An Inquiry Into THE NATURE of ACCOUNTING

by

LOUIS GOLDBERG

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An Inquiry Into THE NATURE of ACCOUNTING

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To M.H.G. *and* L.J.G.

Preface

IN RECENT YEARS there have been numerous signs in the literature of accounting of an increasing awareness of the need to develop a framework of accounting theory against which the procedures and practices of accountants in their everyday work may be measured and assessed. Not a few writers and practitioners appear to regard this as one of the most urgent of the required developments in the whole area of accounting.

So long as accounting is not to be a stagnant craft in a static society, the full development of such a structure will be a task for many people over many years; certainly at present no one person or body of people could claim to have found the final answer to all—or even to many—of the questions that arise in accounting. The present work is submitted as a contribution towards this development. Nothing in this book is claimed to be a final solution; the ideas are presented as contributions to continuing discussion on the nature and meaning of accounting.

Some of the ideas and expressions presented may appear somewhat strange to readers at first acquaintance; I should like to make it clear that I consider the former to be more important than the latter, that is, where unusual words are used to draw a distinction between ideas, it is the distinction that is significant rather than the terms as such. If there are any places where the intended meaning may be misunderstood, this is probably due to my own failure to express my thoughts as clearly as I should have; this can only be determined by the experience of exposure, and I can only hope that any such misunderstandings will occur on relatively minor points rather than on any major issues.

No doubt there will be readers who disagree with some, and perhaps with many, parts of it. This will be all to the good provided that some positive new knowledge comes out of the disagreement. If it provokes some people to contribute further to such positive knowledge, it will, from my point of view, have justified my temerity in foisting upon a possibly unwilling audience yet another book on an already overpopulated planet of written endeavour.

No person could claim to have read everything apposite and relevant to a particular area of study or investigation, and the present work is bound to be deficient because of ignorance or forgetfulness of some relevant points. Moreover, I believe that knowledge is a continuum in which the boundaries of the various fields are frequently incapable of clear and precise definition and that accounting is no exception in this respect. I have therefore ventured at times into regions in which I am a very raw amateur and in which, as a consequence, I may have committed some egregious errors. I hope that others better qualified than I am in these areas will correct any such mistakes and follow out the implications of their corrections in the development of thought relating to accounting. Thus, some readers may think that in some directions my reading has not gone far enough, while at the same time they may consider that in others it has gone too far and got me out of my depth. I am prepared to admit in advance the validity of this possible criticism; I may well be of the same opinion myself in a few years' or a few months' time. But, as of this moment, I feel that I have done what I have conceived it to be necessary to do and what I have been capable of doing; the result is what it is.

A work of this sort is never really finished; it merely reaches a stage when it has to be pushed out into the world for criticism, amplification, and modification. Writing a work of this kind is something like rearing a child. There are times when it annoys, frustrates, tantalizes; and others when it enchants. One watches it grow—from the amorphous infancy of an idea or a few ideas to a degree of relative maturity; one watches with concern its setbacks and its periods of languor, and rejoices when these are overcome or, at least, when one thinks they are overcome. There are times when one seems to know it intimately, and perhaps only too well; there are others when one seems to know it scarcely at all, and perhaps even to feel estranged from it. One gets to know its shortcomings and to imagine its strength, some of each of which may not be apparent to others; on the other hand, one may inadvertently be blind to defects which others may be quick to detect in it. It develops a personality of its own, so to speak, sometimes demanding and domineering, sometimes submissive and tractable. In the end, however, it must be sent out into the

world to make its own way. For the present work, that time has come.

No work of this nature is wholly the work of the author alone: it must be founded on that of others. The more obvious instances of my indebtedness to other writers will be clear from the text of the work itself, and I have acknowledged all those of which I am aware. But there are doubtless many others whose ideas have been less consciously in my mind—absorbed, assimilated, and, so to speak, ingested and taken into and enriching the blood stream of ideas; these are not readily identifiable, but have been none the less influential.

To all those who have proffered advice and suggestions, I render sincere thanks; the work is unquestionably much improved by the advice which I have taken. The fact that I may not have taken it all is due rather to my own perversity than to the view that the advice or suggestion was anything but sound. So, for all the advice, my gratitude; for the failure to adopt it all, my apologies.

The production of the monograph is made possible by the American Accounting Association, especially through the efforts of Professor James Don Edwards, Vice President of the Association. It was critically edited by Dr. Anne C. Garrison, who saw it through the printing. I thank them sincerely.

At a more personally intimate level, I gratefully and proudly acknowledge the helpful criticism of those who have read or discussed with me parts or all of the manuscript at various times. These include Sir Alexander Fitzgerald, Dean Emanuel Saxe, Professors H. R. Anton, M. O. Jager, T. R. Johnston, M. Moonitz, W. J. Schrader, G. S. L. Tucker, Dr. K. Rivett, Mr. L. C. Voumard and Mr. C. Goode. Their comments, resulting in many improvements, have been greatly appreciated. The responsibility for any errors, omissions and deficiencies is wholly my own; I hope that, on balance, it will be thought that they are outweighed by what I fondly (but perhaps mistakenly) imagine to be virtues.

Finally, to my wife and daughter I give thanks for putting up with the moods of composition over a long period; to them this book is affectionately dedicated.

L. G.

Melbourne, 1964

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Here as elsewhere, names are "noise and smoke"; the important point is to have a clear and adequate conception of the fact signified by a name.

T. H. HUXLEY
Romanes Lecture, 1893

Fancy with fact is just one fact the more.

ROBERT BROWNING
The Ring and the Book

Socrates: *It is you who are wise, my dear Ion, you rhapsodists, actors, and the authors of the poems you recite. I, like an unprofessional and private man, can only speak the truth.*

PLATO
Ion, translated by P. B. Shelley

Part I

THE PROVINCE OF ACCOUNTING

CHAPTER 1

Introduction

I General Attitudes to Accounting

ACCOUNTANTS are usually thought of as being matter-of-fact people dealing unimaginatively but sensibly with mundane, everyday matters which have an inescapable taint of pecuniary sordidness. H. L. Mencken, for example, was reported to have said some years ago:

> Suppose you had your free choice between going to a convention of Rotarians and going to a convention of accountants, which would you choose? Obviously, you would choose the convention of Rotarians, just as you would go to the Follies rather than to a meeting of the Ladies' Aid Society. Accountants, in their way, are the wisest of men. Once, working as a newspaper reporter, I covered one of their assemblages, and in four days I didn't hear a single foolish word. What they said was sober, sound and indubitable. But it was also as flat dish water.[1]

And the description of an auditor, generally attributed to Elbert Hubbard, is well known:

> The typical auditor is a man past middle age, spare, wrinkled, intelligent, cold, passive, non-committal, with eyes like a cod-fish; polite in contact but at the same time unresponsive, calm and damnably composed as a concrete post or a plaster of Paris cast; a petrifaction with a heart of feldspar and without charm of the friendly germ, minus bowels, passion or a sense of humour. Happily they never reproduce and all of them finally go to Hell.

Overdrawn and cruel though this description may be, it is probably, in the common view, exaggerated only in language and reflects the attitude which many if not most people still have toward members of the accounting profession.

It is submitted, however,—and this is the chief burden of this thesis—that there is, in the study and practice of accounting, some-

[1] See *The Certified Public Accountant,* VIII, 2, (February, 1928), 33.

thing beyond and behind measuring, that "most futile of all occupations" as Virginia Woolf once put it.[2] Measuring, admittedly, there certainly and inevitably is, but in addition there is an underlying theory and purpose, the implications of which have not yet been fully realized.

The basis of accounting theory, as that of economic theory or legal theory, lies not only in the institutional framework of a particular society, but also in social philosophy. Now this is the field of imagination, and accountants, no less than economists and lawyers, rank among the imaginative workers in society. It is not perhaps generally or sufficiently recognized that it is the artists and the poets who in truth are the realists of our culture: the painter seeks to portray things as he sees them, the poet's imagery purports to be the expression of an actual experience; and the task of the artist is to communicate his experiences—vivid and real as they are for him—to his audience by means of his chosen medium. The worker in the field of things social has, on the contrary, to resort to hypotheses, to fictions, and to reason. One is not normally moved by reason—the expression is a contradiction in terms; and it is the reasoners who perforce appeal to the imagination because they cannot communicate directly the conviction of their experiences.

The matter is one of degree of abstraction and interpretation. Several writers have pointed out that there are different levels of abstraction from reality.[3] Even things and persons commonly regarded as factually existing represent, to a greater or less extent depending upon one's point of view, abstractions of qualities and characteristics which for convenience we group and recognize for given purposes as a unit. Although we classify and dissect and analyze in order to bring things within the boundaries of our comprehension, we must realise that classification and analysis are human procedures and not inherent in the things themselves; and that when we have succeeded in classifying and analysing some thing, the thing itself is not merely a sum total of the parts

[2] Virginia Woolf, *A Room of One's Own*, (London: Penguin Books, 1945), p. 88.

[3] For example, Aldous Huxley, *Ends and Means*, (Readers' Union and Chatto & Windus, 1938), p. 255; Stuart Chase, *The Tyranny of Words*, 6th Ed., (London: Methuen, 1947), p. 6.

into which we have analysed it, but rather all that together with the relationships (often very delicate and difficult to ascertain) between the parts. And when we realise this, we next begin to classify and analyse the relationships, and so a never-ending spiral of truth-chasing is fairly before us. The classification and the analysis are abstractive processes, and the recognition of relationships is no less an abstraction. Classifications are highly significant in our thinking, yet they are always imposed by us upon the material under consideration and have no functional relationship to the material which they arrange.[4]

In the general accounting theory with which this thesis is concerned, a fundamental proposition is that the procedures which accountants apply in the course of their practice are based on a number of concepts, unitary in themselves, but interacting in the process of application. These concepts are necessarily notional, but they are used to interpret events in such a way that the results may be and usually are expressed and understood as objective facts.

Although these concepts may be isolated for purposes of analysis, none can be applied to the utter exclusion of all others. Consideration of each, therefore, represents a process of abstraction; the danger in abstraction, however, lies in the possibility of losing contact with communicable referents in the use of words. The higher the degree of abstraction, the further the result is from positive and recognizable referents, and the greater the chance of misinterpretation. One of the most difficult, and yet one of the most important tasks which men have to face is to prevent the use of words from being the master of their thoughts instead of their servant.

In accounting we should be concerned with expressing the truth (a word of high degree of abstraction) about the social unit to which accounts or reports are related, so far as it is ascertainable and expressible in the units selected as appropriate for this purpose. The accountant is thus concerned primarily with ascertaining and presenting the truth, and "truth" here is taken to mean something more than isolated facts; it is taken to include

[4] Cf. Ralph Linton, *The Study of Man,* New York: (D. Appleton-Century, 1936), p. 24.

relationships between facts. If "presentation" of accounting information is carried out as part of the task of ascertaining or assisting in determining relevant relationships, it is considered to be part of the ascertainment of truth; this almost inevitably involves a judgment as to the relative importance of facts and the use of precise language in reporting them.

A distinction is also to be drawn between presentation and dissemination, even though it may be a fine one in many cases. While the ascertainment and presentation of truth is a matter for the accountant, the extent of its dissemination is very often not in his hands and is a matter of policy, whether of business management or government management or even professional institutional management. If an accountant is concerned with dissemination, it is as a secondary, social function, and, strictly speaking, in a non-accounting capacity. That is, in any given case, the accountant, *qua accountant,* is not directly concerned with either propaganda or prudence which may result from the application of certain policies; to the extent that he is concerned, he is widening his responsibility beyond his primary and principal task of the ascertainment and presentation of truth. What, however, is the nature of this "truth" within the context of accounting? It is some aspects of this question which the following pages attempt to answer.

II Accounting and Economics

In recent years much discussion has taken place on the desirability of reconciling accounting concepts and procedures with the tenets of economics. Thinking firstly in what they call real terms as contrasted with monetary terms, and secondly in terms of the community or economy as a whole as distinct from any individual person or other economic unit within the community, economists have found themselves unable to accept some of the current accounting practices, especially those based on the measurement in monetary terms of events happening to an individual economic unit. Many accountants, too, have recognized that some of the traditionally hallowed and somewhat dogmatically expressed tenets of earlier text books have not only been shown to be inadequate to solve problems of the individual economic

unit but have given rise to anomalies in the relationships between different groups of persons interested in the results of the activities of economic units. These accountants have expressed feelings of disquiet at the state of accounting theory, especially in times of rising prices or rising taxes, and have advocated in varying degrees modifications of widely accepted practices—modifications which often reflect, sometimes implicitly, sometimes explicitly, sometimes directly, sometimes indirectly, the views of the economists. And both accountants and economists have deplored the lack of material on the borderland between economics and accounting.

However, there are some people who have consciously attempted to reconcile economics and accounting. Their efforts up to the present have constituted a somewhat hesitant and tentative movement to effect a reconciliation between the views of economists on the one hand and accountants on the other upon matters which in fact are their common concern. Most of these attempts have taken the form of an exposition of accountants' views to economists and vice versa. The economist has tried to use the information provided by the accounting procedures and has found it wanting for his particular purpose. The accountant has been at some pains to explain that the information was neither gathered nor presented for specific use by the economist but for very different purposes. Conciliators have appeared from both camps in an endeavour to overcome the methodological and informational gap.[5] The study of "social accounting"[6] is an example, and much valuable work has been done in this direction, while the problems of cost accounting and the "theory of the firm" have been brought much closer together by workers in both fields. The net extent of their success to date, however, has been relatively slight.

[5] See, for example, John T. Wheeler's chapter on "Economics and Accounting" in Morton Backer (Ed.), *Handbook of Modern Accounting Theory* (New York: Prentice Hall, 1955), pp. 43-76.

[6] The term "social accounting" has been appropriated in recent years by economists—with little reference to and less protest from accountants—to a field which would be more properly described as "national income estimating." Although the expression seems to have taken root, it is certainly not "accounting" as accountants generally understand the word, and it certainly covers only a small portion of the connotations of the words "social" and "society."

From this point of view, however, there is a multiple problem. It has been suggested that there are two areas for economic study: micro-economics, which is concerned with the economics of a relatively small economic unit such as an individual person or an individual firm, and macro-economics, which is concerned with a large economic unit such as a national community or the "economy as a whole." If this suggestion is adopted, it seems necessary to reconcile micro-economics with a corresponding micro-accounting, and macro-economics with a corresponding macro-accounting or acounting for society as a whole. Up to date, very few accountants have paid any attention to accounting for society as a whole, those few being interested in "social accounting." All accountants, of course, are interested in accounting for the individual person or firm or organisation; some have shown concern for the discrepancies affecting this kind of unit, while some have been interested in the relation between "micro-accounting" and macro-economics. Even though a field of study and practice in government accounting (sometimes termed "fund accounting") has of necessity been developed by accountants, this has not constituted a "macro-accounting" analogous to the area of macro-economics.

If the distinction between micro-economics and macro-economics is justified, or if it is adhered to, whether justified or not, then a corresponding distinction in accounting may have to be developed; or, to be more precise, a macro-accounting may have to be developed which will require reconciliation or, at least, alignment with the presently existing micro-accounting on the one hand and macro-economics on the other.[7]

There is, however, another aspect of the discrepancy between economics and accounting which has not, to my knowledge, at-

[7] The following classification of accounting systems has been proposed:

- Monetary Accounting
  - Micro-accounting
    - Business Accounting
      - Financial Accounting
      - Managerial and Cost Accounting
    - Government Accounting
    - Household Accounting
  - Macro-accounting
    - National Income Accounting
    - Input-output Accounting
    - Money-flow Accounting
    - Balance of Payments Accounting

See Richard Mattesich, "Towards a General and Axiomatic Foundation of Accountancy," *Accounting Research* (October, 1957), p. 331.

tracted much attention, but it is one which may well be at least as important as, and perhaps even more important than attempts at reconciliation. This is the point of view that there is a field of study which, so to speak, underlies both economics and accounting and in which both economic and accounting concepts may find a common source and possibly a common expression but which has not been explored to more than a very limited extent, if at all. Perhaps it is an act of faith to believe in its existence, but this belief will be found to colour much of what follows,[8] and from it stems the further belief that, if this field can be adequately explored, many of the apparent discrepancies between economic conclusions and accounting practices may disappear or become relatively easy of solution.

III Accounting and Law

There can be little doubt, if any, that the practices of accounting have been very greatly influenced by the law. There is nothing strange or unnatural about this, since any practices which affect considerable numbers of people in any given community must of necessity be subject to legislation and will inevitably be affected by the legal framework within which they operate. It could, for example, be said with equal truth that the practices of banking or of gambling or of retail selling or even of housebreaking have been profoundly influenced by law. The fact that practices are subject to constraints of law is simply a recognition that they are of sufficient significance in the lives of a sufficient number or proportion of people in the community to warrant the attention of the lawmakers. The existence of strong legal influences on accounting practices constitutes a recognition that accounting is a social activity and, as such, must operate in a legal environment.

These influences have been examined by certain writers[9] and some of them are under fairly constant scrutiny. The influence of taxation, company law and regulatory legislation are expe-

[8] For example, some of the matters discussed later in Chapters 8, 10, 13 and 15 below may have implications for economics as well as accounting, although aspects of the latter only are discussed in this work.

[9] See, for instance, Influences Shaping Accounting—N. F. Stevens, "The Influence of Taxation;" L. C. Voumard, "The Influence of Law"—in *Proceedings of Convention,* Australian Society of Accountants (Melbourne, 1958), pp. 219 ff.; Bernard F. Magruder, "Law and Accounting," in Morton Backer (Ed.), *Handbook of Modern Accounting Theory* (New York: Prentice Hall, 1955), pp. 79 ff.

rienced almost daily by accountants in their work; many accountants have at least occasional and some have frequent contact with legal requirements arising out of bankruptcy proceedings, trusteeship problems, or municipal and other governmental or semi-governmental regulations; and some of the criteria of professional conduct and practice have been considerably influenced by decisions of law.

In addition to these direct influences on accounting practices, the influence of legal concepts can be seen in some widely held accounting concepts. The notion of the distinct entity for accounting purposes owes much of its recognition and acceptance to the development of the limited liability corporation—a creation of law; this relationship is examined to some extent in Chapter 9. The notion of profit has also been affected to some degree by legal considerations, which have not always contributed to its clarification. Accountants' thinking about depreciation and goodwill has also been greatly coloured by the arguments of learned judges exercising their analytical powers in cases which have come before them for decision; sometimes, accountants have tended to formulate general propositions from decisions having application to particular cases only, but they are not altogether to blame for this, since the doctrine of precedent, which is powerful in law, has often induced legal writers to make similar generalisations and predisposes judges to conform to such generalisations unless they can find specific overriding facts in a given case to warrant or, indeed, necessitate a departure from conformity.

It would appear that, in many areas in the past, the influence of law on accounting has been much greater than that of accounting on law. This is probably largely due to the comparative tardiness in the development of an accounting profession and the difficulties which accountants have found in formulating acceptable basic propositions by which lawyers might have been guided in cases when such propositions may have had significant influence. As recently as 1951 one writer was able to say:

> The courts have not yet developed sophistication in accounting matters. . . . The decisions of the court, resting on the evidence and on statements of counsel, will with infrequent exceptions not exceed in accounting sensitiveness the clarity with which the accounting complexities of the case have been argued and briefed. . . .The courts appear to accept as synonymous the word

"accounting" and all terms containing that word, such as "accounting principles," "accounting methods," "accounting practices," and "accounting theories," none of which the court seems to distinguish perceptively from the old-fashioned word "book-keeping." This lack of definitiveness is due to the artless behavior of lawyers, in the eyes of accountants, and to the incompatibility of accountants in their failure to agree on terminology and principles.[10]

When matters of accounting have to be considered in a court of law, they are as much open to different interpretations as a musical composition is in its performance, with the difference—apart altogether from variations in skill which may apply equally to counsel and musician—that most seriously aspiring musical performers will have studied the principles of composition before putting their own interpretation on a given piece, whereas few lawyers will have devoted much attention to the principles of accounting before presenting their case to a court.

The law is obviously and by its very nature the dominant side in any mutual interrelationships with other social influences. But these other social influences can nevertheless succeed in having the law altered in specific areas, and this has been true for accounting. Accounting practices which have been developed beyond existing legal requirements have been incorporated as mandatory in subsequent legislation, as has happened in the United Kingdom, for example, in the case of consolidated statements for holding companies and their subsidiaries. In the United States, "Congressional committees make it a point to invite accounting organizations . . . to submit in advance their views regarding proposed laws affecting taxation and other accounting matters."[11]

Further, in cases of legal action, the courts have frequently placed great weight on the customs, practices and standards of performance of accountants as expressed by expert witnesses of high professional repute or by official pronouncements of professional accounting bodies.

In considering accounting and law, there is another aspect which arises, and it constitutes an important difference between them. As has been suggested, they are both expressions of social activity, but, while law can *only* exist in a social context, ac-

[10] George S. Hills, "Statement of Legal Concepts of Accounting," *Iowa Law Review*, XXXVI, 2 (Winter, 1951), 198-99.

[11] John W. Queenan, "An Inquiry into the Relationship of Law and Accounting," *New York C.P.A.*, July, 1959, p. 496.

counting may arise in an individual as well as a social context. For an isolated Robinson Crusoe, law would be unnecessary and, indeed, meaningless in his solitude—at least until Man Friday turned up; as soon as a second member of society arrived, a formulation of relationship between the two men became desirable, if not necessary. Law is surely in essence a matter of relations between different persons and can only arise in a community, the family being, in general, the smallest unit of communal life, with the range extending to the whole human race, as in international law. However, while law for a completely isolated individual would be of no use or meaning, accounting for a solitary human being could conceivably be both useful and meaningful. Crusoe could well have found it useful to keep inventory records, for example—he almost got to that stage, in a crude way, in respect of his barley and rice. The reason is that accounting has an economic side to its base as well as a social one, whereas law has a social base only. A solitary individual is faced with economic problems no less because he is on his own, so long as resources are relatively scarce and he is faced with problems of choice; in problems of choice in respect to scarce means, measurement is an exceedingly useful device, and such measurement is of the essence of accounting.

Thus, in so far as accounting is a social process or instrument, it functions within a legal environment and is subject to the sanctions of law; but not all of accounting stems from social considerations. Hence there are two strands in accounting. One, individual and economic, leads to problems of control and management, including budgeting; the other, social and necessarily operating within a legal environment, leads to "fiduciary" (in a very broad sense to include partnership, agency, company and governmental as well as trustee areas) and responsibility accounting. The two sets of influences, however, are not entirely mutually exclusive in practice, nor are the related accounting procedures.

There are a few other relevant considerations in attempting to assess the relationship between law and accounting. One writer puts a view of law in the following words: "As law is the means of peaceably adjusting the external relations of men and communities among themselves, and to things, so legal science is systematic knowledge of this peaceable adjustment, and all its parts and re-

lations."[12] Both law and accounting are concerned with the relations between men and between men and things; hence there is a basic conceptual nexus between law and accounting as different ways of thinking about similar things. At the same time, however, accounting relationships are different from legal relationships and are not merely the measurable expressions of them, although there have occurred instances in which accountants' procedures and interpretation of circumstances have been radically affected by legal enactments or decisions. For example, the decision in the case of Garner V. Murray,[13] relating to the distribution of assets in a partnership dissolution in which one of the partners is insolvent, caused accountants to revise their previous interpretation of this set of circumstances and to vary their procedure accordingly. Again, the accounting procedures involved in executorship and other trust accounting stem directly from the law relating to trustees and may thus be regarded as being the measurable expression of legal relationships. Against examples of this kind, however, one may cite the history of published reports of companies, in which there has always been a considerable proportion of companies whose published reports contained more information than that required by statute, and in which the initial impetus for the publication of consolidated (or "group") statements for holding-subsidiary company relations came from accountants and company directorates long before they were written into statute law. Hence it is quite erroneous for anybody to believe or aver, on the basis of inadequate evidence, that accountants, in applying their procedures, are no better than they are required to be by law, or that they are merely translating a purely legal environment into accounting language. The fact is that while they have, of necessity, to carry out procedures in accordance with legal requirements in all those areas in which such requirements are laid down, the efforts of many accountants and of professional accounting bodies have pointed the way to legislation by providing examples *in practice* of doing something more and something better than the statutory or regulatory minimum. It may be noted, in passing, that a number of the provisions of the United

[12] K. Gareis, *Introduction to the Science of Law,* Translated from the German by A. Kocourek (Boston: The Boston Book Co., 1911), p. 14.

