accountancy*. Vol. 29: Iss. 3, Article 6.

Available at: <https://egrove.olemiss.edu/jofa/vol29/iss3/6>

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Appraisals and Their Relation to Accounts

BY LESTER G. HAWKINS

Appraisal and valuation matters have not in the past been regarded by the accounting profession as being related to or of more than passing importance in accounting theory and practice. In fact, many text-books on accounting procedure are known to express certain pertinent opinions and instructions, to the effect that appraised property values have no connection with book values, and should not be considered as having any particular importance to the auditor or business advisor, except so far as such values may be of assistance in credit and other purely financial matters.

This doctrine has been entirely ethical so far as the meaning of appraisal, as it has been generally accepted in the past, is concerned, yet it is the purpose of the writer to show that this general definition given to an appraisal has been somewhat misleading, and has thus caused these matters to be perhaps too summarily dismissed by the accountant as having no particular relation to his work.

Appraisals are not, as many suppose, all alike as to their form or scope, manner in which conducted and usage for which they are designed. On the contrary appraisals, as they have become necessary in the last few years, cover a very large number of usages, and the fact that many industrial and utility organizations have had appraisals made of their properties, only to learn a short time later that they required another appraisal for a particular purpose, which the old appraisal could not accomplish in any circumstances, is evidence of this fact.

The "reproduction" appraisal, which is conducted on the basis of "cost to reproduce" theory, is that commonly referred to by the average person in discussing appraised values. The fact that the uninitiated in valuation and appraisal matters have accepted this type of appraisal as being the entire field of the profession has brought about the generally distorted view referred to above.

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The reproduction appraisal has its own particular uses and also its limitations. Among its uses are the following:

1. To place insurable values correctly.
2. To obtain loans.
3. To inspire confidence in stock and bond issues.
4. As a basis for negotiating purchase or sale.

The reproduction appraisal has no place in the accounting field so far as book values are concerned. The taking up on the books of values shown by such an appraisal is, of course, a violation of one of the most fundamental accounting principles.

The test as to what are the uses and limitations of an appraisal is found in the method prescribed for conducting it. An appraisal may be made of reproduction costs and used for any of the purposes above enumerated. It may be made of actual costs, or it may be made of market prices at any given date—and in each case may be designed for an entirely different purpose. The essence of the appraisal, it will be seen, is in the determination of value upon some given basis of cost.

An appraisal of property upon the basis of actual cost should furnish the correct book value of the property, by reason of the fact that it establishes the point as to whether the depreciation reserve is inadequate or excessive.

A reservation for bad debts is made in a manner similar to a reservation for depreciation. The question as to whether such reserve for bad debts is inadequate or excessive is, however, easily determined at the end of the period, because the information necessary to determine the matter is easily accessible. Is it not equally desirable that the question as to whether the depreciation reserve is inadequate or excessive be accurately determined at reasonable intervals? Unlike the allowance for bad debts, the allowance for depreciation cannot be checked at the end of the accounting period, since its justification cannot be fully established under ordinary conditions until the building or machine, after a long period of years, becomes worn out or obsolete. The appraisal, conducted by the scientific appraisal engineer who deals in utilities and values, can furnish the check desired at any time during this long period.

A most important development in the appraisal field has been brought about by our present federal excess profits tax laws.

Corporations' federal taxes are computed on the basis of the ratio between earnings and capital investment. The regulations of the bureau of internal revenue in regard to federal taxes have been based upon the assumption that in many cases book values are misleading and do not form a correct basis for the levying of taxes. To alleviate this situation the regulations have prescribed a remedy, which in many cases can only be applied through appraisal methods.

Representatives of the department, in their interpretation and rulings under the regulations, have also taken the position that appraisals, in the sense in which they are generally regarded, are not acceptable in any adjustments of plant accounts; yet they have specified in effect that the appraisal process is necessary in any adjustment of the fixed assets. A recent communication from the department is quoted in part herewith:

Where there has heretofore been charged off excessive depreciation on property still owned or in use, or has been charged to expense amounts paid out for the acquisition of plant, equipment or other tangible property still owned and in active use, and where in either case the cost of the property has not been specifically recovered in the price of goods or service (special tools, patterns, etc.), then the amounts which have been charged off either as depreciation or as current expense, upon satisfactory proof, may be restored to the surplus account. In order to make such restoration to invested capital it is necessary to prove the amounts excessively charged. In the opinion of this office, if such charges are not readily ascertainable from the books, proof may be made by ascertaining the original cost of all fixed assets and then deducting a proper charge for depreciation.

The ascertaining of original cost of all fixed assets and then deducting a proper charge for depreciation is in any circumstances an appraisal process. Ordinary rule of thumb methods and percentage deductions based on estimated yearly rates of depreciation will not solve this problem.

To illustrate the impossibility of using such methods an example is given which is based upon actual facts known to the writer.

A textile plant, which several years ago adopted an accounting policy of preparing during the prosperous periods for possible future lean years, purchased machinery and plant equipment during those years and charged it to expense. Attempting, under the regulations, to reinstate these items in the machinery account less proper deductions for depreciation the company found itself confronted with a difficult problem.

It became evident at the start that no accurate adjustment

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could be made from the books alone, since, although it was possible to trace to the expense accounts during prior years charges which should have been capitalized, the evidence that the equipment thus charged was still owned and in active use could not be obtained except by a complete inventory of the physical property.

Upon making such an inventory of the property and attempting to reinstate the items in the plant account, less proper deductions for depreciation, certain machinery subject to this reinstatement, on which an almost universal estimate as to the annual depreciation rate was five per cent, was found to have been in continuous operation in the plant for thirty years, and in such condition as to warrant a probable future term of usefulness of from three to ten years. Other machines of the same type, which were less than twenty years old, however, were found to be practically ready for the junk pile. This was due in some cases to the fact that the older machines either had been kept in better repair or had been subject to less wear and tear due to peculiar local conditions. Any attempt to determine the proper deduction from the cost of these machines for accrued depreciation by the use of cumulative yearly rates was so obviously incorrect and inadequate that it was abandoned. The determination of the proper deductions could only be made by ascertaining the actual depreciated value of the machines through inspection and consideration of the necessary factors, i. e., true cost, age, condition and probable period of usefulness—in other words, through a distinct appraisal process.

It is believed that the appraisal procedure outlined must of necessity receive consideration by the accounting profession. It accomplishes that which can be accomplished in no other way. Depreciation rates are at best only opinions and estimates, and even when advanced by the highest authorities they do not measure up to actual performances. Neither can past performances be regarded as accurate bases for estimates for the future, because industrial equipment is not only subject to changing conditions, but is of itself variable as to its susceptibility to wear and tear.

Appraisal is the adjustment between the estimate and the actual performance, and unless it is used periodically for such adjustment the book values will be distorted and reports showing results from operations cannot be regarded as accurate.