[13] Garner V. Murray (1904) 1 Ch. 57.

Kingdom Companies Act of 1948 embody suggestions recommended to their members for some years prior to 1948 by the Institute of Chartered Accountants in England and Wales. This is but one instance of a growing tendency for legislators to seek the advice and guidance of accountants, especially representatives of collective professional associations, in the framing of legislation relating to activities with which accountants are widely or intimately concerned and upon which they can therefore offer counsel as experienced experts. One writer has pointed out that in the United Kingdom there has been, since the 1908 Companies Act,

> a regular pattern in British company law amendment. . . . Once in every fifteen or twenty years a Departmental Committee takes evidence, cogitates, and reports on the state of company law; and an amending statute follows.[14]

Such committees have heard evidence from accountants both as individuals and as representatives of professional bodies.

Another point of interest is that while, in company law, a holding company and its subsidiaries are now regarded as a separate unit for purposes of presentation of information, this group unit is not clothed with other legal rights or responsibilities; for instance, it is not required that separate books of account be kept for it. It seems likely that one important reason for this is that accountants have not found it necessary or advantageous to set up such books of account, the necessary procedures being readily capable of performance through working papers. What seems somewhat strange is that the statutes make no reference whatsoever to such working papers or any other basis for the consolidation procedure, and the legislators appear to be satisfied—at least so far—to leave this procedure completely in the hands of accountants without requiring even the preservation of the evidence of such procedure.

Another aspect which warrants some consideration is the influence of the regulatory aspect, which is fundamental to law, on the search for accounting "principles," which has taken place in recent years in the United States of America, the United Kingdom, and other countries. In these countries, the professional bodies of

[14] Harold C. Edey, "Company Accounts in Britain: The Jenkins Report," *Accounting Review,* April, 1963, p. 262.

accountants have not only formulated codes of "ethical" professional conduct by which their members are bound, but have adopted as objectives the promulgation of standards of performance, particularly in relation to the manner and content of published financial statements to which members lend their names in a professional capacity and to the carrying out of audits prerequisite to the validation of such statements. The pronouncements of such bodies as the Institute of Chartered Accountants in England and Wales (Recommendations on Accounting Principles) and the American Institute of Certified Public Accountants (Accounting Research Bulletins) have had a quasi-legal flavour about them: their observance has not been made mandatory upon their members and they do not carry legal sanctions as do statutory provisions, but they carry an implication that a member who did not observe them would forfeit, in some degree at least, the professional support of his fellow-members should his attitude become subject to question. These pronouncements have been regarded by the Councils or Committees of the Institutes as guides to their members, setting out what they should do in the light of what they (the Councils or Committees), have considered to be the best practice in the envisaged circumstances. In many instances, however, "permitted" alternatives (in the case of some of the English Institute's recommendations, for example) or dissenting opinions (in the case of several of the American Institute's bulletins) robbed them of much of their incisiveness and suggested that the pronouncements as promulgated were compromise expressions of divergent views. In 1959 the American Institute had further thoughts and revised its procedure, establishing an Accounting Research Division which was charged with the task of establishing the basic postulates and principles upon which accounting practice rests and reporting these to an Accounting Principles Board, which in turn would make appropriate recommendations to accounting practitioners.

These attempts at governing accounting practice are pale shadows of legal process, or aspirations after legal stature. However, there are inherent difficulties. For one thing, there are, as pointed out above, no legal sanctions possible. For another, no policing

procedure appears to have been considered, let alone provided for. And again, the subject matter of the recommendations suggests that the pronouncing bodies have been "legislating" for a population different from that which put them into the "legislative" position and to which they are directly responsible. This is a serious source of difference from the legal position. When a statute is passed by Congress or Parliament, be it by the narrowest margin of one, it is none the less an expression of the will of the people through the representatives duly selected by the people. If the statute is considered to be a bad one, the people can express their attitude at the next election by selecting representatives who will repeal or amend it. The statute, however, is passed by representatives of the people who will be affected by it. In the case of the accounting pronouncements, on the other hand, the pronouncing body appears to be "legislating" for the benefit of the community in general or at least the investing public, although its pronouncements are directed to the members of the respective Institutes. It is open to question whether these members selected their representatives primarily or even incidentally for the purpose of issuing such pronouncements. This question of mandate is one which needs to be examined more rigorously by the governing bodies of the Institutes concerned before they commit themselves and their members too far in this sort of quasi-legal activities.

IV Accounting and Management

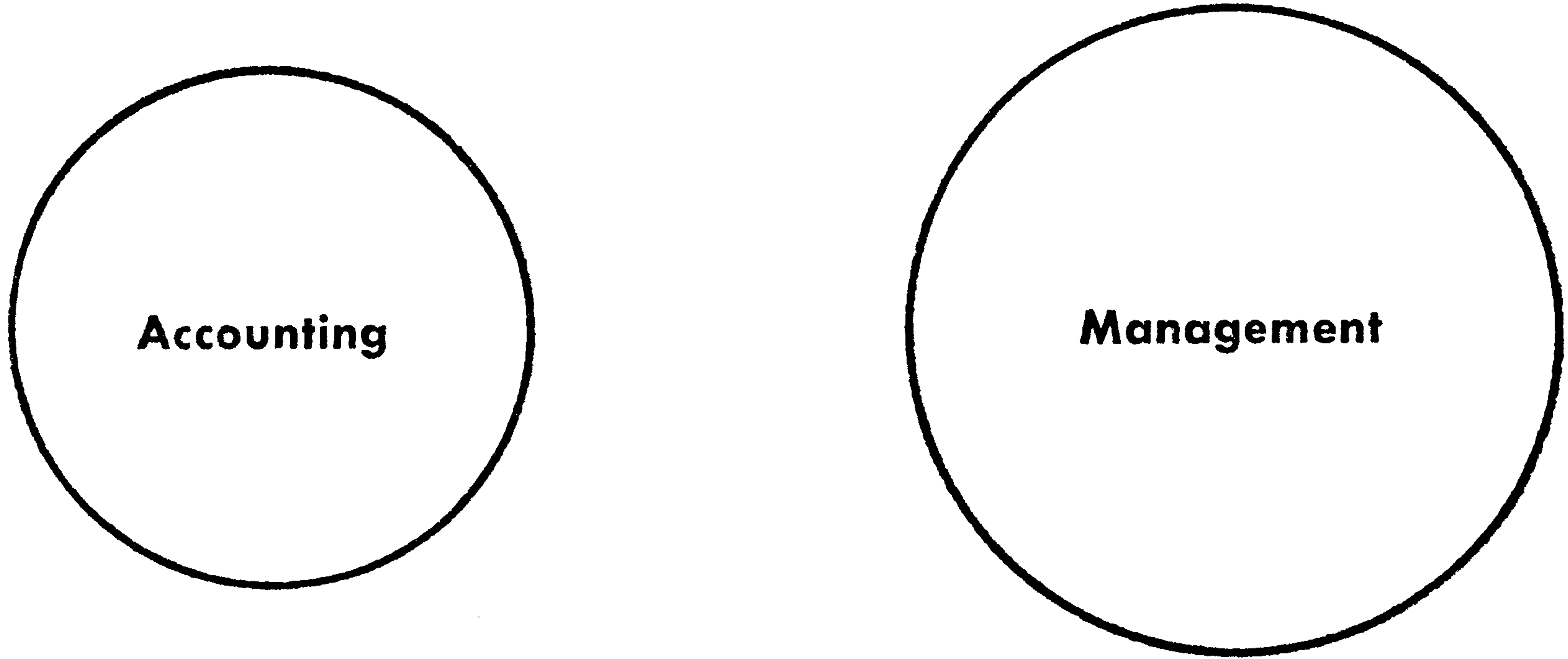
For several years now it has been popular to describe accounting as an aid to management or as a tool of management; innumerable papers have been published and addresses delivered on this theme, and they have been prepared both by accountants who have developed the proposition that accounting procedures being carried out are an aid to managers if they would use and appreciate them, and by managers who have argued, broadly, that accounting should be more of an aid to them than it has been in the past. Both points of view are right of course, in that both managers and accountants could do more, as individuals and as representatives of their type, to appreciate each other's problems and virtues to their mutual benefit. At the same time, both viewpoints are wrong in that they perpetuate a somewhat specious and super-

ficial distinction between two areas of study and activity which, at their bases, have much more in common than appears to be generally or commonly recognised. That is, if the purpose of drawing a distinction between accounting and management is not clearly understood, to make such a distinction gratuitously may well be more confusing than helpful because it is artificial and spurious in respect of a large area of common interest; within this area we can justifiably say that accounting *is* management.

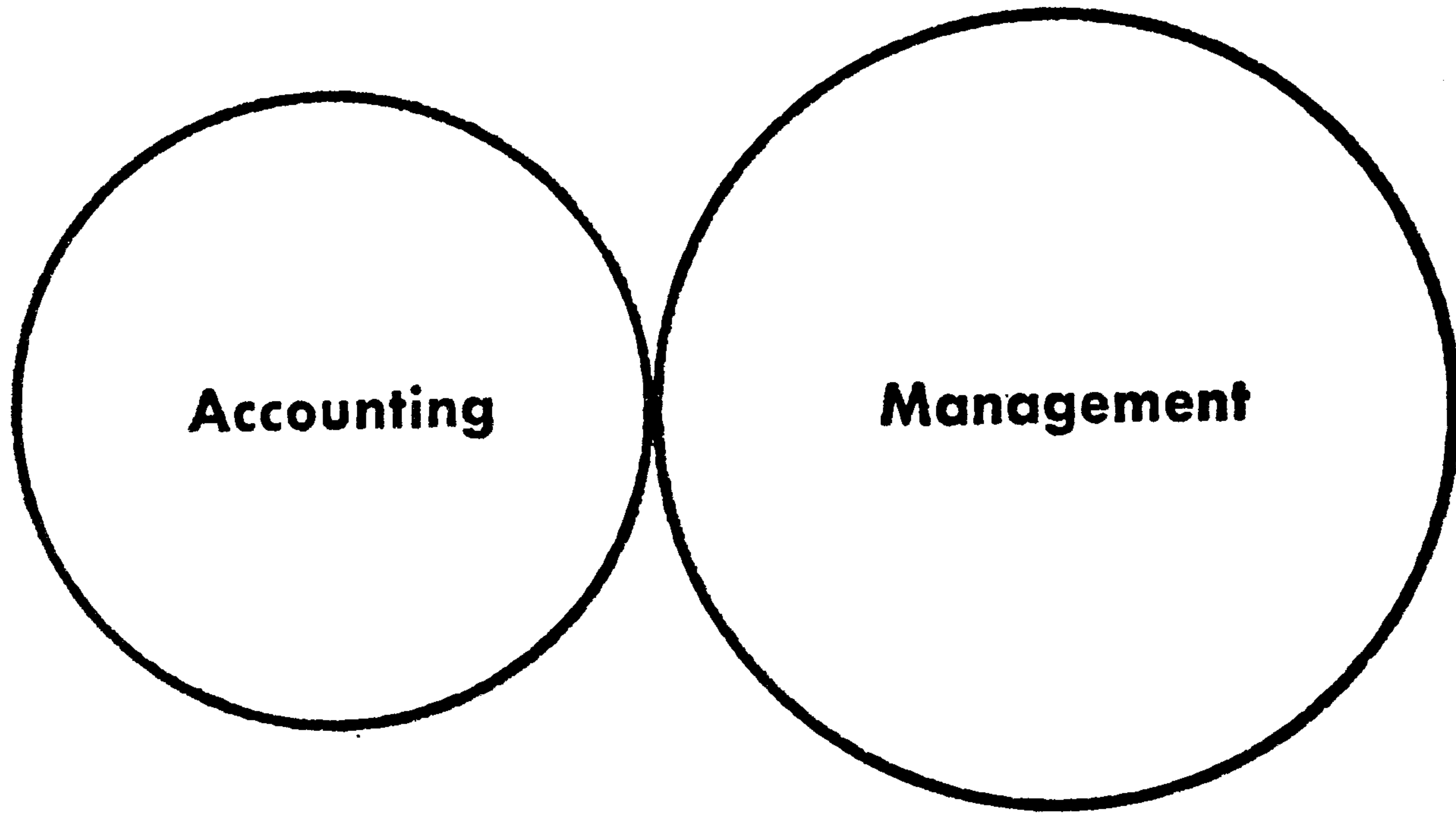
To become an effective manager, and in the course of becoming an effective manager, a person has to know something of accounting. The higher the level of management functions he is required to perform, the greater is the need for such knowledge of accounting. By accounting here we do not mean the minutiae of double-entry recording or the innumerable procedural matters which arise in the accounting processes; it is not necessary, though it may not be disadvantageous, for an effective manager to know how accountants record in detail the phenomena with which they are concerned, but it is necessary for him—if he is to continue to be effective—to understand what it is that accountants do and what meaning the results of their procedures carry. In other words, what it is necessary for the manager to have is not so much a mastery of the recording aspects of accounting as an appreciation of its concepts, meanings, interpretations, limitations and potentialities. It is equally necessary for the accountant to have the same appreciation. Many managers, with a non-accounting background and technical training, have been able to "pick up," with remarkably good effect, these very essentials of accounting, but there are few, if any, managers with any high level of responsibility who can carry out their managerial functions successfully in complete ignorance of the meaning of accounting information or the way in which it can be used.

The evolution—to use a broad term—of this relation between accounting and management may be depicted diagrammatically as follows on page 18.

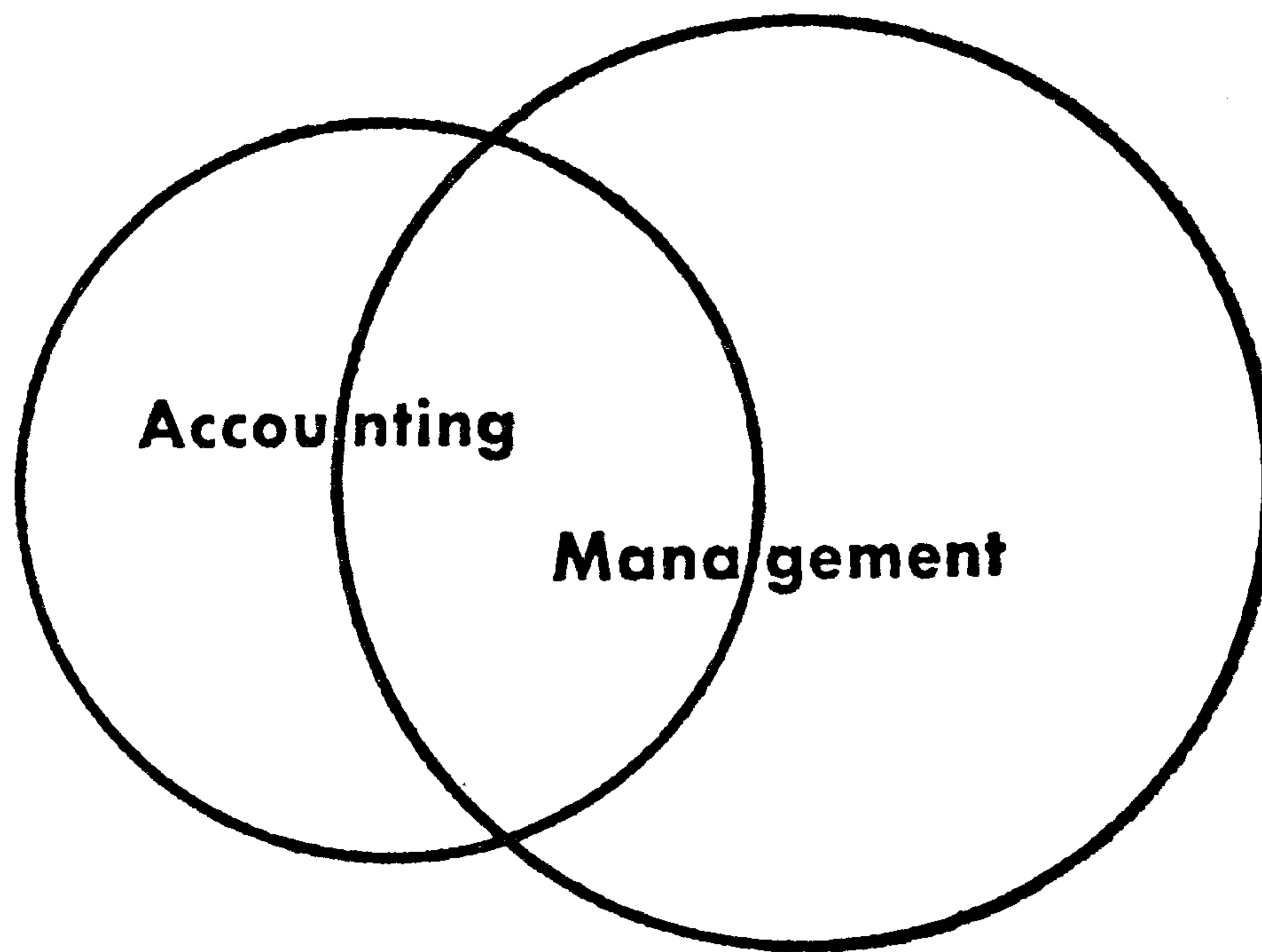
In Stage 1, the two areas are completely divorced or, better perhaps, they have not been introduced to each other. The "accounting" consists of bookkeeping routines with little more than an *aide-memoire* function useful in such business matters as col-



STAGE 1.



STAGE 2.



STAGE 3.

lection of book debts or preparation of taxation returns. In Stage 2, some accounting procedures have been introduced which serve management as well as fulfilling recording purposes, and which are helpful as supplementary data in the making of management decisions; such things as inventory records and cost-finding procedures are in operation. In Stage 3, accounting procedures, specifically designed to provide data useful primarily for managerial purposes, are introduced and integrated with the orthodox accounting routines to provide an information-system with complete "feed-back" of appropriate and adequate data for the carrying out of control and developmental objectives.

This process of "evolution" is not a question of management swallowing or absorbing accounting, neither is it one of accounting infiltrating into management. It is a natural development of increasing mutual awareness between managers (technical and general) and accountants and a recognition that the problems which face the unit with which they are both concerned can best be solved by a joint contribution of their knowledge and capabilities. It is not a matter of accountants as such meeting the requirements of managers as such and thus providing a managerial "tool" while leaving all the initiative in facing problems of management to the managers and themselves preferring to live in their own little double-entry world; it is a case of accountants becoming, in effect, co-managers along with other people who happen to have technical or, rather, "managerial" qualifications. It involves collective responsibility for all the management team of which the accountant is a full member.

On this view, the accountant needs to go further than providing required information to others. He has to seek explanations, suggest decisions and initiate proposals, and, if necessary and in appropriate circumstances, take effective managerial action himself.

This is not to say that the functions of accounting and management cannot be distinguished for certain analytical purposes, nor that the whole of accounting must be known by a manager or the whole of management by an accountant. At the same time, both managers and accountants need to know considerably more of each other's disciplines and fields of knowledge than is, in general, customary at present.

V *Accounting and Government*

In every society there are those who govern and those who are governed; even though, in some cases and to some extent, the people who make a law may be just as much subject to that law as the rest of the community, the function of governing, that is, making laws, is different and distinct from the function of obeying. The purpose of those who govern is to regulate various aspects of living of the governed.

It is beyond the scope of this work to embark on an examination of political and social philosophy which any proper study of government would entail; it appears, however, that the following two basic propositions, which are germane to our consideration of accounting in relation to government, are of at least general, if not universal, validity for modern communities.

The first is that the functions of government are carried out at different social and political levels; in Australia, for instance, we have federal, state and municipal or "local" governments, with more or less distinct geographical and political areas of function, but with some overlapping and interrelationship of interests. Such a hierarchy of governments is typical of practically all modern nations, and while it may, on occasions, give rise to some conflicts of interests and some difficulties in adjustment of various rights, the problems of social organisation make some stratification of government a political necessity.

The second proposition is that modern government is a complicated and difficult matter by reason of both the great diversity of interests of different groups of people within a community and the rapidity with which the circumstances of a community can alter under the influence of technological, political, economic and social changes.

There are three areas of accounting interest to which accountants may apply themselves at each level of government.

In the first place, there is the question of government accounting itself; this involves a study of the procedures developed over a lengthy period to record the events with which a government is concerned, to report them to appropriate persons or groups of persons and to validate them in the interests of those persons and/or

the community generally. In a country with representative government, there are several aspects which raise accounting issues and problems peculiar to the exigencies of government, and government accounting has several distinctive characteristics which are not found in accounting for other enterprises or institutions.

In the form of government with which we are most familiar in the English-speaking world, the necessity to prepare annual governmental estimates of receipts and expenditure on a cash basis for consideration and deliberation by parliament or council each year, and the requirement to account specifically for expenditure under each head of expenditure, which is rigidly restricted to the amount submitted at the beginning of the year, as well as for special "funds," such as trust funds and loan funds, which have developed outside the strict "treasury" system, have served to make government accounting a distinctive area of study to which few accountants, apart from those who are themselves employed by governments, find the time or inclination to apply themselves. Further, the broadening of the functions of modern government to include so-called business undertakings—such as the supply of water, electricity or gas, the provision of public transport, the conduct of postal or telegraph services, and the like—has created problems of accounting which cannot readily be solved by reference either to the traditional procedures developed for "normal" government departments which have solely or predominantly spending or revenue-raising functions, or, on the other hand, to those developed to account for profit-earning, private enterprises.

Secondly, it would appear, at least on the face of things, that accountants are or ought to be the people in a community who, by their training and interests, are best fitted to be the intelligent and knowledgeable critics of a government's management of the resources entrusted to it in so far as this is revealed by accounting and financial information. They are in a position, especially in a democracy, to exercise a wholesome function as constructive critics of the ways in which the government is carrying on its affairs, particularly in their economic and financial aspects. Indeed, it is not too much to say that accountants have a social responsibility to analyse and interpret at least those government reports

which deal with financial matters. To do this, it is obviously necessary for them to understand at least the basic principles of public finance and the characteristic features of governmental accounting. It is true that there are many instances in which governments have appointed accountants from outside government spheres to act as members of boards, committees or commissions of enquiry into aspects of government activity; despite this, however, the exercise of the accountant's analytical capacity has not been widely directed in the past to consideration of government activities as much as it might have been and perhaps as much as it ought to have been.

It is also true that the government accounts are audited and that the people appointed to carry out this task perform their functions thoroughly and well. An auditor's task is completed, however, when he reports to the person to whom or the body to which he is directly responsible, and, in the sphere of government, there is often need for some notice to be taken by people other than the auditors if appropriate action is to result from the auditors' reports. For example, with representative government, if there is a weak opposition in parliament, adverse comments on administration or suggestions for improvement in methods contained in the report submitted to parliament by the Auditor-General might be quite ineffectual unless somebody does something to exert influence outside parliament, such as marshalling "public opinion." Under present circumstances, the reports of auditors-general rarely attract much attention unless they contain some sensational disclosures which the daily press can convert into "news" or propaganda. Seldom are they discussed in the journals of professional accountants who would be—or should be—in a position to consider them with discrimination and understanding.

It must be recognised that decisions made by governments often have long-term and serious effects upon the community and that government revenue and government expenditure nowadays are *big* revenue and expenditure. The people in a community need to be assured that public moneys are properly accounted for and that they are not wastefully employed or used on projects which have not been publicly approved—this is the government auditor's task; but they also need to be satisfied that standards of gov-

ernment performance reach a level which they can reasonably expect—and, in the sphere of financial and economic activity, this is a task for experts outside government spheres, and one which accountants in the community might reasonably be expected to undertake.

Thirdly, there are problems of "private" accounting arising from the relations between private enterprises and the government. The most obvious of these relationships, and the one which has received by far the greatest amount of attention from accountants, and perhaps by governments also, is that of taxpayer and tax-gatherer, especially in relation to income and profit taxes. There are other important relationships, however, such as that between the direction and timing of investment in private enterprise on the one hand and national economic or social policy on the other, or that between private enterprises engaged in manufacturing goods for use in governmental operational programmes; and the need, for example, to have sound and adequate aggregative information for purposes of social planning may have repercussions upon the ways in which accountants are required to interpret, record and report events for individuals and groups within the community.

CHAPTER 2

The Relation Between Accounting Theory, Accounting Doctrine and Accounting Practice

I On the Dangers of Definition

IN EMBARKING upon an enquiry into the scope of accounting, it might, at first sight, seem logical that the first step should be to define accounting. To be sure, this would provide a neat and tidy approach, and is a suitable method of opening for a text-book in which the exposition comprises a development of the implications of the definition(s) initially propounded. Indeed, quite a large number of text-books in accounting, as in other fields of study, do proceed along these lines.

However, there are several reasons for avoiding this procedure in the present case. In the first place, the present work is not and does not purport to be a text-book in accounting procedures; it is not a book in which rules are laid down for students (or practitioners) to follow; it does not purport to be a book of authority in the sense that the author is attempting to teach something categorically to the reader. Rather is it a joint adventure to be undertaken by both writer and reader, in which the former can only point out paths along which he thinks the reader may wish to travel; paths which may lead anywhere—or nowhere. It is intended to explore some of these paths to some extent, but it is not pretended that even those paths have been followed as far as they will go, nor that alternate routes do not exist. It is hoped, therefore, that the dogmatism which often results from initial formal definition may be avoided.

Secondly, if a definition is to be relevant at all, it delimits the scope of discussion, whether it is submitted for that purpose or not. To put it metaphorically, a definition erects a wall around a field of discussion and, if one does not agree with the definition presented, one often finds oneself outside the wall, shut out from at least a large part of the discussion; alternatively, if one agrees in part with the definition, one may find oneself shut inside the wall with no means of getting out or even of obtaining a view of the country which lies outside. As John Stuart Mill pointed out long ago, "it is not to be expected that there should be agreement about the definition of anything, until there is agreement about the thing itself."[1] Let us first strive to reach agreement about the thing—in this case, accounting—and the definition may well follow.

Thirdly, there appears to be some doubt among logicians themselves as to what comprises a definition and what its purpose is. For instance, Susan Stebbing[2] discusses such various types of definition as extensive definition, ostensive definition, biverbal definition, definition *per genus et differentiam*, analytic definition of an expression, definite description and genetic definition; some of these, although recognised by some logicians, are, in her opinion, inadmissible as valid definitions. And on the question whether we define expressions or what the expressions stand for, she contends that the view of many logicians that it is the latter that is defined is mistaken; she agrees with Mill that "all definitions are of names, and of names only."[3] Mill further points out that "in some definitions, it is clearly apparent that nothing is intended except to explain the meaning of the word, while in others, besides explaining the meaning of the word, it is intended to be implied that there exists a thing corresponding to the word. . . . There are, therefore, expressions commonly passing for definitions which include in themselves more than the mere explanation of the meaning of a term."[4] And although Stebbing is in

[1] John Stuart Mill, *A System of Logic,* Introduction, Sec. 1, p. 1.

[2] L. S. Stebbing, *A Modern Introduction to Logic* (London: Methuen & Co., 5th Ed., 1946), pp. 422 ff.

[3] Mill, *op. cit.*, Book I, Ch. VIII, Sec. 5, p. 93.

[4] *Ibid.*, pp. 93-94.

agreement with this position in her discussion on definition, she begins her chapter on the theory of definition by stating that

> definition is an aid to clear thinking and, therefore, to the communication of thought. . . . We can define words only when we understand them. We understand a word when we know what it is to which a word refers or when we can use it significantly in combination with other words.[5]

However, if we understand what a word refers to, does not this reference introduce the "thing," that is, an object or concept or person outside the word itself? Is not the important matter that of communicating thoughts about things rather than about words?

Further, we are concerned with the question: What is accounting?, and a definition at this stage would of necessity presuppose the course and result of subsequent discussion. Admittedly, of course, we must have some general notion of what the principal term—acounting—relates to; one would not expect to find, in a work on accounting, a discourse on ballroom dancing or the care of tropical fish, although, it seems only fair to warn the reader, our enquiry may indeed take us into some strange and unwonted territory (that is, strange for accountants). Some idea of the field of accounting procedures is presumed, however, and it is hoped that there are few reasonably educated adults in our society who have not some such idea—even if many people at present do think of accounting merely as the distasteful task of adding up columns of refractory figures in nauseating books and documents. Even that may be sufficient to understand the treatment which follows.

Another reason for avoiding a definition at this stage is that accounting may be defined differently by various persons according to the particular point of view. We shall have to consider some of these points of view because the point of view colours the form and direction of discussion, but an initial definition from a particular point of view would necessarily ignore or at least underemphasise other points of view which may, in fact, be just as legitimate as the point of view adopted.

The process of definition (especially definition *per genus et differentiam*) is largely a part of the process of classification, and when a definition is offered the basis of classification is often presupposed. Frequently, given a certain basis of classification, the

[5] Stebbing, *op. cit.,* p. 421.

definition of terms within that classification must conform to a pattern in accordance with it; with a different basis of classification, a different definition is almost inevitable.

All this does not mean that it is undesirable to define accounting at any stage or for any purpose. Nor does it mean that none of the terms used in the following discussion are to be defined. It means, simply, that definitions will be introduced only as considered necessary to enable the inquiry to go on, and that since "the definition we set out with is seldom that which a more extensive knowledge of the subject shows to be the most appropriate"[6] it is more fitting to postpone postulating any short definition of accounting at least until a later stage of the inquiry if, indeed, it is desirable at all. After all, the really important thing in any discussion is that each party should make his arguments clear to the other (or others) so that the latter may be able to interpret them correctly and exercise his judgment as to their validity; if a formal definition is necessary for this purpose, it should be used; if the objective can be reached without formal definition, then its use may be not merely unnecessary, but in some cases unduly restrictive.

II The Historical Perspective

The history of accounting still remains to be written—or, to be more accurate, I know of no study in the English language that gives a comprehensive and satisfying account of the origin and development of accounting. For example, despite the interesting and valuable work of such researchers as Peragallo,[7] Littleton,[8] Murray,[9] Brown and his associates,[10] and the de Roovers,[11] a de-

[6] Mill, *op. cit.,* p. 1.

[7] E. Peragallo, *The Origin and Evolution of Double Entry Bookkeeping* (American Institute Publishing Co., Inc., 1938).

[8] A. C. Littleton, *Accounting Evolution to 1900* (American Institute Publishing Co., Inc., 1933).

[9] David Murray, *Chapters in the History of Bookkeeping and Accountancy* (Jackson Wylie, 1930).

[10] Richard Brown (Ed.), *History of Accounting and Accountants* (Edinburgh: T. C. & E. C. Jack, 1905).

[11] Florence Edler de Roover and Raymond de Roover have written numerous excellent articles on early accounting records. See, for example, "Partnership Accounts in Twelfth Century Genoa" by the former and "The Development of Accounting Prior to Luca Pacioli According to the Account-Books of Medieval Merchants" by the latter, in A. C. Littleton and B. S. Yamey, *Studies in the History of Accounting* (London: Sweet and Maxwell, 1956), pp. 86 and 114 respectively.

tailed account of how and where double-entry recording originated is still not available, let alone a satisfactory explanation of the reason why it came to be used at the time and place (or places) it was used. On this matter, of course, the original source material is not readily available to the English student; indeed, it may not be available at all, and what original material is available is in Latin or medieval Italian. Whatever the reason, however, this constitutes one serious gap in our knowledge of accounting. Further than this, neither has there yet been written a history of accounting in the nineteenth century, during which the major developments almost certainly took place in English-speaking countries—an exposition weaving threads of development into a useful cloth of history. The difficulties as to source material in this case are surely not as great as in the former; but no one with the requisite capacity and scholarship has yet come forward to fill this second serious gap in our knowledge of the history of accounting.

Very briefly, the story of accounting development as it appears from available secondary and tertiary sources in the English language, runs somewhat as follows.

There is evidence that the cultures of ancient Babylonia, Chaldea and Egypt included a function of recording of transactions in relation to an organised community of some economic complexity. There are extant clay tablets and papyri exhibiting records of a commercial and fiscal character, in which measurements of a quantitative nature give an appearance of an accounting, or at least a bookkeeping purpose to them. In the literature of the ancient Greeks there are references also to fiscal accounts and audits, while in Rome the keeping of accounts for private as well as public matters was apparently well developed. Some investigators, indeed, have read into the legal aspects of Roman account keeping sugestions of double-entry recording, but it has been shown that the Romans did not use double-entry or any close approximation to it.[12]

[12] G. E. M. de Ste. Croix, "Greek and Roman Accounting," in A. C. Littleton and B. S. Yamey, *Studies in the History of Accounting* (London: Sweet & Maxwell, 1956), pp. 14-74. One writer has questioned de Ste. Croix's conclusion in respect of one papyrus of 191 A.D. See David Green, Jr., "Financial Statement Working Papers," *Journal of Accountancy,* October, 1961, pp. 49-50.

It is generally agreed now that the characteristic features which distinguish double-entry recording from other techniques were developed in the commercial city-states of Italy in the later Middle Ages. Pacioli, writing in 1494, expounded a system which had been in use for a long time, the earliest known double-entry records being those of the commune of Genoa, dated 1340. What the problems were that double-entry was designed to solve, to what extent it was successfully applied, and to what stimuli it was a reaction, are questions which do not appear to have been adequately explored; it seems not unlikely, however, that the answers to these questions may well be important in throwing some light upon matters of theory and practice which concern us very greatly today.

The technique of double-entry recording has been modified and improved in the centuries since 1494, but the fundamental basis of the bookkeeping process has not been altered. During the nineteenth century, however, new problems, arising from the commercial and industrial revolution whose effects first became evident in England, faced the controllers and managers of the property and economic processes involved in this development. The device of the incorporated limited liability company was the answer to two problems specifically raised by the accelerating economic development of the late eighteenth and early nineteenth centuries, namely (i) the requirement of a marshalling of investment of a quantity previously unthinkable for industrial, commercial and financial ventures, and (ii) the need for protection both of creditors who were often at a grave disadvantage in dealing with unincorporated joint-stock associations, and of members of such associations who were, legally, partners with unlimited responsibility to each other and to creditors. The divisibility of proprietary contributions into transferable shares was not a new phenomenon—it was used by many of the unincorporated joint-stock associations in the eighteenth century—but when it was coupled with recognition of a legal entity distinct from the shareholders themselves who owed it a strictly limited contributory duty, one of the most significant and fruitful inventions of modern times was devised.

This device was no less significant for accountants than it was

for business men, economists and lawyers. It was very largely, although not entirely, due to the advent of the company that the "accomptant" of the beginning of the nineteenth century—who combined with the duties of financial record-keeping such functions as those of writing-master, teacher of arithmetic, agent or dealer—was transformed into the professional accountant and auditor of the end of the century, with a well-developed technical skill, a high sense of moral as well as legal responsibility and an ideal of service consciously motivating his professional activities. But more than this, the company focussed attention upon certain aspects of accounting theory, the implications of which are still being worked out. Incorporation of a company created a new legal entity in terms of which accounting had to be carried out; a new accounting point of view was therefore created. Although it is possible that this point of view might ultimately have been developed in relation to other forms of organisation existing in the eighteenth century—consideration of the unincorporated company or the trust might eventually have brought this about—there is little, if any, evidence that any point of view other than that of the proprietor was considered before about the middle of the nineteenth century. The creation of a corporation "with no soul to be damned" meant also the creation of an entity with characteristics of potential immortality; there is no inherent reason why a company should not endure forever, or at least beyond the foreseeable future, as a "going concern." The recognition of continuity as a basic factor in accounting procedures derives great emphasis, if not its whole existence, from the company. Allied to this is the requirement for periodical assessments of results and consequent financial position; and although there is some evidence that the problem of periodical reporting, with its implications of the capital/revenue distinction, was being recognised before the nineteenth century, it is clear from a consideration of the legal cases relating to divisible profits of a company which were decided in the latter part of the century that the problem had to be squarely faced when the interests of shareholders in and creditors of a limited liability company were involved.

It is therefore important to recognise the great influence which the company has had on accounting theory, but at the same time

it is also important to avoid over-emphasising it. There are some phases of accounting which owe little to the advent of the company as such. For example, the development of cost accounting in something very like its present form would no doubt have been necessary whatever legal device might have been used to meet the problem of large-scale production and distribution. As another example, the levy of an annual income tax would sooner or later have almost certainly directed attention towards the problem of capital and revenue in at least some of its aspects. And the wider problems of social accounting, in the sense of the aggregation of results for purposes of national economic planning, have arisen in recent years with practically no direct reference to any particular form of economic organisation.

Thus it seems likely that, even in the absence of limited liability companies, accounting might well have developed along rather similar lines to those it has in fact followed, but it is also likely that, if this had been the situation, its progress would have been more leisurely, its professional growth much slower, and perhaps—at this stage at least—its unresolved problems fewer.

III The Analytical Perspective

Let it be premised that we deal in accounting with the recording and reporting of events. These are far from being the only matters covered in accounting, but they are pretty fundamental. Written records, or at least records not of a purely ephemeral nature, are almost indispensable for accounting—almost but not quite. It is conceivable, but not likely, that a human being could carry out accounting procedures mentally without recourse to writing or some other form of recording and carry the results "in his head." A person who did this for the full range of accounting procedure for any given unit of activity would be a rare phenomenon indeed, but not so rare is the person who does it in part. Some of the keenest and most successful business men have been able to "see" the results of transactions as if they were dealt with in accordance with accounting precepts without anything being written or otherwise recorded. Of course, this does not make accountants of them, but it enables them to appreciate what might be called the accounting effects of transactions. Further, in this

modern age, the electronic computers now coming into our lives make it appear that what is an unlikely achievement for a human being can become an accomplished fact for a robot.

Although there may often be evidence of the *effects* of mental processes, such processes, however relevant or significant they may be, cannot themselves be isolated and captured for investigation —at least under existing circumstances. Hence it may be taken that, in general, accounting records, reports, documents and so on are still in writing or its equivalent.

Professor A. C. Littleton[13] has listed the essential elements (antecedents or ingredients is his expression) of double-entry bookkeeping as writing, arithmetic, private property, money, commerce and capital, and he enumerates them schematically as follows:—

1. A Material (something which needs to be reworked)
   a. Private property (power to change ownership)
   b. Capital (wealth productively employed)
   c. Commerce (interchange of goods)
   d. Credit (present use of future goods)
2. A Language (a medium for expressing the material)
   a. Writing (a means of making a permanent record)
   b. Money (medium of exchange, "common denominator")
   c. Arithmetic (a means of computation)

These elements, when energized by favorable economic and social circumstances, produce:

3. A Methodology (a plan for systematically rendering the Material into the Language)

This methodology is bookkeeping.[14]

From the historical point of view with which the learned author was concerned, it may have been true that all these elements were necessary for the historical emergence of bookkeeping. But from an analytical point of view it is at least open to question whether these seven elements constitute the minimum conditions necessary to the application of the technique (a word which is here considered preferable to "methodology") of double-entry recording. It must be pointed out, also, that Littleton is using the word "bookkeeping" in no narrow sense, since he insists that not only

[13] A. C. Littleton, *Accounting Evolution to 1900* (New York: American Institute Publishing Co., 1933), pp. 12 ff.

[14] *Op. cit.*, p. 13.

are equilibrium and duality necessary before complete double-entry bookkeeping is possible but also proprietorship,

> that is, a direct ownership of the goods handled and a direct claim upon the income which emerges. . . . The *form* of complete bookkeeping is the duality and equilibrium which derive from early record-keeping precedents; the *substance* consists of proprietary calculations of the gains (or losses) from ventured capital.[15]

Thus for him double-entry bookkeeping is the "organized instrumentality" for measuring and explaining the "tangible results" of the "ownership of property and its dedication to gainful activities."[16] With these ideas as the basis of his enquiry, he has built up an ingenious and plausible hypothesis to explain the emergence of double-entry recording in the later Middle Ages, but it must be emphasized that, as he himself agrees,[17] his hypothesis is a surmise for the support of which conclusive historical evidence is not yet available. This, however, is by the way for our present purpose. More apposite is his list of ingredients.

The "material" of his first group comprises, in effect, a field of human activity within which phenomena occur or appear; the "language" of his second group constitutes a means whereby certain of these phenomena are expressed for human interpretation (including, very largely, measurement). Some of the questions which arise, and to which attention must be paid, are: What is the nature of the phenomena which are relevant for accounting purposes? What is the basis of their selection, or, in other words, what distinguishes them from other phenomena arising out of human activity? What is the purpose of selection and measurement? To what extent is this purpose successfully served?

Questions such as these suggest that there is a field for investigation in accounting which is analogous in scope to that of jurisprudence in law; and that the problems involved in these questions are additional though closely related to the problems of technique which normally form such a large part of accounting study. There is a practice of law which embodies rules of procedure, developed through centuries of legislation, codification and legal interpretation; but there is also a theory—or, rather, there are also

[15] *Op. cit.*, pp. 26-27.
[16] *Ibid.*
[17] *Op. cit.*, p. 40.

theories—of law which seek to explain the means by which the practice has developed and in terms of which practice may be modified. Thus one writer on jurisprudence distinguishes between "the pure science of law, functional (or sociological) jurisprudence, and teleological jurisprudence"[18]: he quotes another as suggesting "analytical jurisprudence, sociological (or functional) jurisprudence, and finally the theory of justice."[19]

In a somewhat similar way there is a practice of accounting which has been developed over a long period and—whether this has so far been generally recognised or not—this practice reflects a theory underlying it. This theory has not (or perhaps it should rather be these theories have not) as yet been explicitly and satisfactorily expounded in detail, although some attempts have been made in relatively recent years. It is the purpose of the present work to present an outline of such a theory.

IV A Suggested Classification of the Province of Accounting

If we are to succeed at all in analysing the phenomena of accounting, we need some tentative classification at least. There are three areas of investigation in accounting which may be distinguished and which, for convenience, may be called respectively accounting theory, accounting doctrine, and accounting practice. The characteristics of each of these may be thought of in outline as follows.

In the field of accounting theory we may include any attempts to discover statements of general principles and/or notional axioms which may be referred to for the logical solution of practical problems or for a rational explanation of current practice or past practice. If a high-sounding new term is desired to designate this field, the word "euthunology" has been coined (from εὐθύνα, euthuna, examination of accounts) and is offered to those who may wish to use it to impress their intellectual neighbours.

Accounting doctrine comprises statements of procedures in accounting which, according to the proponent, ought to be followed.

[18] G. W. Paton, *A Text Book of Jurisprudence* (Oxford University Press, 2nd ed. 1951), p. 3.
[19] *Ibid.*, p. 3n.

From this point of view, accounting is the study of the best means of achieving certain envisaged results, and aims at setting up accounting standards. Accounting doctrine in this sense is the method of most text-books on accounting; it also underlies legislative and similar enactments which affect accounting procedures. It may be regarded as the normative view of accounting; its method is authoritarian, in the sense that its propositions are accepted because they are promulgated by an authority—individual or group —whose pronouncements are either respected or feared. The word "euthunosophy" might be favoured by some who wish to coin a new expression to denote this idea.

The field of accounting practice comprises statements of what accounting procedures are in fact followed in particular cases and the factual results of these procedures. The point of view may be expressed as "Accounting is what accounting does," or, more precisely, "Accounting is what accountants do"; that is, it may be regarded as a functional view of accounting, the method of application being pragmatic and that of investigation being chiefly inductive. It is suggested that the word "euthunetics" might be coined if a new expression is desired to indicate this field.

This classification is suggested as an instrument of inquiry only It is recognised, of course, that all three—accounting theory, accounting doctrine and accounting practice—react and interact upon each other and are not in fact divorceable except for purposes of analysis. In the next three chapters we shall consider each of them in turn in a little detail.

The Basis of Accounting Theory

I The Nature of Accounting Phenomena

IN CONSIDERING accounting theory as here envisaged, the first matter to be examined is the nature of the phenomena with which the procedures of accounting are concerned.

As a first approach, the facts of accounting may be postulated as objective data which can be observed, and comprise things and persons possessing a certain physical objectivity. Solipsists—if there are any left nowadays—might object to this, saying that the self knows and can know nothing but its own modifications and states, that the self is the only existent thing, or that all reality is subjective. The contrary is assumed as a starting point; if this assumption is false, all that follows is wrong. This possibility is not denied, but if the assumption is false then all our everyday activity is based on this same false assumption, for we act continuously as if the self can and does take cognisance of things and occurrences outside it.

It is perhaps apposite to recall the story told by Kai-Lung[1] about the Mandarin T'sin Wong, who, after his pigtail had been mysteriously abstracted from his person, summoned a council of wise men to solve the problem of his missing pigtail. During the deliberations of the council the following exchange is reported to have taken place.

"Thus positioned," urged one who styled himself an Accurate Thinker, "would it not be feasible to maintain—as all solid matter is consentably a

[1] Ernest Bramah, *The Moon of Much Gladness* (London: Cassell & Co., 1932). See p. 48.

deception of the mind, possessing no substantial being—that the disappearance of the pig-tail is in the nature of an untenable illusion?"

"Admittedly," replied Tang-san, with a slight corrosion on the polished surface of his usually indulgent voice, "if, when we are called upon to disclose a practical solution, the accommodating upholder of this view will equally produce the material illusion that the pig-tail is now back again in its natural position. Failing such a manifestation it is extremely likely that the impartial-handed law-giver would direct the resourceful theorist's very picturesque head to be detached from his really ornamental body, on the plea that to do so charitably removed an incongruous hallucination."

The position adopted here agrees with that of Tang-san.

We start, then, with a world of persons who can and do apprehend things and other persons. In this context "things" may include non-material or non-tangible activities and services as well as tangible objects.

When we speak of Thomas Smith being the owner of a store, or of Edward Jones being a debtor, or of Arthur Robinson being a shareholder, we have for these personal names specific referents outside ourselves which can be readily comprehended. When we speak of buying a roll-top desk, or installing a blast furnace, or selling a high-speed lathe or a box of matches or an Encyclopaedia Britannica, or using a thousand cubic feet of town gas or a kilowatt hour of electricity or taking a course in public speaking, we have again specific referents, within fairly narrow limits, to inanimate things which we normally experience little difficulty in understanding. These, it is suggested, are the basic data for accounting.

We do not, however, account for persons or things *as such*—that is the field of the medico, the psychiatrist, the physicist and the chemist—but rather for certain relationships which are taken to exist between persons and between persons and things. Now relationships, in contrast to the persons and things comprising our primary objective data, are reflections of the human mind, that is, of a mental attitude which abhors and cannot understand chaos, which seeks orderliness in the objects of its comprehension and which cannot rest satisfied until it finds order in them or imposes order upon them.

Relationships between individual persons and between individual persons and individual things are the terms in which accounting standards and procedures are to be explained, and it is the

nature of these relationships, which are, it must be remembered, human constructs, which has to be examined if we are to find a basis for accounting theory.

One of the tasks of the accounting theorist is to elucidate the characteristics in relationships that make them accountable. It is submitted that, while there are many relationships between persons which do not involve things, most of these are not normally accountable relationships. That is, if relationships between persons are to be accounted for (in the technical sense of this term and not in the sense of "explained"), then they must bear some proximate or ultimate reference to things; that is, an accountable inter-person relationship is dependent upon the common interest of the persons in some thing or things. There are, obviously, many inter-personal relationships which have no reference to things and which are not the subject of accounting; some of these are socially and legally recognised, such as the relationship of marriage or parenthood, some of them are socially but not legally recognised, such as political or religious affinity or a common scientific interest; but unless these relationships can be expressed, either directly or indirectly, in terms of things lying outside the self or person, they do not come within the scope of accounting.

II Basic Social Relationships

It is submitted that accountable relationships are chiefly (though not solely) social in character, that is, they derive the greater part of their meaning from a social context.

The recognition of relationships between persons and between persons and things (as also those between one thing and another thing) constitutes an act of abstraction, which, while necessary to give meaning to the world around us, involves us by its very nature in notions or concepts. These are the very stuff of which culture is made, and it is with some of these (but only some) that accounting is concerned. It is important to recognise that accounting is concerned, in essence, with notions or concepts and that most of these are aspects of social relationships and are not inherent in persons or things as such. Whether there are, indeed, any such inherent qualities or relationships at all need not

concern us here, so long as we recognise the nature of the social relationships.

Of the many relationships dealt with in accounting, two appear to be generally recognised in practically all societies and, indeed, seem to be socially necessary; that is, it is difficult to conceive a society in which they are not recognised at all.

The first of these is the relationship of persons to property of various kinds. It is not, of course, contended that there is any universal or natural right to private property, since it is not impracticable to conceive a society in which all property belongs to the community as a whole. In fact, however, all societies include some aspects of both private and communal property ownership, the various combinations of which comprise an extensive series of gradations. As one anthropologist puts it,

> another tendency which seems to be almost universal among human beings is the acquisitive one . . . it is clearly recognisable at the sub-human primate level. Apes will fight for food, and the stronger will take it from the weaker. Their reactions differ from those of men in this respect mainly in that they have much less tendency to hoard. Apparently they lack the foresight necessary for this. Men, being able to look ahead, try to provide for the future. Their acquisitive tendencies are never completely lulled, and as a result we find that all societies have had to develop techniques for ensuring a share of the necessities of life to all their members. At the same time, there is no society in which there is a complete ownership of property. A man's trousers, or their local equivalent, always belong to him. It may be taken for granted by other members of the group that if a man has two pair of trousers he will pass over one of them to any one who happens to find himself trouserless, but this does not nullify the fact of ownership. The owner merely becomes a donor and is repaid in gratitude and social prestige.[2]

And again, "although all societies recognise the existence of individual property, all of them also place certain limits on its acquisition."[3]

> Even when patterns of individual ownership are well developed [he also states], it is not uncommon for the clan as a corporation to retain a sort of residual interest in its members' property and to be able to veto the sale of land or valuables to outsiders. This situation probably derives from the fact that as long as the patterns of mutual assistance between clan members remain strong there is a pooling of economic resources within the clan in practice if not in theory. The group can draw on the resources of its component individuals in time of need. The sale of property, especially land, to

[2] Ralph Linton, *The Study of Man* (New York: D. Appleton-Century, Inc., 1936), p. 142.

[3] *Ibid.*

outsiders thus means a reduction in the capital of the clan as a corporation, and it is natural for it to take an interest in such transactions.[4]

Even in the conceptually possible society in which all property is communally owned, a right to property, vested in the community itself, would exist.

A right to property constitutes a relationship between individual persons or groups of persons and things or, in the case of our conceptual society, between the community (an aggregation of persons) and things.

However, a right to property appears to be meaningless unless it is envisaged as a right against some person or group of persons, and it is this which constitutes the second socially necessary relationship in the field of accounting. Where all property is communally owned, no individual or group of individuals within the community would have any *ownership* rights against anybody else within the community, but even in this case it appears inevitable, except in the most altruistic and anarchistic kind of society, that individuals and groups should have rights of *use* against others. And if a right to own or to use personal property is recognised, as it appears to be, in all known human societies, rights against other persons and obligations towards other persons (these generally being the obverse and reverse of the same relationship) necessarily follow. Thus, this property relationship between persons and things is necessarily accompanied by a relationship between persons.

In some cases, the individual's rights are extended to others in a group without being quite lost. For example, one writer has pointed out that amongst the Australian aborigines of Arnhem Land,

> no man would think of using the weapons or personal possessions of another without specific permission. To do so would lead inevitably to a fight. But there are a few well-defined exceptions to this rule which occur in some special relationships within the kinship system, where behaviour is marked by much freedom, and in which relatives of certain orders . . . borrow one another's *gerri* without permission and without any fear of resentment or reprisal.[5]

[4] *Ibid.*, p. 204.

[5] Donald F. Thomson, *Economic Structure and the Ceremonial Exchange Cycle in Arnhem Land* (Melbourne: Macmillan & Co., 1949), p. 54. "Gerri" means goods or possessions.

Among these people, even minor theft is regarded very seriously, yet within certain recognised kin relationships much freedom in use of individual possessions is permissible. The author emphasises the point that "although material possessions among these people are simple and relatively few, the question of individual ownership of property and the right to dispose of this, is never in question."[6]

Another anthropologist has pointed out some other complexities of property in certain primitive societies: for example, while in some communities a desire to enhance his reputation may lead a man to accumulate food or cows or canoes, in some others it may lead him to the opposite activity, such as deliberately giving more than he receives in an exchange, or expending his resources in marrying off his son or burying his father, or, in an extreme case, destroying his most valued property in order to outface a rival in public esteem.[7]

These instances are cited simply to suggest that we should not be impervious to the fluidity of the notion of property, and, indeed, some of our ideas about it are undergoing change in our own society in our own time.

> We have moved, in short, from the idea of property as real assets, such as land, gold, or cattle, to the idea of property as promises: securities, mortgages, bonds, bankbooks, and paper money. All these are symbols of ownership; they do not connote actual possession.[8]

Yet despite its variations, there is a persistent notion of property which can be recognised. But this is not to say that in certain circumstances an individual person may not be deprived of his property rights, and, indeed, in the case of slavery, human beings themselves have been reduced to the status of things (chattels). But, to the extent that this takes place, the individual loses his rights against other persons. It is recognised, too, that a person may lose or may not acquire certain property rights and yet hold certain other rights, such as a right to vote or a right to protection against criminals. The property relationships, however, have far greater significance for accounting than other social relation-

[6] *Ibid.*, p. 55.

[7] See Raymond Firth, *Human Types* (New York: Mentor Books, 1962), p. 65.

[8] Richard Eells and Clarence Walton, *Conceptual Foundations of Business* (Homewood, Ill.: Irwin, 1961), p. 177; see also pp. 175-97 for some slight elaboration of the evolution and fluidity of the current notion of property.

ships because they are in fact often measured, whereas the others are in fact rarely measured; but, if suitable units of measurement could be devised, there is no inherent reason why any phenomena related to these could not be accounted for in accordance with the techniques developed by accountants over a long period of accounting for property relationships.

III *Accounting Measurement*

Accounting needs for its existence not only something to be accounted for, but also a means by which the "accounting for" may be accomplished; this means is measurement. That is, the objects of accounting must be measurable, for measurement is of the essence of accounting.

This does not mean that at the most fundamental level of accounting a common or widely used unit of measurement is necessary; it means only that units of measurement are necessary. It is conceivable that in a community one man might account in terms of sheep, another in terms of gold pieces, and a third in terms of shark's teeth, and the records of each would be none the less accounting records for that. Indeed, a person may even use a method of simple counting without the use of any unit of translation into a common measure and yet maintain an accounting record. For example, a valid statement of resources could be prepared in the following form and it would possess the characteristics of an accounting statement:

	Sheep	*Horses*	*Cows*	*Pigs*
On Loan to A.B.	2	1	1	
On Loan to C.D.			3	2
On Hand in Own Paddocks	6	3	4	10
Total	8	4	8	12
On Loan from P.Q.	3			2
On Loan from R.S.		1	1	4
Total Owed	3	1	1	6
Measure of Net Ownership—X.Y.	5	3	7	6
Total	8	4	8	12

The proprietor here—X.Y.—has six sheep on hand, of which up to three belong to P.Q., but besides this he has loaned two to A.B., but these still belong either to him or to P.Q.; hence his net ownership of sheep measures five. Similarly with the other types of live stock.

Accounting records could be maintained on such a "real" basis, and even the change in proprietorship from time to time could be assessed in such terms. But it must be recognised that even here there is some approximation to a common unit. For although such a basis of reckoning is free from any assumption that one cow is, for example, equivalent to ten sheep or twelve pigs or any other non-bovine (mathematical) function, there is the assumption that each sheep is similar in significant respects to each other sheep, that one cow is no better and no worse than any other cow, and so on. But this may not hold if there is any shift in the criterion of significance. The assumption may prove invalid if the significant characteristic of the cows is the yield of milk and if the cow in A.B.'s hands gives (say) twelve quarts of milk per day while that on loan from R.S. gives eight quarts per day. It might, of course, happen that the two cows, despite a discrepancy in yield of milk, are equivalent in terms of butter fat content, which depends upon the quality as well as the quantity of the milk from each, but this involves a further shift in significance. The point at issue is well recognised by mathematicians, and a popular exponent of mathematics points out that when we say there are 100 sheep in a flock, what we mean is that when they are all arranged in single file the last sheep is the hundredth, and in treating the sheep as equivalent to each other for the purpose of enumerating the flock all we mean is that each is qualitatively the same kind of individual as any other. Quantitatively, that is, as regards height, weight, volume, number of fibres in its fleece, and so on, each sheep is different from the others.[9]

The adoption of a unit of measurement is, at bottom, a subjective evaluation; in many cases, units have been conventionalised, that is, they have been agreed to by large numbers of persons in order to facilitate social intercourse, exchange of property, and exchange of ideas.

[9] Lancelot Hogben, *Mathematics for the Million* (London: Allen & Unwin, 1940), p. 47.

Consideration of the implications of this position must be left for later sections;[10] the point which concerns us here is that, given a unit or series of units which are acceptable to a person or group of people, an accounting may be carried out in terms of such unit(s). The unit or units adopted are based, fundamentally, upon a subjective appraisal by the person who is considering his relationship to the things which are being measured, and for each type of thing there *may* be a separate *individual* unit of measurement. It is not until a generalised concept of worth or value is required that what we might call a *general* unit of measurement is necessary, that is, a unit in terms of which different types of things may be evaluated by the person—an expression of subjective appraisal in generalised terms. And a common *social* unit of measurement normally arises only when the stage of exchange between persons is reached. Accounting could conceivably take place without any common unit of measurement at all—whether a general or a social unit—but some unit of measurement, even if it be an individual unit, is necessary.

IV Proprietorship

In examining the nature of double-entry bookkeeping in a search for its essential characteristics, Professor Littleton rejects duality as being of its essence, although he admits that duality is implied in the expression "double-entry" and that several of the earliest books on bookkeeping expounded one or more phases of this in the form of duality of books, such as ledger and journal, duality of account form, such as debtor page being opposite creditor page, and duality of entry or of the postings of an entry. While he agrees that these phases are characteristic of double-entry bookkeeping, he argues that they constitute the form rather than the substance, and therefore are not the essential criterion of complete, co-ordinated account-keeping, which, for him, is the way in which double-entry bookkeeping must be interpreted.[11]

With this view of a complete and co-ordinated system, he also rejects equilibrium of results as the criterion, despite the apparently inevitable equilibrium of the balance sheet—within the

[10] See below, Chapter 10.
[11] Littleton, *op. cit.* See pp. 23-24.

statement itself and within the accounts from which it is derived. This equilibrium is found in the antithesis of either (a) positive and negative properties and (b) proprietorship, that is, assets minus liabilities equal net worth, or (a) capital kinds and (b) capital sources, that is, assets equal owner's capital plus borrowed capital. But, like the duality of form, this antithesis is the consequence of the fundamental characteristic of double-entry rather than the element which gives it comprehensiveness and finish. It is, he states,

> axiomatic that the parts (positive and negative properties) are always equal to the whole (proprietor's net investment), and it is quite true that the sum total of the several kinds of property will always be equal to the sum total of claims by some one to those properties.[12]

He argues, however, that it does not necessarily follow that such equilibrium is "that criterion the appearance of which indicates the existence of double-entry bookkeeping and the absence of which leaves us without complete, coördinate record-keeping,"[13] since, while equilibrium is important in modern accounting and is perhaps a distinguishing feature of the method in comparison with statistical procedures in other fields, it is possible nowadays to have a

> complete financial information tabulation service yielding all the data now coming from double-entry bookkeeping without the conscious use of either duality of form or equilibrium of result.[14]

The feature which he considers essential and which must be added to duality of form and equilibrium of results before complete double-entry bookkeeping is possible is proprietorship, that is,

> a direct ownership of the goods handled and a direct claim upon the income which emerges. Without this element account-keeping (bookkeeping) consists merely in recapitulating the details of a responsibility and casting them into a convenient form.[15]

His conclusion is that "the *form* of complete bookkeeping is the duality and equilibrium which derive from early record-keeping precedents; the *substance* consists of proprietary calculations of

[12] *Ibid.*, p. 25.
[13] *Idem.*
[14] *Idem.*
[15] *Ibid.*, p. 26.

the gains (or losses) from ventured capital,"[16] and by combining the terms he uses we can arrive at his definition of double-entry bookkeeping as the "organised instrumentality" for measuring and explaining the "tangible results" of the "ownership of property and its dedication to gainful activities."[17]

This view of the nature of accounting appears to be rather too narrow, being circumscribed by the limitations of what is often termed commercial accounting, that is, accounting for enterprises in the conduct of which the primary aim is usually taken to be that of making a profit for their proprietors. The use of terms such as "ventured capital" and "ownership of the goods handled" makes this point of view explicit, and emphasises a proprietary theory of accounting which needs at least some further examination before it can be accepted.

There are, for example, cases in which gains on proprietorship are not significant, but where it would seem that accounting in a complete sense is nevertheless carried out. In the case of a university or a college, the significant purpose of the accounting is to account from time to time for the funds acquired from whatever sources; a large profit during any given period might reflect, not a laudable result, but a falling short of the standard of service which should be rendered. In the case of a deceased person's estate, there is admittedly a corpus which represents an actual or potential source of revenue for the beneficiaries and which has to be zealously guarded by a trustee responsible for its preservation, but, in many cases at least, the accretion of this corpus by "gains" is to be avoided and all revenue is to be distributed to beneficiaries (tenants-for-life). In such cases, an injustice may be committed between different classes of beneficiaries (that is, as between tenants-for-life and remaindermen) if either increase or decrease of proprietorship is accepted as the objective of the trustee. And in cases of liquidation and bankruptcy, the very purpose of the accounting is to show how the available assets of an enterprise have been realised and the proceeds distributed among various claimants, of whom the proprietors are residuary candidates.

[16] *Ibid.*, p. 27.
[17] *Idem.*

Considerations such as these do not necessarily or completely vitiate Professor Littleton's point of view, but it is submitted that they do raise doubts as to whether the most significant feature of accounting is the emphasis upon proprietorship and its growth or decline. It is suggested that the point of view of proprietor is but one of several points of view from which accounting may be undertaken and that one of the significant features of accounting is that, in any particular case, its procedures are applied from one particular point of view. The important thing to recognise at this stage is the existence of *a* point of view which gives to accounting procedures a coherence which entitles us to regard them, in given cases, as forming an accounting system. This matter of a point of view is discussed at greater length in Chapter 9.

Professor Littleton's view may also be regarded as being too narrow because it appears to restrict consideration of accounting to its recording and reporting functions only and does not take cognisance of its interpretative and control aspects. These latter, however, have been a later development than, and are dependent upon the performance of the former; without adequate records and reports, valid interpretation and reasoned control are scarcely possible. In this sense, while recording is not by any means the whole of accounting, it is a fundamental part of it; at the same time, a theory of recording is not by any means a complete theory of accounting.

V The Minimum Requirements of Accounting

The minimum requirements of accounting—the fertilised ovum, so to speak, from which the body of accounting theory, accounting doctrine and accounting practice has (analytically, if not historically) developed—are thus conceived to be a relationship of ownership and/or use (or control) of property and a means of measuring that relationship from a particular point of view.

The existence of a point of view is fundamental for accounting, the one thing often being regarded from different points of view with very different accounting results. To illustrate, take the simple case of land which is rented by the owner to a primary producer. The owner obviously has a relation of ownership to

the land; the relationship of the tenant is one of use.[18] The land itself is a common factor for both of them, but each regards it from his own point of view. The proprietorship or wealth of the owner will be increased by an excess of rent received over all expenses incurred by him in respect of the land; the proprietorship of the tenant will be increased by the excess of revenue from sale of produce of the land over expenses incurred by him, of which rent paid to the owner of the land is only one item. The task which accountants face is that of accounting from whatever point of view is proper to the circumstances of the particular case.

The exploration of such matters as the basis of accounting relationships, the characteristics of the point of view to be adopted for accounting purposes, the nature of the unit of measurement, and the purpose of recording and communicating relevant data, constitutes an inquiry into what is here considered to be the proper area of accounting theory.

[18] Cf. Richard Eells and Clarence Walton, *Conceptual Foundations of Business* (Homewood, Ill.: Irwin, 1961), p. 185.

CHAPTER 4

The Field of Accounting Doctrine

I The Object of Accounting Doctrine

THE FIELD of what is here called accounting doctrine is a forum for the discussion of the standards of accounting practice. What constitutes good accounting? What are the criteria by which the goodness of accounting procedures can be assessed? Can these criteria constitute absolute standards within our universe of discourse or are they relative, and, if they are relative, what are they relative to? These are questions which are implied in the expression "accounting doctrine" as here envisaged.

The purpose of setting up a body of accounting doctrine is to arrive at standards by reference to which the validity and propriety of accounting practice may in some measure be gauged, with the object of improving that practice. Standards of this nature are set up, either explicitly or implicitly, in any professional activity in which the practitioners (or even their clients) have any communication of ideas among themselves; indeed, they are doubtless present to some degree even in a primitive society where, say, the efficacy of professional witch-doctors is measured by the speed and certainty with which their victims die or their patients recover. The recommendations of the Institute of Chartered Accountants in England and Wales, the research bulletins of the American Institute of Certified Public Accountants and many a text-book treatment of accounting have this in common with the Ten Commandments and the Sermon on the Mount, that they are guides to activity and exhortations to conduct, seeking to establish standards by reference to which the failings of

practice can be seen, even if they cannot be precisely measured. They are, indeed, authoritarian norms which say in effect, "Do this and you do right."

This sense of the word "doctrine" is rather wider than that in which it was used by Dr. S. Gilman,[1] whose usage has been followed by a considerable number of writers on accounting within recent years. At the same time, the two senses have much in common. Dr. Gilman used the word as being equivalent to "policy," and it is worth recalling his words here.

> Because certain broad accounting *policies,* such as those referring to conservatism, disclosure, consistency, and materiality, are of more general application than many of the propositions termed "principles," it would be a matter of considerable convenience to call these four propositions "doctrines." Strictly such usage would not be entirely correct in view of the fact that they are not specifically taught nor is any relationship of student and instructor implied. The practical convenience of adopting such a nomenclature might well justify a certain amount of freedom from the severe limitations imposed by dictionaries.
>
> Perhaps some justification for the proposed adoption of the word "doctrine" can be found in such a phrase as the "Monroe Doctrine" which in effect is *a statement of policy* and scarcely implies a pupil-instructor relationship. Only by considerable stretching of strict definition does the policy enunciated by President Monroe represent a doctrine.
>
> If, therefore, it is legitimate to adopt "doctrine" as referring to a general statement of accounting or reporting policy as evidenced by the words "materiality," "disclosure," "conservatism," and "consistency," such legitimacy may be derived from such a usage as the "Monroe Doctrine."[2]

The reasoning thus presented can scarcely be regarded as rigorous: the use of the term by Monroe was not strictly legitimate but such legitimacy as it has in an accounting context may be derived from Monroe's usage. This surely amounts to saying that the word is really not legitimately used in accounting but is adopted as a matter of convenience and in defiance of its strict meaning.

Apart from this, however, the word as thus propounded by Dr. Gilman appears to have a dual sense. As something which is taught, with the implication of an instructor-pupil relationship, that is, as a precept or body of precepts, such a doctrine has an ethical or normative flavour. As something which is carried out,

[1] S. Gilman, *Accounting Concepts of Profit* (New York: Ronald Press, 1939).
[2] *Op. cit.,* pp. 186-87. Italics supplied.

a policy may well be the practical expression of a doctrine. Thus it is consistent to consider a policy of conservatism, in pursuit of which assets are, say, undervalued through excessive depreciation, as the practical conformity with a "doctrine" of conservatism which states in effect, for example, that assets ought not to be overvalued under any circumstances. (The question of what is meant by "undervalued" and "overvalued" must be begged for the present, as being not germane to the present discussion; we are at the moment discussing conservatism purely as an example in an attempt to settle a meaning for the term "accounting doctrine.")

The sense in which the word "doctrine" is used in this chapter is more embracing than this. In his everyday work the accountant must of necessity have some standards of performance in mind to which he tries to conform; these standards are set up, explicitly or implicitly, in conformity with some generalised ideas of an ethical or normative character which he has derived from somewhere; it is to the body of these ideas that the term "accounting doctrine" is applied in the present context.

In all his conduct, a man acts in accordance with certain standards which result from the inculcation of precepts which he has absorbed during his life—his activities are an expression of his philosophy of life. If his actions are capricious, this is very likely because his basic outlook on life is confused; if they are governed more by emotion than by reason, it may be because his mind has not been subjected to a sustained or wide course of intellectual discipline; if they are directed towards illegal pursuits, it is possibly because, as a strong individualist and an egoist, he has rebelled against and rejected the standards which govern the conduct of most of his fellow-men and set up others of his own design. In each case, however, there *are* standards to which his actions conform; there is a basic philosophy which the standards and the actions express and illustrate. And when a large number of people react to certain given circumstances in the same way, it is probably because they are thus giving expression to the same standards and a similar philosophy, similar at least to the extent that it has a bearing on these activities.

So, if, in the field of accounting activity, we find a large propor-

tion of writers or practitioners following the same course, it is probably because they are trying to adhere to the same standards, and because they have, to this extent, the same philosophy of life which has been transmitted to them in a series of precepts in something very much akin to the pupil-instructor relationship. It is the examination of this "philosophy," this basic outlook upon accounting matters, which I consider to be the substance of what is here called "accounting doctrine."

II The Basic Features of Accounting Doctrine

In this sphere of norms and standards in accounting there is an almost bewildering lack of homogeneity in the presentation of the views of recognised authorities. Standards of performance have been laid down for some considerable time in accounting text-books, in legislative requirements and in a long series of legal cases; in more recent years, accountants' professional bodies and legal committees have issued authoritative pronouncements on various aspects of accounting procedure, panels of accountants have issued statements of accounting principles, and control authorities have issued regulations to which the accounting records and/or reports of certain enterprises have to conform. All of these have a greater or less doctrinal influence and in some cases, of course, a compulsive effect on accounting procedures; but in almost all of them, if not in all, some fundamental features of the norms advocated are implicit, taken for granted or overlooked.

One fundamental aspect of setting standards which does not appear to have received sufficient attention is the basic purpose of accounting—the goal at which accountants aim in preparing accounting records and reports. Admittedly, some writers have presented definitions of accounting which include a reference to its purpose. For example, Professor W. A. Paton defined accounting in terms of relation to the operation of the private business enterprise (which, in his view, is the unit of economic organisation with which the accountant is primarily concerned) as "the body of principles and the technical mechanism by means of which the economic data of the particular concern are classified, recorded, and periodically presented and interpreted, for the pur-

pose of effective control and administration."[3] As another instance, Hodge and McKinsey stated that it is "with the use of reports as a means of business control that the student will be chiefly concerned in the general survey of the accounting field . . . it is not necessary or desirable that the student should attempt to narrow his concept of the field of accounting beyond that of the use of reports as an aid to the conduct of business, and incidentally an aid to the control and regulation by society of certain phases of private business enterprise."[4] Several later writers have written in similar vein to these pioneers of modern accounting.[5] Definitions such as these are open to the objection that they restrict the interpretation of accounting to private business enterprise. The accounting unit is not necessarily either a private enterprise or a business enterprise. For example, some of the largest users of resources are government departments, many of which are neither private nor business, but their activities have to be accounted for. Indeed, this insistence among text-book writers on the problems of private business enterprises seems a little strange when we consider that among the earliest known records of an accounting nature are those of governmental or communal instrumentalities. Thus, the records of the Massari or stewards of the city-state of Genoa rank among the earliest known examples of double-entry bookkeeping, while the communal transactions of temple-officials in ancient Babylonia comprise some of the earliest known accounting records yet unearthed.

A more serious objection is that some of the steps needed to fulfil even these averred purposes of accounting are also implied rather than explicitly set out. It is submitted that the principal and basic aim in making accounting records and reports is to provide an explanation of events and to facilitate interpretation of their effects in relation to a given unit—whether the unit be a sole trader, a holding company, a government department, a

[3] W. A. Paton, *Essentials of Accounting* (New York: Macmillan, 1938), p. 3.

[4] Hodge and McKinsey, *Principles of Accounting* (Chicago: University of Chicago Press, 1920), pp. 2-3.

[5] See, for example, Arnold W. Johnson, *Elementary Accounting* (New York: Holt, Rinehart and Winston, 4th ed. 1962), p. 2; William H. Childs, *Accounting for Management Control* (New York: Simmons-Boardman, 1960), p. vii.

wage-earner or a housewife, a deceased person's or a bankrupt's estate or a marriage settlement, or a whole community. The necessary steps to be taken in this process of interpetation are:

(a) recognition and selection of the events which affect the unit;
(b) measurement of these events;
(c) recording of the measured events;
(d) summarising, classifying and reporting the events;
(e) analysing the reports;
(f) interpreting the reports.

If each of these steps is accurately and adequately taken, then, as a result of all of them, a sound basis for formulating policy *may be* arrived at, but to the extent that any one or more of these steps is unsteady or omitted, from whatever cause, the result is likely to be vague and possibly misleading. If, however, we accept such a positive aim for accounting as that submitted, we are provided with an instrument by means of which we can find our way through the at times marshy and at times too-thickly wooded field of accounting doctrine.

In order to achieve this purpose of rational explanation and interpretation, the primary function of accounting records is, it is suggested, to reflect *accurately* those measurable events which affect the accounting unit adopted. It soon becomes apparent that there are difficulties in determining what is meant by accuracy. Many of the events are not capable of accurate measurement at all within a short period and therefore their effects have to be estimated. The unit of measurement selected may vary in relation to other possible or conceivable units of measurement. Some persons, in a position to affect the records, may consider their interests to be better served by inaccuracy than by accuracy; some may be ignorant of the importance of accuracy or merely careless in their attitude towards it. The recognition of events and their effects may bear different interpretations by persons who are actuated by different motives, that is, events and the effects of events may appear differently to different people; and policies of misstatement may be followed deliberately in an attempt to forestall or govern future events.

Despite these difficulties, it does seem implied that accuracy should be the aim in making accounting records. The whole scope and procedure of auditing in relation to such records, for example, can be seen from this point of view as an attempt to ensure their accuracy.[6] Whether, in the face of the position outlined, absolute accuracy can be attained or even whether it exists is another matter for consideration. The immediate point is that, implied in the various statements of accounting doctrine (as here envisaged) and the expositions of standards of performance, there is an unexpressed suggestion that accounting records and reports should *"aim at"* expressing accurately the impact of events upon any given unit. Evidence for this implication lies in the insistence by many accountants upon the difficulties in achieving accuracy and upon the inherent limitations of the accounting processes, and in the recognition of the important part which estimating plays in accounting. It is as though the laws of motion, which may be used to explain the path which a projectile would take if there were no factors such as friction and wind resistance operating to turn it from its mathematically correct course, were implied rather than expressed, but none the less vaguely and generally recognised.

Similarly, the purpose of accounting reports, it would seem, is to inform persons entitled to information. Again, this is a norm which is not always attained and sometimes does not appear to be clearly recognised. Indeed, in examining some of the reports which are even now made public, one sometimes wonders whether their purpose is to impart information or to serve as an intellectual puzzle. Certain it is that the compulsive powers of legislation as well as the persuasive powers of extra-legal pronouncements have for many years shown a tendency to require a greater degree of disclosure of information to those who are, or who are deemed to be, interested parties. As one instance, the tenor of company legislation relating to the contents of the published financial statements of public companies has changed from a complete absence of regulatory provisions, as in the English Companies Act

[6] There is, of course, a further function in auditing, namely, to ensure, as far as possible, that the information in accounting reports is fairly presented to interested parties; there are as many difficulties in assessing "fairness" in this context as in determining accuracy in relation to accounting records.

of 1862, to the inclusion of provisions requiring a considerable amount of information under the Act of 1948 (Eighth Schedule).

The problem of communication, that is, the problem of imparting accounting information, is a complex one. In the first place, it must be remembered that the events which are recorded in the accounting records are themselves a selection from among all the phenomena which impinge upon an accounting unit. For example, in the case of a trading concern, the appointment or dismissal of a particular salesman or operative may have an important influence upon the activities of the business, but such appointment or dismissal is not, in itself, recorded in the books of account. Or an advertising campaign may have beneficial or deleterious effects upon the marketing of a product, but only the cost of the campaign is directly recorded. Or again, the success of a business may be largely dependent upon the capabilities of one or a very few executive officers, but these capabilities may never be brought to account or may only be brought to account indirectly when the business changes hands. In most cases, therefore, no set of accounting figures can tell the whole truth about any given enterprise or unit; there must remain much that cannot be expressed in terms of the unit of measurement adopted for reporting purposes, and, indeed, in some cases, part of the truth may scarcely be expressible even in words, but may only become evident by subsequent actions.

Secondly, it must also be remembered that the events recorded are classified according to one or more bases of classification which, however adequate for some purposes, may not necessarily be adequate to serve all possible purposes. Multiple bases of classification are common; for example, a creditors ledger classifies purchases on the basis of sources by individual suppliers, but a classification by types of goods and services acquired may also be needed, and a columnar purchases journal or voucher register is often instituted to provide further analysis; yet neither of these tells us, for instance, in what products particular materials have been used, and additional records have to be set up for this purpose. Hence the records are often subjected to special examination to yield information which was not envisaged when they were initially designed. Whether they can meet the demands upon them

depends not only on the selected bases of classification originally adopted but also on the amount of detail included in the recording process; and as a rule of practice it has generally been found preferable to include a good deal of detail which in fact may never be used beyond the initial purpose than to omit detail which, if required for some reason later on, can only be recovered at great pains, if at all.

Thirdly, it must be remembered that the accounting reports which are prepared are summaries of the data in the records, and subject to the biases and defects of summaries. By its very nature, a summary cannot tell a complete story; its preparation depends upon the omission of many more points than are included, and no matter how objective it may purport to be, there is, somewhere or other in its make-up, the mark of an inescapable subjective imprint. For instance, sales may be included in a revenue statement at a total figure for a given period; but this in itself does not reveal that, say, sixty per cent of the sales were made to one customer; and even if this information were included, there would still not be revealed that, say, seventy per cent of the sales figure had been attained in the first quarter of the year; and even if all this were revealed, the fact that, say, forty per cent of the sales were of one out of many types of commodity handled may remain undisclosed, despite its probably high relevance in interpreting the statement intelligently. One could go on indicating matters that these summaries do not reveal until one reached the point where virtually all the items contained in the records were individually included, and the notion of the summary dispersed altogether.

What has happened, of course, is that these summaries have been conventionalised, and people believe that the information which is supplied in these reports is the information which they need for their purposes; this may be a satisfactory situation in many cases, but often, whether they need more or not, it is all the information which is vouchsafed them. Much of the technique of analysis of accounting reports lies in the comparison of measures designed to overcome some of the deficiencies of the records and reports themselves and to make them reveal relevant and significant factors, which in and by themselves they are not de-

signed to reveal. And when, finally, all the techniques have been applied, they may yet not reveal the most significant features of all, which may not be measurable by any of the current accounting or economic units of measurement. For example, the most significant feature in the affairs of a concern may be the blood pressure or dyspepsia of its chief executive officer, but the accounting system to record this has not yet been designed.

It is clear that the accounting procedures can be and are made into an instrument of policies. If they were applied only to objective, verifiable events, such as cash received and cash paid out, probably few conflicts would arise. But when the standard of objective, verifiable events is departed from—as it is in all but the simplest forms of enterprise and activity—accounting for policies, for estimates and for opinions becomes inevitable. The question is whether one should retain as an ideal the standard of objective, verifiable events, and *to what extent* policy which involves estimate and opinion should be allowed to modify the facts.

III The Criteria of Good Accounting

To revert to the question postulated in the first section of this chapter, namely, What is good accounting?, it soon becomes apparent that it is a very difficult question to answer.

As a first approach we might attempt an answer in the general terms that good accounting comprises the best means to achieve required results. While this may represent an answer which is acceptable in some respects or in some contexts, it nevertheless throws up a further question, namely, What are "required results"? The answer to this will reflect the point of view envisaged by the person considering it. It might be answered that the pursuit of a particular policy is a required result; for example, the preservation and growth of a given social unit such as a commercial or industrial enterprise or a sporting club or a government department or a particular type of economic organisation for many industries may be considered desirable. In such a case, "good" accounting procedure would incorporate whatever records, reports and analyses are directed towards such preservation and growth. To take a specific illustration, the people in control of many an industrial concern in the latter part of the nineteenth cen-

tury were apparently imbued with the notion that it was important for the preservation and growth of their enterprise to discourage shareholders from seeking to withdraw, in the form of dividends, resources which they (the controllers) considered could be better used by them in conducting the activities of the enterprise. They therefore followed a policy which tended to understate the amount of periodically determined profit available for dividends, and many of them came to take the "safe" view even for their own information. Although this possibly oversimplifies the position somewhat, it does appear to be the essential basis of the so-called policy of conservatism which has played a big part in influencing accounting procedures. In the light of such a policy, good accounting would comprise such procedures as give effect to understatement of periodical profit.

On the other hand, a required result may be deemed to be the provision of as much information as is practicable for shareholders to enable them to formulate their investment policies on a basis of enlightened self-interest. In such a case, "good" accounting would comprise such procedures as will conform to such a policy of disclosure.

Or again, the required result may be the assistance of the "controllers" of a social unit in their managerial functions. "Good" accounting would then comprise such procedures as provide the information requisite to facilitate such control in such a form as to be assimilated by them as easily as possible.

Again, the required result may be the provision of information to enable economic and social planners to formulate and carry out their plans in respect of any given social unit or aggregate of units. If this objective is adopted, as it is in what has come to be known as "social accounting," then "good" accounting comprises the procedures which enable the postulates of the planners to be assessed.

In each of these cases the "required result" is such as to wed accounting procedures to a particular policy of control, and a change in policy profoundly affects accounting procedures. Thus the widespread reaction in recent years against extreme conservatism in accounting is evidence of a recognition that the results of a conservative policy are not now required results, or at least that some

of its results conflict with other norms. There is a tendency now for knowledge of past events for the benefit of shareholders, employees and/or the community to be substituted for manipulation of records of past events to hide knowledge of them.[7] This is a phase of a social trend towards knowledge for the exercise of prerogatives by different classes of people: where once the knowledge was required to enlarge the "freedom" of owner-managers, the later phenomenon is a recognition of the importance of the "freedom" of shareholders, employees and investors.

It is against a background such as this that the "doctrines" which Dr. Gilman distinguishes may be considered. Although, as already pointed out, the sense in which the term "accounting doctrine" is here being used is wider than that in which he employs it, consideration of the doctrines he enumerates may be useful as an approach to determining a basis or bases for criteria of good accounting.

The "doctrine" of conservatism portrays an aspect of a social philosophy, in the accounting expression of which the owner-manager is the central character in an enterprise. It is his interests which are paramount, despite rationalisation, in some expositions of it, in terms of protecting shareholders from their own rapacity and the preservation of the future prospects of a concern at the cost of the present. In its later phases it has formed part of an argument on the side of managers in discussions whether they or the ultimate owners should be regarded as the principal persons entitled to information, or a point of view for adoption by financial executives faced with proposals put forward by production, sales or technical managers. Conservatism was often considered necessary to counteract the natural optimism of business

[7] That this tendency still has scope for further application is demonstrated by the fact that "the Jenkins Report reveals a deep cleavage of opinion inside the Committee on the question of the exemptions granted to banks and discount houses. The majority was for the full retention of these exemptions, but a strong minority of five . . . was for severely cutting them down. . . . The minority agrees that it is essential to maintain confidence in the banking system, but it is not convinced of the necessity, for this purpose, of withholding information about the banks' operations from the public or from the shareholders. . . . The minority does not greatly cavil at undisclosed reserves as such, but it is not satisfied that any real harm would result from disclosing realized losses after they have been incurred, even if potential losses were kept secret." See *The Accountant*, July 14, 1962, pp. 32-44.

men.[8] A policy of conservatism and a policy of secrecy have been so frequently followed concurrently that in many cases they have been regarded as identical. Thus "secret" or "hidden" reserves arise from applying a conservative policy in accounting; conservative policy has also dictated the practice of omission from published statements of information which might enable investors to form a reasonable judgment in respect of their investment on the ground that it would at the same time provide useful information to competitors, whether actual or potential.

The "doctrine" of disclosure reflects a social philosophy in which, in relation to any given corporate enterprise, the shareholders and other investors hold the predominant place among those concerned with accounting information. Some writers argue that this place should be shared with employees of the concern and with members of the community in general. From this proposition it follows that good accounting would be that which makes available to interested parties as many of the facts relating to the enterprise as possible. Certain difficulties arise here, however. There may well be several different kinds of "interested parties," each interested in different aspects of the concern's activities: an employee's interest in the company for which he works is not necessarily the same as that of a shareholder in the same company. Different parties want different facts, or different reporting of the one set of facts.[9] The problem in following out a policy of disclosure is how to satisfy all the parties whose interest should be gratified. As already indicated, selection is an essential ingredient of the accounting processes, and *full* disclosure is incompatible with summarising and hence, in a close analysis, becomes impracticable. And in the process of selection it is impossible to *know,* although it is generally reasonable and always necessary to surmise, what information will in fact help a particular person in his relations with a given enterprise. Thus the preparation of multiple reports designed to inform different kinds of "interested par-

[8] Cf. G. O. May: *Financial Accounting* (New York: Macmillan, 1943), p. 44: ". . . losses from unsound accounting have most commonly resulted from the hopes rather than the achievements of management being allowed to influence accounting dispositions."

[9] Cf. G. O. May, *op. cit.*, pp. 3 ff.

ties" can only be a partial solution to what may be, in essence, an insoluble problem.

The advocacy of disclosure may be regarded as an attempt to increase freedom of choice for those to whom the disclosure is directed. It may be symptomatic of a social trend in the direction of greater individual freedom of opportunity, on the argument that since "free" choice is not truly free unless all the circumstances surrounding the object of choice are known, the knowledge of those circumstances must be made available to the people concerned. As the Harvard Committee on General Education in a Free Society puts it:

> We believe that men are not in any genuine sense free to choose unless the fullest possible truth is presented to them. That is to say, freedom is not permission to flout the truth but to regulate your life in knowledge of it.[10]

From this point of view it is a reaction against the policy of the closed fist and the tight lips of secrecy which has so often accompanied the practice of conservatism. On the other hand, the advocacy of disclosure may be viewed by the sceptical as a rather belated attempt to bolster up a crumbling, or at any rate a cracked economic structure, the argument being that since secrecy and conservatism have undermined the structure, a greater degree of disclosure will cover up the cracks and prolong its existence.

The "doctrine" of consistency is based on the proposition that an intelligent use of accounting data can be made only if they are collected, compiled and presented in the same way from time to time. Fundamentally, this depends on acceptance of the ideal of comparability as an article of faith. In a sense, it is an attempt to reconcile the points of view of those who are in control of an enterprise and those to whom they are responsible, since effective comparison may be regarded by both groups as a prerequisite for action. Complete and strict adherence to consistency, however, has certain implied and inherent dangers. The conditions under which an enterprise is operated do in fact change, and the object of consistency is to abstract from these changes. In other words, the object of a consistent policy, so far as accounting is concerned, is to segregate the effects of changes over which the

[10] Report of the Harvard Committee on "General Education in a Free Society" (Cambridge: Harvard University Press, 1946), p. 105.

controllers of an enterprise have control from those over which they have no control. By eliminating or minimising the former, it becomes possible to assess the latter more accurately. However, difficulties arise in the determination of the limits of the respective areas of control and no-control. The dangers of extreme adherence to consistency are reminiscent of the dangers of conservatism in accounting. Where conservatism "stultifies itself" through the impossibility of being for long consistently conservative,[11] and because of an ultimate reaction against cumulative departures in one direction from a norm of reasonably accurate determination of results, so consistency may break down over a long period through an ultimately inescapable accumulation of departures from realistic interpretation of events for the sake of comparability.

Consistency is not, *ipso facto* and of necessity, a supreme virtue. Samuel Butler, for instance, presents a point of view which warrants some consideration when he says:

> Then he saw also that it matters little what profession . . . a man may make, provided only he follows it out with charitable inconsistency, and without insisting on it to the bitter end. It is in the uncompromisingness with which dogma is held and not in the dogma or want of dogma that the danger lies. [And after describing an incident which happened to his hero, he describes its effects in the following words]: Having, then, introduced an element of inconsistency into his system, he was far too consistent not to be inconsistent consistently.[12]

Although one may suspect that Butler was self-consciously and deliberately setting out to say something smart, there is probably an element of validity in the point of view that there seems to be as much danger in making a fetish of consistency as there has been in making a dogma of conservatism. Consistency may well be a

[11] This was apparent to at least some accountants many years ago. For instance, M. Peloubet pointed out in 1937 that "you can always be conservative in a balance sheet; you can never be consistently conservative in income accounts. It is mathematically impossible." See *American Institute of Accountants Fiftieth Anniversary Celebration* (New York: American Institute of Accountants, 1938), p. 356.

[12] Samuel Butler: *The Way of All Flesh* (Penguin Edition, 1947), p. 274. Butler, by the way, was himself apparently something of an accountant, or at least a bookkeeper, for elsewhere he states: "I wished him to understand bookkeeping by double-entry. I had myself as a young man been compelled to master this not very difficult art; having acquired it, I have become enamoured of it, and, consider it the most necessary branch of any young man's education after reading and writing." (*Ibid.*, p. 318.)

logical necessity in the short term; in the long term it may turn out to be merely crass pigheadedness.

The "doctrine" of materiality appears to reflect an impatience with meticulous detail or a recognition that consistency down to the last detail is impracticable. In a broad interpretation of it, it is intended to focus attention on major aspects of, in particular, accounting reports. Again there is a possibility of danger. Who is to decide whether something—a result, an event, or a measurement—is material or not, and on what grounds? Adherence to this doctrine involves, in fact, a deliberate presentation of something less than the full quantum of presentable information in an attempt to present "major" issues. It represents a further restriction in presentation of data superimposed upon the restrictions inevitably resulting from the use of summaries; it is a departure not merely from the whole truth but from the available quantum of truth. This is not to say that such restriction and such departure may not be justified; but it is desired to point out that we should recognise what we are doing when we insist on a criterion of materiality.

Suppose we were to say that good accounting is that which clearly portrays what has happened. The first desideratum here is a determination of "what has happened," that is, it becomes necessary to select the phenomena which are to be portrayed. This problem has already been discussed in earlier sections and need not detain us here. In addition to selection, however, we have to consider what is meant by and involved in portrayal of events. In any portrayal or explanation of events there appear to be two parties—a person who portrays or explains the events, whom we may call the portrayer, and a person to whom or for whose benefit the events are portrayed, whom we may, for convenience, call the reader. The case in which something is portrayed for one's own satisfaction is merely a special case in which the two parties are embodied in one person, the functions being nevertheless distinct.

The problem of identity of outlook upon the events then arises. Here the difficulty lies in ensuring that the way in which the portrayer interprets the events is the way in which the reader would interpret the same events if he were in the position of portrayer.

We can never be quite certain that one person understands by any given term or symbol precisely what another person understands, even in relation to concrete things. When, for instance, I say that one book is bigger than another, or that a particular book has a green cover, you may agree, but there is no certainty that what you interpret as "bigger" or "green" is the same as what appears to me. There is an underlying assumption that the book presents the same characteristics to you as to me. And this depends as much upon our respective interpretations as upon the book itself.

This potentiality of disparity is even more marked when we deal with generalisations and abstractions than it is when we are dealing with concrete things. Thus you may agree with all that I am at present saying, and yet we can never be sure that your interpretation of my argument is the same as mine. The best we can expect is to hope that I am using the words I do in the same way as you use them, but of this neither you nor I can be sure.

It will be gathered from this discussion that none of the answers so far put forward to indicate the criteria of good accounting is considered to be fully satisfactory. In terms of existing conditions, the criteria are variable according to the particular doctrine or point of view which is adopted; and these doctrines are often imposed upon accountants so as to affect the accounting processes by circumstances which arise out of non-accounting activities and purposes. In the absence of criteria derived from a coherent body of accounting theory, accountants have been constrained to accede to one or more of these extraneous influences. An answer to the question, What is good accounting? will be possible only after the development of a coherent general theory of accounting from which the criteria can be derived and to which they can be referred for validity-testing.

CHAPTER 5

The Significance of Accounting Practice

I *The Pervasiveness of the Accounting Function*

TO A GREAT EXTENT the importance of accounting in practice can be gauged by common observation and a little reflection. Accounting is usually thought of in connection with business affairs, and it is true that many of the significant advances in its development have come from an impetus originating in commercial and industrial activity.

It is not necessary to expound at length the place of accounting practice in the business sector of a modern free enterprise economy; this has been done many times and the following passage, although written some years ago, will serve as a convenient summary and reminder.

> All sorts of business enterprises which are operated for profit depend more or less upon accounting for the control of their operations. This is true alike of farm, mine, factory, fishery, bank, railroad, insurance company, and wholesale or retail store. It makes no difference whether a business enterprise is organised as a partnership, a corporation, a business trust, an individual proprietorship, or some other form of the business unit. It makes no difference whether the persons desiring information are the managers and employees of the enterprise, the stockholders or partners, the financial institutions from which funds are borrowed, the vendors from whom merchandise is purchased, or the government officials who are collecting taxes from the concern. Whatever the form of organisation, and whatever the purpose for which precise quantitative information is desired, accounting is the device which supplies information as to the various activities of the enterprise: marketing, production, purchasing, personnel, and finance. . . .
>
> Certain aspects of modern business make accounting of vital importance in the control of a specific enterprise. In the first place, modern business is complex: the operations of a single factory comprise such varied and technical

activities as the mixing of chemicals, transportation of materials, assembling of parts, generation of power, testing of finished products, and supervision of workmen. It will often lie beyond the power of the most intelligent business manager to supervise and direct personally the varied processes being carried on under his control. His task is rather to co-ordinate the work of certain technical specialists who are responsible for the varied activities. In the second place, business enterprise is frequently operated on such large scale that its very size would prevent one man from directing it personally. Many enterprises employ thousands of men to carry on their activities. And even if the tasks of all these men were simple enough to be understood by a business manager, it would be impossible for him to maintain direct control over the activities of each employee. In the third place, the geographical areas of enterprise are often so great that peculiar problems of control arise. Many large companies employ salesmen and establish branches which operate in all parts of the world. Even a simple enterprise doing a moderate amount of business must maintain accounting records when the employees are continuously absent from the center of business activity. Other characteristics of modern business could be cited to emphasize the need for some device to supplement direct personal observation and contact in the control of a given enterprise. Enough have been mentioned to demonstrate that the powers of the individual manager must be multiplied if he is to maintain control over important areas of economic activity. This multiplication of powers may be accomplished through recorded data, properly classified, summarised, and interpreted.

The private business enterprises have been keenly aware of the importance of accounting in the control of their affairs and have made great progress in developing accounting technique applicable to their individual needs and purposes. This is because private business is inspired by the profit motive, and accounting makes possible the efficient control of resources to the end that profit may be increased. Accounting is, of course, applicable equally to the problems of the non-profit organisations. The failure, in individual cases, of other types of enterprise to follow the lead of private business in the adaptation of accounting to their needs has sometimes resulted in their being poorly administered.[1]

There is, however, rather more to accounting than even this quotation indicates. In the exercise of government, whether municipal, national or international, the operation of accounting procedures is necessary to account for the resources received by way of levies and taxes; under modern, democratic conditions, this accounting is done for representatives of the electorate, and one important function of democratic institutions is to provide material for constant critical review of their working. Unfortunately, relatively few of the people ultimately affected have the techni-

[1] C. R. Rorem, *Accounting Method* (Chicago: University of Chicago Press, 2nd Ed., 1930), pp. 3-6.

cal equipment, the time, the opportunity and the courage to criticise the accounting methods and results of these institutions. In a modern society, the complexities of what has come to be called public finance need an extensive period of training in several fields of study for their comprehension, but among them a solid base of accounting knowledge is well-nigh indispensable. One writer[2] has noticed an anomaly that has arisen.

> It was impossible [he says] that this development of accounting as a control device originating in the business world would go unnoticed by legislative bodies and judicial and administrative officials. It was inevitable that, in the search for effective means of obtaining data as to social and economic phenomena, resort should quickly be had to accounting data. Thenceforth it was but a short and logical step to reliance on the accounting process, first as a means of regularly observing the activities of economic units, and then as a means of prescribing and proscribing courses of action. It is most interesting to note, in passing, that the effective use of accounting as a control over government itself has lagged far behind the use of accounting by government as a means of policing and controlling those it governs. Only recently have some of the most obvious improvements of business accounting been enlisted in the effort to control governmental activities.

What this author has noted in passing is, for our present purposes, the most significant part of the statement quoted. It is the effective use of accounting as a control over governmental activities which opens up possibilities of creating an instrument by means of which democratic forms of society may be made more workable. An interesting speculation which suggests itself as a possible piece of research is an inquiry into the relationship between modes of accounting and modes of government—an examination, for instance, of the accounting methods used by, say, the tyrannical Stuarts of England and Bourbons of France and an estimate of the extent to which their downfall was precipitated by inadequate and inept accounting practices on the one hand and, on the other, the desire (not necessarily expressed in precise accounting terminology but nevertheless expressed effectively) of their subjects for more adequate admission of accountability and a recognition and acceptance of a fiduciary position. It might even be possible to draw a comparison between this position and some aspects of our contemporary institutions, private and semi-

[2] William W. Werntz, "The Influence of Administrative Agencies on Accounting," *Iowa Law Review*, XXXVI, 2, (Winter, 1951), 271.

public as well as governmental. It is a mistake, for instance, to think that accounting is inevitably tied to private enterprise in a capitalist economy. Mrs. Allan, in a survey of communist institutions as they were in operation during the nineteen-thirties, has a hint of an accounting problem of the sort envisaged here. In the course of describing one of the collective farms which had made news by installing a new heated farm stable, she writes:

> When Simeonova, whose paper was interested in ferreting out shortcomings as well as lauding achievements, asked if the farm management was efficient, all the women began to gabble at once. "The book-keeper! Doesn't keep track of our workdays right! Gets 'em all mixed up! A fine book-keeper he is! He's a cobbler and that's all!" (To label anyone a 'cobbler' means that he bungles every job he touches.)[3]

It is not only minority shareholders who may be prompted to grumble as a result of inept accounting practices.

The use of accounting techniques for economic control has greatly increased in both range and intensity since the nineteenth century. The recognition of the value of audited financial statements, for example, has extended so far that a social or sporting club of a dozen or twenty members, not one of whom has any clear notion of the functions of an auditor or the procedures of auditing, will almost invariably insist upon including in its constitution a clause necessitating the appointment of an honorary auditor. To the lay mind, there appears to be an aura of magic about an auditor's report which apparently serves as a guarantee of impeccable accuracy, despite the fact that in many cases it is virtually impossible, for a variety of reasons, to perform an adequate audit of the records of these small enterprises. In most of such cases it is clear that the members do not really want an audit at all, but rather some sort of statement from the auditor, almost irrespective of what it contains, in accordance with the prevailing fashion and on a presumption that the auditor accepts responsibility for the honesty of the honorary treasurer. This attitude is possibly much more widespread than is generally suspected by professional accountants. At bottom, however, it is evidence of the extent to which accounting practices have permeated the social ideas affecting our present environment.

[3] Seema Rynin Allan, *Comrades and Citizens* (London: Victor Gollancz Ltd., 1938), p. 184.

A companionate idea in the minds of laymen is that of annual statements. The year is an astronomical phenomenon and no doubt found its way into human affairs through the influence of agricultural practice. So deeply imbedded in our racial consciousness is it that it has been adopted for such a long time now as the temporal unit for governmental and business activities that it is virtually ineradicable, at least without a major revolution in outlook, despite its artificiality and unsuitability for many types of enterprise. So widespread is its adoption that the constitution of every little club and society provides for the submission of annual financial statements, and, even though the members may be incapable of understanding the implications of even the simplest of such statements, the failure to present one regularly each year would be regarded with misgiving, even though a patently absurd, misleading or even fraudulent statement might be accepted without question. In such cases it is the fact of annual presentation, and not the contents of the statement presented, which is significant for those concerned. In the field of business, in some industries a year is too short a period, in others too long, to constitute a natural time unit, but the exigencies of social affairs have compelled its adoption as the maximum time unit for accounting purposes.

Nor is it only in business enterprises that we find the requirement, for managerial purposes, of frequent accounting reports and diversified accounting records, but also in the activities of government, whether of a business or of a purely administrative character, in semi-governmental enterprises such as public utilities, in co-operative societies, in social welfare institutions, and in other types of activity which go to constitute the social environment in which we live. Wherever the problem of control is significant in an enterprise or in a group of enterprises, reports of various kinds are necessary; not all of these come within the category of accounting reports, but many of them do, and one important contribution which the accountant can make towards the effective control of the activities of any social operating unit lies in the frequency, the quality and the significance of reports for which he is responsible and which, if he is possessed of the necessary vision, he can often initiate. Of course, to do this he must appreciate, as accountant, the problems and requirements of others who

may not be accountants and who are certainly not acting as accountants in the relevant organisation. And a word of warning might here be suggested: it is not a good thing in itself to multiply the number of reports or records in any given case—reports and records should be useful, and the test of usefulness is the way in which they are used. Hence he who aims at becoming an accountant capable of thinking in terms of managerial requirements may need to develop a keen sense of discrimination. Further, in some cases at least, it may be necessary for the accountant not only to design and prepare reports but also to educate others to appreciate their significance and even teach them how to read and interpret them.

We should briefly notice here two developments of recent years with which accountants may well find themselves more and more concerned in the relatively near future. The first is in what has been called "social accounting," an attempt not only to apply some of the simpler concepts and procedures of accounting in the study of national economics, but also to interpret and modify the results of current accounting procedures to fit in with the concepts of current economic theory. This has given rise to much lively discussion and controversy among both economists and accountants, past and current accounting practice and doctrine being critically examined, with much smoke and even a little warmth generated in the process of distillation of thought. Whether the bubbling and rumbling emanates from the cauldron of a witch or the retort of a scientist is still in doubt.

The second is the use of the results of accounting procedures, especially accounting reports, by corporate bodies of various kinds as a feature of their public relations. The people in control of an increasing number of companies, for example, obviously address their published reports to an audience much wider than the current shareholders. The reports are often an attempt to make customers, employees and (especially with the aid of the press) the community in general, acquainted with the recent history of the concern as measured by its latest balance sheet and profit and loss statement.[4] There is a marked tendency towards expressing the accounting concepts of technical documents in

[4] In the United States, the term "income statement" is now almost universally used for the latter of these reports. But see Chap. 13: Sec. III below.

simple and unsophisticated language, often supported by pictorial aids. Whether these efforts achieve the objectives envisaged, whether the result is the opposite of that aimed at, or whether it is negligible, is largely unknown and, as yet at least, not widely investigated.

Whatever the ultimate results of these two developments may be, one result already is an increasing self-consciousness on the part of accountants themselves in relation to their procedures and concepts—they are at least beginning to realise that they no longer live in a world insulated by techniques from that of the other human beings in their community outside the particular organisation with which they, as accountants, identify themselves.

Accounting procedures are often thought of as being restricted to matters connected with monetary units and financial control. Of their importance in this sphere there is little argument and there is a growing appreciation of the need for accounting procedures to facilitate cost control. But while advances in techniques have been and are being steadily made in these directions, the application of accounting information and processes to the control of production, use and distribution of materials and services is still far from fully developed. These are largely questions of quantity control, and while quantity accounting has been developed to some extent, as in commodity stock records, it has not yet been widely applied to other activities for which it could be equally apposite.

II The Functions of Accounting

Irrespective of the nature of the data with which accountants concern themselves, the functions which they presume or are required to undertake under present conditions normally comprise one or more of the following:

(a) Recording, which involves collecting and sorting data into suitable categories, applying a common unit of measurement to them, and bringing relevant data together for summation and comparison. One of the most important recording techniques is that of double-entry bookkeeping, which involves consideration of each accountable event in isolation from all others, an interpretation of it, from a twofold

point of view, in respect of the elements of a simple accounting equation, its notation in an appropriate record of originating entry to facilitate summation and classification in appropriate ledger accounts, and its transfers to these ledger accounts.

(b) Reporting, which covers the summarising of the data recorded in the books and the preparation of suitable reports based on these data for the information of persons entitled to such reports.

(c) Interpretation, involving a critical analysis of the information made available through the recording and reporting procedures. The adequate performance of this function is usually considered to require the calculation and application of statistical measures and an appreciation of the limitations as well as the purport of the statements examined.

(d) Designing, that is, planning the technical procedures involved in recording and reporting.

(e) Checking, that is, verifying, so far as is reasonably practicable, the accuracy and fairness of the information contained in the records and reports.

Of these functions, those of recording and checking are of longest standing being discernible in the records of some of the earliest civilisations.

There is much to be said for adopting the view that "accounting is what accountants do." They are engaged in doing something practical—something which can be examined objectively; and what they do reflects their attitude towards accounting theory and accounting doctrine; that is, accounting procedures are theory and doctrine in active operation. It may be argued with considerable force that it is the way in which accountants carry out their procedures that really matters in the long run, and that a thorough investigation of the actual processes of accounting in operation would reveal general tendencies which would constitute a theory of accounting.

The broad question towards which such a study of accounting practice would be directed is this: What, in fact, are the phenomena with which accountants are concerned, and how, in

fact, do they deal with them? The answer to this question, however, would also be the answer to another, namely: What accounting standards do accountants recognise, and to what extent do they conform to them?

Put in this way, these questions are of the most general nature and imply a host of other questions, a few of which are noted below, but in order to arrive at answers to any of them empirical investigation is necessary. The object of empirical study is to find or provide referents for the generalisations of deductive study—referents to which theory or doctrine can be applied. It is impossible here to make an extensive empirical survey of accounting practice—that is a task for many people over many years; all that we can hope to do at present is to submit a few suggestions which may prove helpful to other investigators.

Whether empirical study can be regarded as proving anything depends upon the meaning that is attached to the word "prove." In this present discussion, two very different senses may be given to the word, with virtually opposite results.

If by "prove" we mean the kind of formal proof that is used in a theorem of pure mathematics or formal logic, then empirical study cannot be said to prove anything, for this kind of proof is pre-eminently the function of the deductive method. This kind of proof is an appeal to our reason.

Some writers think that deduction alone is the most powerful instrument in the advancement of knowledge. For example, in the field of economics, Professor Robbins dismisses the efforts of the proponents of "institutionalism," "quantitative economics," "dynamic economics," the "historical school" and other opponents of "orthodox" analytical economics by claiming that

> not one single "law" deserving of the name, not one quantitative generalisation of permanent validity has emerged from their efforts. A certain amount of interesting statistical material. Many useful monographs on particular historical situations. But of "concrete laws," substantial uniformities of "economic behaviour," not one . . . the greatest slump in history finds them sterile and incapable of helpful comment—their trends gone awry and their dispersions distorted. Meanwhile, a few isolated thinkers, using the despised apparatus of deductive theory, have brought our knowledge of the theory of fluctuations to a point from which the fateful events of the last few years can be explained in general terms, and a complete solution of the riddle of

depressions within the next few years does not seem outside the bounds of probability.[5]

His view of the function of economics is that

> economic analysis turns out to be . . . the elucidation of the implications of the necessity of choice in various assumed circumstances. . . . In pure Economics we examine the implication of the existence of scarce means with alternative uses . . . the assumption of relative valuations is the foundation of all subsequent complications.[6]

On this view, "pure" economics is a series of theorems based on a set of original, axiomatic propositions and "the *validity* of a particular theory is a matter of its logical derivation from the general assumptions which it makes."[7]

Provided the assumptions are accepted and the logical sequence is technically (that is, according to the laws of logic) flawless, the conclusions are inevitably sound and no empirical evidence can upset them. In this sense of the word, empirical study cannot "prove" anything.

But the word is often used in the sense of an appeal to experience rather than to reason. We do often test a proposition by an appeal to the experience of observation or experiment, and if it passes this test we are satisfied that it is proved. Professor Robbins himself recognises a distinction between the validity of a theory and its applicability to a given situation, which, he says, "depends upon the extent to which its concepts actually reflect the forces operating in that situation."[8] In this sense, a proposition deductively derived can *only* be proved by empirical investigation, by an appeal to "facts," that is, to conditions that exist in the world other than the world of ideas. Study of facts—using this word by way of contrast to ideas—is the essence of empirical study, and it can be used to test conclusions arrived at through deduction, or to suggest lines of reasoning, or to indicate necessary variations in premises for the deductive processes. In the case of alternative deductive processes, an empirical procedure

[5] Lionel Robbins, *An Essay on the Nature and Significance of Economic Science* (London: Macmillan & Co., 2nd Ed., 1937), pp. 114-15.
[6] *Ibid.*, p. 83.
[7] *Ibid.*, p. 116.
[8] *Ibid.*, pp. 116-17.

can often be used to provide a basis of choice between them; in this category are the crucial experiments of the natural sciences. Unless and until a deductive proposition or some subsequent deduction from it can be thus tested by an appeal to recognisable facts, it must, for all purposes of *practical and practicable* application, remain barren, no matter how convincing the process of logical exposition may be.

The kind of distinction being drawn here is similar to that which applies in other fields of study—a distinction similar to that

> between an abstract science and its concrete representation or application. For example, if we conceive of geometry as describing the properties of the space in which we live, that is, the space accessible to our senses, and which we are in the habit of explaining in terms of the sensations of sight and touch, we must remember that we are applying that science to things to which strictly it does not apply. When we talk about points, we are thinking of abstractions, things without size; lines are without breadth, planes are without thickness. We know that such things are not observable in the world accessible to our senses; we can observe only things which approximate to them. Even when by means of carefully made instruments we are able to draw thousands of straight lines to the inch, we still have things which possess breadth, not the lines of abstract geometry. Think of two lines which make an angle of $\frac{1}{1000}^{\circ}$. There is no instrument in the world accurate enough to distinguish the angle between them. Yet we do conceive it abstractly. When we wish to determine whether our abstract science can be applied to our world, the best we can do is to test it, to see if it corresponds to the observed properties of concrete space to *within the possible error of observation.*[9]

It may be suggested that in one sense accounting practice is the final test for both theory and doctrine; that a body of theory or a doctrine which is not in harmony with practice cannot be valid. We must note, however, in respect of accounting at least, that an appeal to practice may take the form of either or both of two distinct questions. In considering a particular aspect of theory or doctrine it may be asked either "Does it accord with facts?" or "Is it practicable?" Both questions represent an appeal to the "facts" of practice, but the implications of each are quite different: the former is a question of science, the latter of art. Each may be apposite and relevant at different stages of consideration, and perhaps confusion is not likely to arise so long as the nature

[9] John Wesley Young, *Lectures on Fundamental Concepts of Algebra and Geometry* (New York: Macmillan Co., 1939), pp. 22-23.

of the question is recognised when it is being considered. Danger lies in an appeal to practice on a mixed basis or where an answer is sought in terms of one question when in fact the appropriate answer is to the other.

To take an example, the proposition that in accounting "conservative" understatement of net earnings is inevitably followed —sooner or later—by overstatement of earnings[10] is capable of deductive proof by means of hypothetical examples which "stand to reason" and which serve to make the proposition almost self-evident; nevertheless, empirical evidence of specific factual instances, impartially marshalled to test it, are scarce in accounting literature but would be welcome.

It often happens, however, that if a proposition is determinable deductively, empirical evidence is not required unless (or until) some doubt is raised about the validity of either the premises or the chain of reasoning.

There are numerous questions in accounting which can be resolved only by empirical study. Some of these have important implications at least for accounting doctrine if not for accounting theory as well. A few which readily come to mind are: What factors affecting an enterprise do investors take into consideration in determining whether or not to invest in it? What information do shareholders want or think they want in the periodical financial statements of a company? To whom do accountants consider they are reporting? How do accountants calculate periodic profit? What bases of valuation for various assets are employed, and in what proportions? What methods of pricing of inventory issues are used and in what proportions? What methods of costing are used in industry and in what proportions? To what extent are costs of production a governing factor in fixing prices of commodities? The list could easily be extended.

One important service that an extensive empirical study of accounting would probably yield is the bringing to light of the influences which do in fact affect accounting practice, and this discovery might serve as a wholesome corrective or a heartening substantiation of some of the doctrinal writing which takes up so much space and time in accounting literature today.

[10] Cf. S. Gilman, *op. cit.*, p. 234.

III Sources for Empirical Study in Accounting

The field for empirical study in accounting is enormous. Every enterprise—commercial, industrial, financial, social, governmental, legal—for which accounting records of any sort are kept or accounting reports or analyses prepared, is a potential case-study. In fact, however, relatively little of this case material is generally available for study. It might be thought that the simple and obvious proposition that accountants do in fact carry out procedures of recording, reporting and the rest would have given rise to an extensive literature of a purely empirical nature, but this is not the case, and the literature describing actual procedures in operation in specific instances is, relatively, surprisingly small. While numerous articles and books set out what *should* be done in given cases, that is, prescribe from a doctrinal point of view, thorough-going empirical studies describing procedures which are in actual operation are comparatively rare.

For example, typical of the attitude commonly adopted by writers on accounting systems is the following extract from a publishers' announcement of a book on specialised accounting systems:

> This volume describes the business procedures and transactions peculiar to 14 businesses which involve accounts and accounting methods not covered in the usual books on accounting . . .
>
> Before publication, each chapter was submitted to at least one man actively working in the particular line of business covered in that chapter. The suggestions made by these businessmen were incorporated in the book.
>
> The author doesn't try to set up an actual, detailed accounting system for any single type of business since accounting methods vary so greatly from business to business. Instead, he has added a chapter in the second edition, "System Construction and Installation." This chapter provides the reader with an outline of the general procedure which should be followed in setting up such a system, without burdening him with details which apply in relatively few cases.[11]

Clearly enough, the author of this work made an empirical study of accounting methods, since the statement that "accounting methods vary so greatly from business to business" is an empirical conclusion; and the results of such empirical study are doubtless embodied in the book; but the object of the empirical study has been to provide an outline of the general procedure

[11] H. A. Baily, *Specialized Accounting Systems* (New York: John Wiley & Sons, 2nd. Ed., 1951).

which *should be* followed, that is, the object has been doctrinal and not purely investigatory—a search for what is considered the best means of carrying out a series of activities. The procedures which are applied in actual practice are themselves hidden behind a generalised procedure and consequently are not available for consideration.

However, it must not be thought that the province of accounting is quite devoid of empirical studies, nor that there does not exist a potentially rich source for investigation. Technical articles describing procedures actually in operation do appear from time to time in professional journals; but these are of a somewhat ephemeral nature, being, in the first place, likely to be overlooked after a short time unless a historical search is made, and, in the second, subject to modification or obsolescence as conditions change. As one writer puts it:

> Accounting is essentially open-minded. It emphasises good practice as the criterion by which any procedure is to be tested. Good practice does not consist of a set of rules or precepts that can be memorised. It has been and is being progressively developed by free and untrammelled meeting of conditions in the light of experience, guided and governed by belief in the inherent reasonableness of its problems and the possibility of their solution.
>
> The answer to why procedures are as they are lies in large measure in understanding of the problems and conditions out of which they have developed. On the other hand, the accountant knows that more satisfactory and better procedures are still to be developed by closer study and better understanding of the distinctive features of a business.[12]

In the English-speaking countries—and in others, of course—there are available numerous published financial reports of enterprises—companies whose shares are dealt in on stock exchanges, public utilities, government departments and instrumentalities. Admittedly, there are many enterprises whose reports are not made available to the public, but those in the categories mentioned above constitute a considerable proportion of the national economy. It must also be recognized that the quality of presentation of the information and the extent of data included in these reports vary according to local and even individual practice, and this must be taken into consideration in comparing results of different units and categories. Nevertheless, there is here a vast reser-

[12] Hermon F. Bell, *Retail Merchandise Accounting* (New York: Ronald Press, 1936), p. 3.

voir of information which has been tapped only to a slight extent to date—source material for research which can be adequately undertaken only by people with some training in and knowledge of accounting.

In considering the functional view of accounting—the sphere in which an empirical study of what accountants in fact do in respect of the subject-matter of accounting—one significant question that could well be asked is: Can a survey of current practice indicate the norms which are adhered to by practitioners, and to what extent are these norms identical with those indicated by the consideration of accounting doctrine?

Empirical study would also tell us much about the history of accounting and remedy a lack noted already in Chapter 2. Some work of this nature has already been done, but much more remains to be done.

There is, in short, a need for many dispassionate and detailed studies of accounting data and of accounting procedures, by investigators trained in research methods; this work requires patience and diligence, and much of it may appear, on a superficial view, trivial and inconsequential. But, apart altogether from the interchange of information between specialists that this would provide, who knows when a Darwin might arise to gather the many threads together and weave them into a cloth of grand pattern and enveloping utility? Better to have a superabundance of material on which he shall be able to use his selective discrimination than to frustrate his efforts by an absence of empirical data.

CHAPTER 6

Postscript To Part I

IN PART I of this work, a classification of accounting has been used which, it is suggested, might prove useful in its further development as a field of study; and something of the nature of the problems arising within each area has been indicated. But it is necessary to warn against undue compartmentalisation.

The three categories suggested—accounting theory, accounting doctrine and accounting practice—are so closely related that it is possible to dissociate them only for purposes of classification and conceptual consideration. Like any other classification, this threefold distinction is clearly a matter of convenience as a means of thinking about accounting. In fact, all three aspects are so closely interconnected and mutually dependent that no practising accountant can remain unaffected by considerations of both accounting theory and accounting doctrine; neither can an accounting theorist afford to ignore what happens in practice or be unmindful of the normative purpose of prescribing standards for accounting procedure; while these very standards of accounting can only legitimately be prescribed after due weight is given to both theoretical and practical considerations.

In human matters, as in others, there is a continuum of existence, and a large part of our instruction, from infancy on, comprises an attempt to develop our capacity to impose distinctions upon this continuum—in other words, to develop a capacity for analysis of phenomena. In savage as well as in civilised man, by trial and error as well as by deductive reasoning, this objective is sought. And it is, indeed, a most useful faculty—perhaps the most useful single faculty—for a person to develop for the purpose of living in harmony with his environment, social as well as physi-

cal. It is used, in a greater or less degree, by all living creatures: each living thing strives to obtain or use those things within its environment which serve its individual or racial purpose, to ignore those which do not, and to avoid or destroy those which threaten its life and the future of its species. That the environment is thus "analysed"—whether by instinct or by some rudimentary sense of reason—can scarcely be doubted.

To aspire to an understanding of any phase of life, however, synthesis as well as analysis is necessary, and synthesis involves an attempt to discover the relations between things, and thus to express, even partially, the continuity of which they form part.

This applies in accounting as much as in any other area for study or activity. Each separate aspect and each separate problem in accounting cannot be considered in isolation from others *except* for the purpose of clarifying our ideas; it must eventually be related to other accounting aspects and to non-accounting factors.

Hence, in what follows, although the matter goes under the label of accounting theory, it is recognised and, it is hoped, it will be discernible, that the influences of accounting doctrine and accounting practice are not to be neglected, but rather are to be regarded as an objective towards which the study is directed.

Part II

GENERAL ACCOUNTING THEORY

There can, of course, be no objection to the use of reason in accounting; indeed, we must insist on its application in preference to any other basis for action or thought. But, since we are in search of truth as well as validity, we must also examine as closely as possible the premises on which the trains of reasoning in accounting are based; that is, we must look most carefully at the assumptions that we make and that we normally take for granted in our reasoning in accounting.

It is submitted that there are four of these basic premises or notions, which are considered in this part in the following order:

1. *Activity.* In accounting we deal with activity—principally, but not solely, human activity—and therefore we must examine our concept of activity.
2. *Outlook.* In accounting we deal with activity relevant to some unit of experience and it is necessary to consider the point of view or outlook which is to be adopted.
3. *Measurement.* In accounting we are concerned with measuring these activities, therefore we must examine the unit of measurement and the way in which the measurement is carried out.
4. *Record.* We must examine the nature of the "dealing with" which is involved in accounting. This dealing with comprises the functions of accounting, of which recording is the fundamental one but not the only one. We have, therefore, to consider the unit of record and the nature of some of the procedures developed in the recording and other functions of accounting.

It is also submitted that accounting procedures can be expressed and explained by reference to these notions.

CHAPTER 8

The Unit of Activity

I Events

ACCOUNTANTS are measurers, recorders, reporters and interpreters. What is it that accountants measure, record, report about and interpret? What are the unitary factors in terms of which accounting procedures are carried out? What is it that is common to the medieval Italian merchant princes and the billion-dollar corporation of the twentieth century, to the local golf club and the government department, to the country-town general storekeeper and the nation-wide chain store organisation? When we consider the range and diversity of application of accounting procedures, the highest common factor must be expected to lie at a much lower, or perhaps it would be better to say at a much simpler conceptual level than is usually propounded in the literature of accounting.

It is submitted that the phenomena with which the procedures and practices of accounting are concerned relate to events which take place; that is, they are phenomena of activity. For example, accounting reports, whatever their form may be and in whatever terms they may be expressed, are summaries of events that have occurred or of the results of such occurrences; even statements, such as budget estimates, which purport to provide a prospective view rather than a statement of things past, are concerned with and, indeed, are based on probable future activities. It seems reasonable, therefore, to seek a unit of activity in terms of which accounting procedures may be considered to be carried out.

Let us call this unit of activity an "event." Obvious examples

are payment of a cheque, receipt of a half-yearly dividend, deposit of a number of cheques in the bank, sale of a commodity to a customer, issue of shares to an investor, and so on; also included would be such occurrences as the issue of a tool or of materials from stock for a manufacturing process, the expenditure of time on a job in the course of production, distribution or sale, and the like.

This is a somewhat different sense of the word "event" from that in which it is normally used in everyday speech, although it is not unrelated to it. In common parlance the word is used in a historical context, as when we speak of the Battle of Hastings or the signing of Magna Charta as events in the history of England. But events such as these are complexes or, in a sense, multiples of "events" in the sense in which the word is intended to have significance in this work. The activities which constituted the Battle of Hastings comprised a number of distinct but related incidents taking place within a certain identifiable space and time, which in total comprise the unity of concept designated the Battle of Hastings. Each of these incidents is analogous to the unit of activity which is here called an event, and were it not for its connotations which might well prove to be somewhat confusing, the word "incident" might be as appropriate as the word "event." But the common usage of the word "incidental," in the sense of unimportant or not pertaining to a central feature, overlays the noun "incident," and the expression "incidental expenses" is still in fairly common use in English and Australian, if not American, business and accounting literature. It is therefore considered that the word "event" which is, at present at least, free from business and accounting overtones of meaning, may more aptly be used to convey the meaning of the concept.

For our present purposes, then, an event is an occurrence which can be distinguished from other occurrences by virtue of differences in time, place (or space) and/or character. It is not possible for two or more events of the same character to happen at the same time in the same place, but two events of the same character can happen in a given place at different times or in different places at the same time, while, in some cases, two different kinds of events can happen at the same time and place.

Not all events are accountable in the sense that they are suitable objects for accounting procedures. At the same time, it is likely that many more events are suitable objects for accounting procedures than is generally recognised. For an event to be accountable, it must be capable of measurement so that it may be linked with other events, similarly measurable, into meaningful relationship. The nature of the measure is considered later; a monetary unit, although the most commonly recognised one for general purposes, is not necessarily the only or even the best unit for all purposes. For example, the issue of, say, 100 yards of a certain fabric for Job No. 1 can be brought into meaningful relationship with the issue of 160 yards of it for Job No. 2 as well as with the receipt of 2000 yards from the supplier; and in the use of inventory records it is precisely this pattern of events in terms of a non-monetary measure which is applied. To tie accounting irrevocably to financial occurrences is too restrictive and not in accordance with the facts of accounting procedures as they are carried out at present.

II Ventures

A series of events (not less than two, but often many more) linked by a common measure and a social or economic objective into a meaningful relationship constitutes a "venture." For example, the receipt of a quantity of goods and its piecemeal issue to various production jobs until it has all been disposed of constitutes a venture; so does the purchase and sale of a commodity or a specific number of articles, and the building of a bridge.

These examples are simple and straightforward and may be considered as representative of "determinate" ventures. A determinate venture is a series of events for which there is a determinable result. If you buy a television set and a radio and later sell the television set, you cannot relate the sale of the television set to the purchase of the radio to get a venture, but only to the purchase of the television set.

Many series of events, however, are not so easy to determine, in the sense of setting boundaries or limits on them. For example, consider the acquisition of shares or stock in a company. Dividends are received on the shares, perhaps regularly, perhaps

irregularly; the amount of the dividends may be subject to fluctuation; the shares may be disposed of after a short period or they may be held for a long time, perhaps being transferred from one shareholder to his heir or to the trustees of his estate after his death for the purpose of holding them as a charitable trust in perpetuity. Of course, the shareholding will terminate when the company itself is wound up, but the contemporary social framework is such that the end of such a venture is virtually indeterminable. Or take the purchase or erection of a building. Rent may come in regularly, with some fluctuation in amount from time to time; the building will require maintenance and repair and may eventually have to be pulled down. The title in the building may pass successively from generation to generation, and we can, in fact, see buildings in the old world which have been standing for hundreds of years and which will, it is to be hoped, last for hundreds of years more. The end of such a venture is also indeterminable. And what of the land on which a building is erected? Here is something in respect of which maintenance and repair do not apply—it simply exists, and will continue to exist indefinitely, so far as practical human conception can tell.

So far as a particular human being is concerned, we could, of course, say that all the ventures in which he has concerned himself terminate at his death. *His* shareholding or *his* title to land is no longer his when he himself is no longer here. In this sense, all ventures of human beings are determinate. But if the holding is in the name of a corporate body, which has had an indeterminable period of existence endowed upon it by law, the venture, once more, is indeterminable in so far as the corporation *may* endure beyond the life of any presently living person. It must be recognised, however, that this indeterminacy is a result of a legal convention which gives to corporate bodies a continued existence within the existing social system. A change in the system —such as took place in the supersession of feudal society—might well involve the cessation of the life of many corporate bodies which at present have no foreseeable end. (In some countries, admittedly, there are in existence corporations which have survived from feudal times; this does not invalidate the above propositions—we merely have to extend the period back to pre-feudal

days or, say, the Roman Empire, and we can safely say that none of the then existing and functioning bodies now exist.) Thus, even for the corporation, it is reasonable to conceive the termination of all its ventures, if we are prepared to extend the period of time sufficiently far.

The difference between a determinate venture and an indeterminable venture is thus one of degree and, basically, one of time. The distinction between them is nevertheless convenient for purposes of exposition and analysis. Thus the activities of a corporation may be regarded—until it has ceased or is about to cease to exist—as comprising an indeterminable venture which is composed of a vast number of determinate ventures beginning and ending at numerous and various points of time within its life, overlapping and interwoven in a complex pattern. The accountant's task is to segregate each of these ventures for appropriate accounting treatment, but at the same time he has to determine the relationships between the various ventures and assess the overall result of their interactions. For example, the purchase and sale of each commodity, the acquisition and use of each long-term asset, the issue and redemption of each debenture, are determinate ventures within the life of, say, a company; each one represents a strand in the cloth of overall activity which we call the life of the company. The accountant should not only record each one of these ventures, but he should also relate each one to the others so far as is applicable, determine the result of such interrelation and consider whether the result is satisfactory and what future action the result suggests. Some writers would appear to deny that this last is a function of the accountant as such, averring it to be rather that of managers or directors or government heads; but there is much to be said for the view that the accountant, who should be more familiar than anybody else with detail behind the result, is in the best position to at least recommend and advise on desirable policy (even if he is not given the executive power to carry it out), any recommendations he may make on such matters being regarded as those of a professional expert and, although, perhaps, not mandatory, having a strong (non-legal) sanction.

There appear to be a few primary, recurring patterns of de-

terminate ventures discernible from a consideraion of accounting procedures:

(i) *Trading ventures.* Acquisition and sale of a commodity, with a resulting profit or loss on the venture. The fact that there may be various kinds of outlays incidental to the purchase, manufacture or sale of the commodity—buying expenses, freight, salesmen's expenses, advertising and the like—or that, between acquisition and sale, there may be a change in character of the product, as in manufacture, or an accretion process as in, say, a flock of sheep or an orchard, only serves to make a particular venture or series of ventures somewhat more complex, without disturbing its fundamental character.

The basic pattern is that a commodity is acquired at a cost of £x and is sold for £y, the difference £$(x \sim y)$ being the measure of profit or loss on the venture.

The pattern recurs, in accounting procedures, under such various disguises (among others) as consignment and joint venture accounts, job cost finding, liquidation and realisation accounts.

(ii) *Usage ventures.* An article is acquired and used for a more or less specific objective, the elemental pattern being of the form: Of 100 units of a commodity acquired, 40 are disposed of on objective x, 25 on y, and 35 on z.

The pattern will be recognised as applying to such various procedures as inventory records, pastoral, i.e. live-stock, accounts and long-term asset accounting. What is commonly called depreciation might be explained or, at least, expounded, by saying that when, say, a machine is acquired, it represents a quantum of units of service which are allocated on a usage basis (time being an approximation to usage in many cases) to relevant objectives; a similar representation could apply to "amortisation" of, say, a lease or a copyright, and to "depletion" of, say, a mine.

(iii) *Financing ventures.* Resources are obtained, whether in the form of commodities or money, and a commitment for their subsequent return, in the same or a different form, is entered into, with or without an interim compensation for their availability.

This type of venture covers a wide range, but in each case the three fundamental events can be distinguished.

In the case of an ordinary credit purchase of goods, there is first the event of obtaining the goods and the creation of the liability to pay for them, and, secondly, the discharge of the liability. The third element may arise if interest on the commitment is charged, especially where a promissory note or bill of exchange is an intermediate step in the discharge process, or where goods are acquired on hire-purchase (conditional sale), and the "hiring" charges include a substantial interest element. Or it may appear as discount for prompt payment, which means, in effect, that the cost of acquisition may turn out to be less than the invoice price of the goods if discharge of the commitment takes place within a specified period; in this case, the compensation for the availability of the resources is included in the initial commitment but is rebated under appropriate subsequent circumstances. In the case of a cash purchase, the discharge of the commitment takes place so soon after its creation as to be regarded for all practical purposes as simultaneous with it.

The issue of shares or stock in a company involves, firstly, the acquisition of monetary resources from the shareholders, with, secondly, a commitment for an ultimate return of the resources, whether augmented or diminished, whether in the form of cash or other form of resources, when the company is finally wound up. There is an interim obligation to pay dividends periodically out of available profits, as compensation for the investing of the resources. Similarly with the investments of partners, while the issue of bonds or debentures or borrowing under a fixed-period loan is also closely analogous, except that the commitment for the return of the resources is fixed in amount and usually in time, and the compensation is in the form of interest at a fixed rate independent of the making of profits or losses.

Where a bank overdraft is used, as is common in the United Kingdom, Australia and other countries, the resources are acquired in the ordinary way from suppliers, but the discharge of the commitment to them is effected by an exchange of that commitment for one to the bank, and the compensa-

tion becomes payable to the bank as interest, rather than to the supplier. Thus it frequently happens that a creditor will allow a discount on being paid promptly, while the payment increases the interest charge payable to a bank because of its increasing an overdraft. The overdraft must be settled ultimately by repayment to the bank either on termination of the borrower's activities or earlier, and in turn this may involve a different financing venture, such as an issue of shares or debentures or the raising of a mortgage on some of the borrower's property.

(iv) *Service ventures.* A natural or acquired skill, of a personal nature, is made available for the benefit or enjoyment of others for a reward, which may be financial or non-financial.

This type of venture covers not only professional activities of various kinds but also those of tradesmen, agents, salesmen, sportsmen, entertainers, artists, domestics, and all those cases where personal services are involved.

(v) *Custodial or fiduciary ventures.* Resources are placed under the control or management of a person(s) who, while not being the beneficial owner of them, is responsible to another or others for their safekeeping or disposal. Trusts, charitable and educational foundations, receiverships, and some government activities will be recognised as being basically of this character, while some aspects of the accountability involved are often present in some of the other types of venture.

In any given set of circumstances, several ventures of each kind are normally being undertaken at the same time, and the character of some of the ventures may influence ventures of another type. Thus a decision to acquire a machine or a building may be affected by past or prospective financing ventures; a particular financing venture may be undertaken in order to permit certain trading or usage ventures to be carried on. Hence the accountant's task in relating each venture to its contemporaries and in determining its characteristic features distinctly from those of the others is not always easy. Isolation of each venture does not necessarily reflect a valid result, because of the interaction between different contemporaneous ventures. Nevertheless it is necessary, as a preliminary to sound decisions, to isolate each venture

from all others, and it is this aspect of isolation which constitutes a basic feature of the recording process in accounting. The recording of events is, indeed, a fundamental aspect of accounting, but, as is now widely recognised, it is by no means the only important aspect. As a next step, the accountant must examine the recorded events and relate them to each other in such a way that the relationships so determined are significant for and relevant to the objective in view.

III The Matching Procedure

The term "matching" has been used in recent years to describe the procedure followed by accountants in determining the relationships between series of events. In most cases the term has been applied to "matching costs with revenue," as exhibited in a periodic profit and loss statement (or, in current U. S. terminology, "income statement"), the objective being to determine periodic result. The concept, however, has a much wider application than this and can be applied to any venture of whatever type, or to any series of ventures. A profit and loss statement is merely a summary of ventures related to each other by virtue of their concurrence through a particular period of time, and much of this concurrence may, in a given case, be an accident of time. There may well be other equally important and perhaps even more fundamental bases of relationship.

The relating of events to each other within a given venture is itself a form of matching, for matching involves bringing things into significant correspondence with each other.

In a trading venture, the significance is usually taken to lie in the net financial result, which is measured by the difference between "costs" and "revenue," or, better perhaps, between the revenue and appropriate charges against revenue. Difficulty arises in determining what are appropriate charges, for somewhere in the procedure there must be a subjective judgment, and in this case it lies in the interpretation of appropriateness. This is the main reason why different results of the same series of ventures can be obtained by accountants applying different criteria—some of the criteria depend upon the application of personal judgment (whether "expert" or otherwise) to ventures, the result of which cannot be definitively ascertained.

In usage ventures, the matching is often applied to physical rather than monetary aspects of usage. Thus, in a continuous inventory record, the *number* of items of a commodity used is compared or matched with the number of items acquired. The objective is a controlling of the quantity on hand from time to time and the revealing of leakages or of errors in recording usage on particular jobs, and it is in this physical comparison that the significant relationship here lies. Again, in the case of long-term or "fixed" assets, accountants, so far as they may be regarded as having a general or uniform attitude on the question, appear to consider that the acquisition of a machine or building or motor vehicle represents the acquisition of a physical embodiment of a quantum of services which is allocated on some pre-determined basis through time or through exhaustion of services.[1] Although the allocation is almost invariably expressed in monetary terms, the underlying comparison or matching is between the quantum of services acquired in the first place and the quantum of services used up in a given subsequent period.

In financing ventures, the matching lies in the charge and discharge character of the record of the commitment initially entered into. This is a very old form of record-keeping and is succinctly described by Professor A. C. Littleton in the following terms:

> Its principal characteristic was that the party reporting would charge himself with the values he became responsible for and discharge himself in the record from every release from responsibility regardless of the cause.[2]

This description constitutes but one example of a large series of what are here regarded as financing ventures. The elements of charge and discharge are present in every debtor's account and every creditor's account, in every page of a shareholder's or debenture-holder's register, and in every bank account and mortgage account. The significant relationship here is of necessity a financial one, and the determination of the difference between the expressed amounts of the two elements, that is, the balance of the account from time to time, is the significant objective. This is a

[1] Cf. W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Chicago: American Accounting Association, 1940), pp. 82, 84.

[2] A. C. Littleton, *The Structure of Accounting Theory* (Urbana: American Accounting Association, 1953), pp. 2-3.

matter that admits of no differences of opinion (provided, of course, that the record is full and correct); it is, to use an expression of Professors Paton and Littleton,[3] objectively verifiable.

The matching procedure in this wider sense is thus a universal feature of the recording aspect of accounting, and, indeed, of its reporting aspect as well. As already mentioned, a profit and loss statement is a summary of matched charges and revenues, orientated to a specific period, and is generally recognised as such; the matched character of a balance sheet, a statement of affairs and a funds statement should also be recognised.

With the balance sheet, whether we regard it as a by-product of the profit and loss statement or not, the assets are summarised on the one hand and the creditors and proprietary interests on the other, and the two groups are, in total, perfectly matched. In some forms of presenting balance sheet information, where, for example, current assets are compared with current liabilities and the difference (working capital) is given emphasis, the matching character of the procedure is slightly more apparent, in that a more specific matching of particular groups of items is attempted. The same applies where, say, a mortgage liability is set off against a specific real property asset to show the owner's net equity in the property.

A statement of affairs, arising from a prospective bankruptcy or liquidation, differs from a balance sheet chiefly in the use of estimated realisable and estimated ranking amounts for all items of an asset and liability character respectively; they are matched none the less, with specific matching between such items as secured creditors and the estimated value of the secured property.

In the funds statement, the matching takes place between the sources of additional resources over a period and the way in which those resources have been applied to certain objectives. It should be noted, however, that much specific matching may be hidden (and, incidentally, much detailed information of use to the reader may not be given expression) by the short-cut method of its preparation and the summary character of presentation of the statement. For instance, the fact that a bank overdraft or bank loan had been raised to meet a seasonal financial demand and dis-

[3] *Op. cit.*, pp. 18 ff.

charged within the period covered by the funds statement would find no outward expression in the statement as conventionally prepared and presented.

IV The Concept of Coherence

As we have seen, events are, in themselves, occurrences which can be considered in isolation from other events and in relation to other events. The link between one event and another is their inter-relation within a venture which is so expressed by the procedure of matching. Events are, so to speak, the atoms of accounting; ventures are its molecules; and just as, in the chemical world, there are simple molecules and complex molecules, so we may have simple ventures and complex ventures.

Ventures may vary from an almost (but not quite) simultaneous pair of events to an almost (but not quite) infinite series of events extending over decades or even centuries. They may vary from the extremely simple one comprising the purchase-cum-sale of one unit or commodity to the exceedingly complex one comprising the incorporation, growth, decline and liquidation of a company or the institution, operation and abolition of a government department.

An essential concept in accounting is that of coherence within the venture. From beginning to end of a venture, the events comprising it are related to each other as parts of a whole. What gives this "wholeness" may vary from case to case. It may be a physical or (relatively) natural unity, as in the purchase and sale of an acre of land or the construction and use of an electronic computer. It may be a social unity, as in the case of the life of a golf club or a musical society. It may be a unity arising from a legal obligation, as in a trust estate. It may be an economic unity, as in a commercial or industrial enterprise.

In the complexity of contemporary life, various kinds of ventures are being undertaken by any one person or group of persons at any one time, the overall effect being that the distinction between them is often blurred. It is one of the important services of accounting to provide a technique by means of which the events in a conglomeration of ventures can be distinguished, segregated and analysed, and their inter-relations and interacting effects determined.

Consider the simple case of, say, a tennis club, which provides facilities for regular week-end sport for its members, with inter-club matches during a season, a club tournament twice a year, and social functions, such as dances, from time to time. Several of these ventures may be in course of execution at any given time; the dance committee may well be selling tickets to members and others while a tournament or inter-club match is in progress. These ventures are contemporaneous, but not necessarily of the same duration; we have not a succession of ventures, but series of ventures overlapping in time and duration. The club dance may be regarded as one venture, and as it is, say, the responsibility of the dance committee, it might be thought that it is this functional responsibility which is the basis of unity for the venture. However, the case is rather the reverse: it is the unity of this one venture which underlies and even creates the functional responsibility of the committee. Whether it has discharged its responsibility well or ill may be judged from the results of the venture —that is, the dance—when viewed as a unity in itself and apart from the other ventures which the club undertakes through other committees or members.

Functional responsibility, however, may be the reason behind the unity of some series of events. The illustration of the tennis club may be simple and relatively unimportant, but similar considerations apply in more "serious" areas. For example, the production manager who has the responsibility of carrying out and controlling the production programme of a manufacturing organisation will normally view his activities as stopping at the completion of the process of manufacture; what the ultimate fate of the products may be is not his concern functionally. The sales manager, responsible for the marketing of his firm's products, will view his series of ventures as starting with the putting of the finished products into the store or warehouse; if he is concerned with production, it is only in so far as it affects the supply or quality of the products he has to sell. Each of them will be judged on the ascertained results of an agglomeration of ventures. Viewed as an economic phenomenon, however, the ventures should each be regarded as comprising production and sale of commodities or services. The general manager who is responsible for the whole organisation as an economic unit will, of necessity, view the ac-

tivities of his subordinates in relation to each other as parts of the ventures of production, selling and financing.

The venture is thus a very fluid concept. When we ask what it is that gives a venture its essential unity, what it is that makes events cohere, so to speak, within a venture, the answer is not found in any single factor, unless it be the subjective one of intention or decision to engage in a venture. That is to say, ventures do not merely happen as "natural" phenomena; they are a result of social relationships consciously created—relationships between different human beings or between human beings and "things." The motive of profit that is often taken to be the mainspring of accounting is a partial answer to the question: it is valid for a large number of ventures, but not for all; it is not valid, for example, for the wide field of governmental and state-owned public utility ventures. Similarly with the notion of proprietorship and its accretion; while this view may explain much that happens in accounting, especially in the field of industry and commerce, it is not a satisfactory explanation for all areas. For example, in fiduciary accounting, the venture is undertaken by a trustee for the benefit of others; neither trustee nor beneficiary is, strictly, a proprietor in the sense of uncontrolled owner of the property comprising the estate, and the function of the trustee is to administer the estate, without diminution if possible or with a minimum diminution (as in the case of bankruptcy) but not necessarily with the object of increasing it.

A venture is coherent, in the sense here used, by definition. A venture *is* a series of related events, and the relation constitutes the coherence. It is not necessary for events in a venture to be "continuous" in the sense that there can be no lapse of time between them. On the other hand, a venture "continues" in the sense that it is still in operation until it is completed. The continuity is one of relation between events: it begins when the venture begins, it ends when the venture ends. This continuity is not merely a matter of convention, as is often suggested;[4] it is, rather, a matter of fact. Neither is the continuity applicable only to the whole of the activities of an enterprise viewed throughout its lifetime;

[4] Cf., for example, W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Chicago: American Accounting Association, 1940), pp. 9 ff., or almost any introductory accounting text-book published in recent years.

it applies to each of the separate ventures engaged in—to the determinate as well as the indeterminable ventures. Indeed, the continuity which is generally propounded in accounting text books is, to some extent, an illusory continuity: the determinate ventures of a commercial or industrial enterprise are so numerous—and contemporaneous as well—that they give an illusion of continuous activity when the enterprise is considered as a venturing unit itself. Nevertheless, the separate ventures are there, and the accountant is faced with the task of segregating each one from the others and of assessing its influence from time to time.

Having set up the continuity of an enterprise as one of the basic postulates in accounting, many writers go on to say that this continuity is arbitrarily interrupted by temporal considerations, that is, by the necessity to assess the progress of the enterprise from time to time. If the continuity convention as thus generally postulated is accepted, this futher proposition is no doubt true. However, what it amounts to, in the view and terminology here suggested, is simply that at any given point of time within an indeterminable venture (or, for that matter, within a determinate venture), the venture is not complete. Put in this way, it appears to be tautological; but when we recall that some indeterminable ventures are compounded of many determinate ventures, we can get more meaning if we consider that at a given point of time within a complex, indeterminable venture, many of the unitary ventures, both determinate and indeterminable, are not complete. It is this which explains and justifies accrual accounting.

V The Time Period

The multifariousness and complexity of ventures are in themselves sufficient to make the accounting for them a task that is far from easy, but the difficulty is increased—and so too, incidentally, is the interest—because of the need, under modern conditions, to recognise the pervasive influence of a time factor.

The element of time has never been quite absent from accounting procedures—dates have always been important in accounting records and reports; but in the days when ventures were relatively few and took months or years to become finalised, regular periodical accounting would have had less meaning for the venturers than the accounting for the several ventures as they became final-

ised. With the speeding up of transportation and communication and with the development of continuous manufacture in anticipation of ultimate consumption, the typical venture became both foreshortened and extended. Rapidity of manufacture meant that commodities or materials were quickly turned into finished products and sold, while mass production stimulated demand and reduced the measurable unit for sale or disposal. Thus the typical commercial and industrial venture became a smaller and quicker thing than before. At the same time, however, the development of machine methods of production involved the use of more capital than could be provided by a few partner-investors, and necessitated a more permanent form of investment than the device of partnership permitted; the venture became indeterminably lengthened to the life of a joint-stock company or public utility organisation with no determinate limits within that life. Of course, there were exceptions to both movements, but in general it appears to be true that in the last century and a half there has been a replacement of the finite venture by very short trading ventures and very long financing ventures, with usage ventures being sometimes of short and sometimes of long duration.

Influences were also at work which came to necessitate the regular periodical assessment of venture results, so that multitudes of short ventures had to be accumulated while long ventures had to be split up in order to accord with the concept of period. These influences are well recognised, including, as they do, such factors as legal requirements in company legislation for annual statements, the marriage of the notion of profit with that of rent yielding annual dividends as their offspring, and fiscal requirements of annual statements of income for purposes of levying tax based on or related to annual income. In the course of a relatively short period, the year became a sacrosanct concept in governmental and business practice and, indeed, in all our social life, to such an extent that it is now almost universally used in accounting practice,[5] whether or not it is a suitable or natural

[5] One significant exception lies in the area of fiduciary accounting; in the case of a liquidation or bankruptcy, for example, the accounting is fundamentally on a "when through" basis rather than on a periodical basis, but, where the realisation and disposition of assets extends over a lengthy period, interim periodical reports are prepared and progress distribution of proceeds may be made.

period and whether or not other periods—longer or shorter—are envisaged in addition.

The concept of a fixed, regular period has been imported into the field of accounting through social influences from sources outside accounting. It has brought with it all sorts of difficult problems, some of which have not yet been solved; at the same time, it has brought independent, professional status to accountants who have to deal with those problems and present answers to them. The concept of an accounting period has become one of the basic postulates of accounting theory, doctrine and practice as these are expounded today, and is so well known that it needs no further specific exposition here.

There are, however, a few aspects which have not usually attracted much attention but which deserve some consideration.

Rightly or wrongly, a year's activities have themselves *come to be regarded* as a venture. The accounting view which establishes the year's results as a comparison of the position at the end of a year with that at the beginning is an illustration of this. It is tantamount to saying, in effect: We started on this periodic venture in that position; at the end of it, a year later, we were in this position; the result of our venture is the difference between this and that.

In governmental affairs, the pervasiveness of the year as a basis of venture measurement is especially noticeable. A government treasury lives from year to year, estimating governmental activities and their results near the beginning of the year and having legislation provided accordingly; rarely can legislation in relation to financial resources be provided for events beyond the year; and at the end of the year a new estimate is made and fresh legislation is passed for another year, with the past year's experience as a guide but as little more. The procedure of budgeting seems to be essentially founded on the view that a period is the basis of the venture, and the regular comparison between "actual" and budgeted results reinforces this view.

What this means, in effect, is that the events taking place in, say, a year are related to each other in terms of time, and, whatever other relationships may subsist between them, this temporal relation is regarded, for the purpose of accounting for

them, as being extremely, and perhaps supremely, significant. Short-lived ventures are accumulated over a period, while long-lived ventures (that is, those whose temporal limits extend beyond one or both boundaries of the given period) are split up between the several periods involved. In short, one of the very significant relationships between events in this sort of case is that they all take place or are interpreted as taking place within a given period.

It is this presumed coherence of events in terms of time which has given rise to the "accounting period." Its importance has been indicated so frequently in accounting literature of the past fifty years that it is not necessary to emphasise it here. As one instance, however, we may cite Professor W. A. Paton who wrote in 1922 that

> accounting . . . might almost be defined as the art which attempts to break up the financial history of a business into specific units, a year or less in length. In other words, it is the business of the accountant to prepare valid statements of income and financial condition in terms of specific periods of time. . . .[6]

The element of time relationship is inescapable in accounting procedures, but not merely for the reasons implied in this passage from Professor Paton's work. Even if, as accountants, we attempted only to report in terms of ventures, we should find that many of the outlays we were normally concerned with—rent, insurance, interest, are obvious examples—are made on a time basis, as also is revenue in some cases. We should thus be forced to consider the problem of "time outlays" and "time revenue" in relation to specific ventures. It is thus not merely a question of attempting "to break up the financial history of a business into specific units" of time; it is a matter also of building up time elements into specific ventures, and of building up and breaking up ventures into units of time. The "financial history of a business" is itself the history of a venture; a venture occurs through time, that is, it takes some time for any venture to be carried out.

One other point of minor criticism might also be raised to this statement. This is the emphasis placed upon financial history and upon the business. Within the context of his book, Professor Paton

[6] W. A. Paton, *Accounting Theory* (Ronald Press Co., New York: 1922), p. 469.

is possibly justified in using the expressions he does here, for in his preface he states that "in this book . . . an attempt has been made to present a restatement of the theory of accounting consistent with the conditions and needs of the business enterprise *par excellence*,"[7] and in the introductory chapter, "the essence of the accountant's task consists in the periodic determination of the net revenue and the financial status of the business enterprise."[8] It should be recognised, however, that accounting procedures are not by any means restricted either to business enterprises or financial matters; neither can it be said that all of the advances in accounting procedures have originated in business experience. The concept of budgeting, for example, originated in governmental practice, while the practice of auditing pre-dated the emergence of the modern business unit by several centuries. These comments, however, are parenthetical to the main argument of this section.

Widespread as is the practice of using a more or less arbitrary accounting period and despite the emphasis it has received in accounting literature for a long time, venture accounting is still widely used. Its use, however, is usually made to fit into the framework of period accounting.

There is no doubt that the accounting period or, preferably, the reporting period, is a very important unit in terms of which events are assessed. It is not, however, the only period affecting accounting procedures. Fiscal influences and legal requirements might dictate a reporting period of a year, but the customs of trade and the exigencies of financing, to say nothing of the problems of management, make it necessary to undertake accounting procedures more frequently than yearly. If creditors require payment monthly, it is not satisfactory to defer all accounting procedures to a yearly basis: it would be wise, if not necessary, to keep a record of accounts payable on at least a monthly basis. Employees could not reasonably be expected to wait a year for payment for their services, and weekly or fortnightly payroll records are customary. These periods of a week, fortnight or month do not constitute a reporting period or an accounting period in the usually

[7] *Op. cit.*, pp. iii-iv.
[8] *Op. cit.*, p. 6.

accepted meaning of the latter term, but they do represent significant periods for accounting purposes. That is, while the initial documentation of many events may take place more or less as they occur, whether regularly or irregularly, there is a periodicity in respect of them which is significant for purposes other than reporting. Such periods represent minima in terms of which the respective recording functions of accounting should be carried out. To distinguish this type of period from the more frequently discussed "accounting" period, it may be designated the recording period or the posting period.

The recording period may be and usually is shorter than the reporting period; in some cases, it may be as long as it; but it may not be longer. There may be recording periods of varying length for different aspects of activity within the same enterprise without affecting the length of the reporting period in any way. Thus we may have weekly payroll recording, monthly debtors' billing and quarterly interest scheduling with annual enterprise reporting. The distinction between the recording period as such and the reporting period as such lies in the fact that the former is dictated by the exigencies and conveniences of recording as a procedure, while the latter is dictated by the requirements of reporting as a procedure—whether it is a matter of reporting (by a company) to shareholders on the year's results for the purpose of considering the propriety and extent of a dividend, or a matter of reporting (by a taxpayer) to the government for the purpose of tax assessment, or a matter of reporting (by a government treasury department) to the representatives of the people for the purpose of levying taxes.

The Unit of Outlook

I *Introduction*

IT HAS BEEN postulated in Part I that one of the distinctive features of accounting procedures is that they are carried out consistently from a particular point of view. It is now necessary to consider more closely what this point of view is.

In the past, two main "theories" or propositions have been advanced to explain or expound who or what has engaged in accountable activities. These have come to be known as the proprietary and entity theories respectively. Neither has proved completely satisfactory, and accounting literature in recent years contains several instances of attempts to refine each of them to make it more fully explicatory of and consonant with modern circumstances.[1] In addition, a third proposition was advanced some years ago by Professor Vatter, who advocated the use of the notion of the fund as the basic accounting unit.[2]

Some of the grounds for dissatisfaction with these theories will be considered in following sections, but it may be pointed out here that, while none of them can be said to be a complete theory of accounting, it does not necessarily follow that they are all mu-

[1] See, for example, the following articles in *The Accounting Review:* Waino W. Suojanen, "Accounting Theory and the Large Corporation" (July, 1954); George R. Husband, "The Entity Concept in Accounting" (October, 1954); George J. Staubus, "The Residual Equity Point of View in Accounting" (January, 1959); David H. Li, "The Nature of Corporate Residual Equity under the Entity Concept," (April, 1960); *et al.* See also George J. Staubus. *A Theory of Accounting for Investors* (Univ. of California Press, 1961).

[2] William J. Vatter, *The Fund Theory of Accounting and Its Implications for Financial Reports* (Chicago: The University of Chicago Press, 1947).

tually exclusive, nor that any of them must be completely discarded in relation to appropriate contexts.

The proprietary and entity theories have been advanced principally and primarily in relation to the theory of double-entry, that is, with particular reference to the recording function of accounting. On the other hand, the fund theory has been directed primarily at the problem of reporting for management purposes. The adoption of such limited interpretations as points of departure, even though wider applications may be subsequently attempted, constitutes a weakness in the formulation of any basic theory.

One might be tempted to speak of schools of thought in connection with these theories, but this would be, to some extent, a slight distortion of the actual position. Only a few writers on accounting have clearly indicated an adherence to one of the theories to the complete exclusion of any other. In many cases, while one has been espoused initially, another is used when the occasion is deemed to warrant it. In recent years, however, increasing attention has been paid to the question, especially since the search for accounting "principles" was inaugurated in the United States of America in the early 1930's, and the contrast between the entity and proprietary theories has been sharply drawn by writers such as A. C. Littleton,[3] S. Gilman,[4] W. J. Vatter[5] and others.

Part, at least, of the difficulty in formulating a satisfactory series of propositions in this area of accounting theory has arisen from pre-occupation with the notion of ownership which lies at the base of the proprietary theory and which has been taken over into the entity theory. For the development of a modern theory of accounting, such an emphasis on ownership would seem to be somewhat misplaced, since so many of today's accounting problems appear to be concerned more with management than with ownership. Yet, the problems of ownership must also be given adequate attention, since they may well have at least as great a social

[3] A. C. Littleton, *Accounting Evolution to 1900* (New York: American Institute Publishing Co., 1933), Ch. XI, XII.

[4] Stephen Gilman, *Accounting Concepts of Profit* (New York: Ronald Press, 1939), Ch. 4, 5.

[5] *Op. cit.*, pp. 2-7.

significance for accounting practice as those of management; hence, they should not be ignored or played down in accounting theory.

The propositions we have to consider are concerned with the "point of view" (or "viewpoint") from which accounting procedures are carried out, and it is proper to consider briefly a few matters connected with the meaning of this expression, "point of view."

The expression itself is metaphorical. It means the relative position from which anything is seen or any subject is considered, that is, essentially, a point or position from which to "view" (see or consider) something or anything. Thus, one of the attributes of a human being is his capacity to "have" or adopt and express a point of view. When I say that from my point of view something is advantageous or disadvantageous, or agreeable or disagreeable, all I mean is that I think or feel that it is advantageous or disadvantageous, agreeable or disagreeable. The expression adds nothing to the content of thought, but is merely, in the last analysis, an expression of emphasis.

Thus, a point of view is essentially a personal and individual matter. When we say that we consider something from another's point of view, we mean that we imagine ourselves in that other's place and attempt to consider the subject-matter as we think *he* would consider it. And the only possibility of verifying the identity or correspondence of these two processes of considering lies in communication of the result.[6]

II The Entity Theory

The theory which is probably most widely adopted nowadays by accounting writers and teachers in presenting at least the initial approach to accounting is the entity theory, and it is also the one which is most generally accepted by the present generation of practising accountants—whether in public or private accounting—because of the influence of these writers and teachers.

The entity theory—or, as it is frequently referred to, the entity convention—has been the subject of varying degrees of expo-

[6] For a consideration of some of the difficulties of communication, see Chap. 16, The Problem of Communication.

sition, but, in essence, those who adopt it postulate and insist that the unit in terms of which accounting procedures are carried out is an "entity" quite separate and distinct from any human beings who might have interests in or association with it. That is to say, for accounting purposes, every enterprise is regarded as an entity distinct from its proprietor or proprietors or members as it is distinct from its managers and its operatives.

By an enterprise is meant a unit such as a business or society or association of people through which and in the name of which its owner or members have dealings with other persons. Examples of an enterprise, in this sense, would be the retail store which is owned and managed by one person who has dealings with the people from whom he buys goods and with those to whom he sells goods; a football club which, through a committee acting on behalf of its members, is regarded as renting a ground, buying footballs and equipment from sporting goods traders, receiving subscriptions from its members and collecting admission money from the people who go to see the club's team play other teams; a company which is incorporated as a legal person, whose personality is evidenced by its seal, and in whose name its directors, appointed by and acting on behalf of its shareholders, enter into contracts with other enterprises as here defined.

It is usually readily accepted that in each of the two latter cases the "club" or the "company" is something different from the members or shareholders. In the case of the football club, it is only their interest in a particular team which draws the members together for one purpose only—in all other respects, they follow their own needs and inclinations. The club is regarded as existing apart from any of them in his individual capacity, and we therefore regard it as a separate enterprise, and, for accounting purposes, as an accounting entity. In the case of the incorporated company, somewhat similar considerations apply, and in this case the position is reinforced by the endowment of legal identity and, in most cases, by the limited liability of the shareholders; it, too, is readily accepted as an accounting entity.

The same distinction may be made, for accounting purposes, in the case of the man conducting his own retail store. As a storekeeper, he has dealings with, say, wholesale traders and with his

customers; these dealings are regarded as being undertaken through and on behalf of his business. He may have other commercial interests in addition to his store; for example, he may run a poultry farm or a manufacturing business. Each of these interests is regarded as distinct from the others and distinct from the owner. In each case, he comes in contact with other people through his business, and each interest constitutes a separate enterprise and a separate accounting entity.

For accounting purposes, it is the point of view of this accounting entity which is adopted—that is, it is the records and reports of the enterprise with which accountants are concerned.

Professor Littleton[7] traces the conscious application of the theory by accounting writers to about the middle of the nineteenth century, but at the same time he states that the basis must have been present in medieval agency bookkeeping.

Dr. Gilman,[8] relying on the evidence of Dr. Peragallo,[9] suggests that it was used by Pacioli himself in 1494 when he wrote about branch bookkeeping. At the same time, Dr. Gilman insists that the separate entity applies only in relation to double-entry recording and would prefer the use of the expression "accounting entity" to indicate that it relates only to double-entry records.[10]

It is not necessary at this point to attempt any detailed history of the entity theory, but it may be pointed out that there appears to be little evidence that accounting writers before the twentieth century deliberately and consciously adopted the entity viewpoint in presenting their theses to their readers. However, it began to be specifically adopted early in the twentieth century.

For example, one English writer in 1910 clearly implied the entity viewpoint when he advised his student-readers as follows: "For the purposes of book-keeping treat capital as a liability—treat it just as if it were a debt payable."[11] Another writer in the same year was even more specific:

[7] *Op. cit.,* pp. 193 ff.

[8] *Op. cit.,* pp. 48-49.

[9] Edward Peragallo, *Origin and Evolution of Double Entry Bookeeping* (New York: American Institute Publishing Co., 1938).

[10] *Op. cit.,* p. 48.

[11] Walter W. Snailum, *Fifteen Studies in Book-keeping* (Cambridge Univ. Press, 1910), p. 24.

> The business by its transactions with individuals incurs these losses, or makes these gains. . . . For this purpose the business is regarded as a separate entity, distinct from its proprietors and accountable to them as if it were an accounting party.[12]

It would appear that Harold D. Greeley was amongst the earliest of the American writers to advocate the entity theory wholeheartedly; his work of 1920 contains a strong and unequivocal expression of the theory:

> Whatever form of organization may be used, it should be borne in mind that for accounting purposes the business must be considered as an entity apart from the proprietor. In other words, the proprietor must be treated as if he were completely detached from the working organization, but owning certain rights and incurring certain obligations in connection with the business. This status of the proprietor is clearly defined in the corporate form of organization, where the proprietor, as a stockholder, is in every respect a different person from the corporation. It is less clearly marked, but no less important, in the partnership and the sole proprietorship. . . . Some writers explain the proprietor's distinctive relation to the business by considering the bookkeeper as representing the business and thus as accountable to the proprietor. This seems fanciful and without merit because the bookkeeper or the accounting department has no title to any of the business property and is under no obligations except those of employees. The business should be regarded as a distinct entity without considering any person within its organization as its representative. . . . Statements made throughout this volume to the effect that "the business" owns certain property or is under certain obligations are based upon the distinction between the proprietor and the business.[13]

In 1922, Professor Paton, strongly objecting to the position that "as commonly presented in current textbooks and other writings, the theory of accounting is saturated with the 'proprietorship' concept," extended the "fiction of the corporate entity" to all cases, although he admitted "important qualifications."[14]

Professors Paton and Littleton, writing in 1940, could say that

> it has become almost axiomatic that the business accounts and statements are those of the entity rather than those of the proprietor, partners, investors, or other parties or groups concerned.[15]

[12] James Fitzpatrick, *Book-keeping* (London: Butterworth & Co., 1910), p. 12.

[13] Harold Dudley Greeley, *Theory of Accounts* (New York: Ronald Press, 1920, 3rd printing 1924), pp. 19-20.

[14] William Andrew Paton, *Accounting Theory* (New York: Ronald Press, 1922), pp. iii, iv.

[15] W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (American Accounting Association, 1940), p. 8.

At about the same time, Dr. Gilman presented what is probably the most enthusiastic and whole-hearted exposition of the theory yet put forward.[16]

Basing his treatment on what he calls a personal accounting entity, he uses an illustration supposedly taken from ancient Roman times, in which a slave carries out business dealings on instructions from and on behalf of his master. The records which the slave might have kept would have introduced the pattern of double-entry bookkeeping. These records would have been the slave's own personal record and would reflect "the slave's viewpoint toward his master and toward the world in general."[17] Amounts advanced by the master to the slave for carrying on business activities would be viewed by the slave as debts owing to the master; amounts paid to the master would be regarded by him as reducing that debt, while any losses incurred through carrying out the master's instructions would act equally as a discharge of the slave's indebtedness to the master. Whether profits are made or losses incurred in the course of the slave's business activities, the slave "neither benefits nor suffers because of increases or decreases in the funds transferred to him."[18]

Dr. Gilman makes much of this master-slave illustration, and, although he does not assert its historical truth, he regards it as a vivid and highly satisfactory analogy for "picturing the agency relationship between a business and its proprietor and the absolute right of control over the business *by the proprietor*."[19] His interpretation is thus based essentially on a concept of ownership. His enthusiasm for this master-slave approach brings him to saying that "there is no method of explaining the basic accounting mechanism which is so helpful. The slave is a separate personality and yet under the absolute domination and control of a master. It is from the interplay of these two concepts that modern accounting theory and practice has [sic] developed."[20]

It is interesting to note that Dr. Gilman bases his illustration

[16] Gilman, *op. cit.*, ch. 4, 5.
[17] *Ibid.*, p. 39.
[18] *Op. cit.*, p. 41.
[19] *Op. cit.*, 40 (italics supplied).
[20] *Op. cit.*, p. 45.

on "the story told by Littleton in *Accounting Evolution to 1900*";[21] Professor Littleton in turn acknowledges his indebtedness to a suggestion by P. Kats in the late twenties.[22] At each stage of borrowing the notion appears to have gathered strength and lost tentativeness. It is also of interest to note that more recently Mr. de Ste. Croix has shown conclusively that double-entry recording did not exist among the ancient Romans or Greeks, nor did they have anything closely approximating to it.[23]

Even accepting the master-slave illustration for the sake of argument, however, one might ask whether it is really likely that the slave's attitude towards his master would have been exactly the same as his attitude towards his (or his master's?) creditors. For one thing, the master could whip him or reward him because the slave was his property, but the creditors would not have been able to do so—or if they did it would surely have been only by grace of the master.

Narrowing the circumstances down further to the supply of fund for business activities, if the master wished to withdraw resources which would leave creditors' claims unsatisfied, the slave would surely have felt constrained to tell the master that the creditors would probably request satisfaction and would have recourse against the master, not against the slave. And the master would be foolish indeed if he did not recognise a difference between his claim and that of the creditors. After all, they would be his creditors, and not the slave's.

From consideration of this personal accounting entity, Dr. Gilman moves to that of the modern impersonal accounting entity, typified by the business corporation but relevant and applicable to any case of double-entry bookkeeping. Although he recognises that "an artificial person, strictly speaking, can have no viewpoint"[24]—and presumably he has the modern corporation in mind—he asserts that "nevertheless for clarity it seems permissible to say that from the viewpoint of the entity there is no distinc-

[21] *Op. cit.*, p. 38.

[22] A. C. Littleton, *Accounting Evolution to 1900* (New York: American Institute Publishing Co., 1933), pp. 26, 32.

[23] G.E.M. de Ste Croix, "Greek and Roman Accounting," in A. C. Littleton and B. S. Yamey, *Studies in the History of Accounting* (London: Sweet & Maxwell Ltd., 1956), pp. 14 ff.

[24] Gilman, *op. cit.*, p. 51.

tion between the proprietor and other creditors."[25] But, if an artificial person can have no viewpoint, is it permissible, even for the sake of clarity, to say that it has one? One might further ask what is cleared up by this gratuitous assumption which does not accord with any observable facts. He insists that the entity is "as soulless and automatic as a slot machine,"[26] that it cannot, "in and of itself," make profits or incur losses, and that it is "incapable of enjoyment, sorrow, greed or other human emotions."[27] Nevertheless, he argues that if double-entry records are instituted the records are kept from the point of view of the entity; in the absence of double-entry records, he would apparently deny the existence of an accounting entity.

In attempting to explore this notion a little further, I have, on a previous occasion,[28] expressed the following views:

> Now, if we take the entity theory to its ultimate end, we reach the stage where a person may become an (accounting) entity distinct from himself.
>
> For example, I may keep, on a double-entry basis, an accounting record of all my financial transactions. I may be interested in two or three business ventures, each of which is conducted (under the entity theory) as a distinct accounting entity, showing the amount "owing" to me as a proprietor. Besides these, I may have other assets such as shares, debentures, bonds, a motor car, freehold property, and so on, and liabilities such as bank overdraft, personal creditors, mortgage debts, etc.
>
> A balance sheet can be prepared to show these assets and liabilities, and including as an asset the amount of the capital of each business venture which I conduct. My "final" capital or proprietorship can be made the subject of accounting to myself in the same way as can the capital of any business enterprise. If we accept the entity theory, I have become an entity distinct from myself.
>
> The question then arises: What part of me is it that has become distinct from the rest?
>
> As it is possible for me to account for my possessions, it seems that the entity theory has a philosophical—almost an ethical—basis, in that it emphasises the essential objectiveness of personal wealth. It states, in effect, that a man and his wealth or possessions are not identical. We account to a person bereft of his possessions for his possessions. The things that cannot be accounted for are those physical, mental, spiritual and moral qualities which constitute the ego or personality and which cannot be divorced from it. All else can be accounted for—from shoes to shares and matches to motor cars—because it is measurable. . . .

[25] *Ibid.*
[26] *Op. cit.*, p. 52.
[27] *Ibid.*
[28] L. Goldberg, *An Outline of Accounting* (Sydney: Law Book Co., 1957). See pp. 29-30.

In the consideration of personal accounting, that which really belongs to a person intrinsically—the intangible but inherently most valuable qualities, such as wisdom, learning, health, conscience, personality—cannot form the substance of accounting, not merely because they cannot be measured, whether in money or otherwise, but because they *are* the entity to whom the accounting must be made; they *are* the person. For these things we cannot account.

III *The Proprietary Theory*

The proprietorship viewpoint involves a completely different outlook from that presented in the entity theory. The essential difference is that the unit considered, instead of being regarded as something distinct from the proprietor, is the proprietor himself.

Professor Littleton,[29] in tracing the origin of both the entity and the proprietorship viewpoints, contrasts them succinctly and vividly as follows:

> The entity theory, as the name suggests, stresses the separateness of "the business" and the proprietor. Bookkeeping, under this view, is primarily concerned with accounting to "outsiders" for all property *entrusted* from without to "the business" and dedicated to its purposes. This is quite opposite to the proprietorship theory, in which bookkeeping is viewed as an accounting by the proprietor for his own property in detail and in total.
>
> So fundamental a difference in point of view as this must be indicative of an underlying difference in the concepts of the real function of bookkeeping and of capital and income. Capital, according to the proprietorship view, is the proprietor's contribution; liabilities are merely negative assets. But in the entity theory, capital is the sum total of property active in the business from whatever source derived; liabilities (loans) here are considered to be "capital sources" as much as proprietary investments can be. Profit, according to the proprietorship theory, is an increase in the net figure of positive and negative property (i.e., in net assets); in the equity [sic[30]] theory, profit is the excess of proceeds recovered over the outlays advanced during the business process. In the first view, profit is any increment to proprietorship however obtained; in the other, it is the reward for managerial skill in advancing such outlays as will produce an excess when recovered. In the first theory the concept of capital produces a balance-sheet equation of: assets — liabilities = proprietorship. In the second theory the concept of capital produces a balance-sheet equation of: assets = investments.[31]

One of the best descriptions of the unit adopted in the proprietorship theory comes from the pen of an economist:

[29] Littleton, *op. cit.* See especially Ch. XI and XII.

[30] This appears to be a misprint for "entity."

[31] *Op. cit.*, pp. 191-92. "Investments" here means claimant sources of assets, or "accountabilities," comprising both creditors' and properietors' claims.

> The individual proprietorship . . . is the most common type of business firm. Most farms are operated under this form of ownership, and so are many firms in retail trade, the service industries, and the professions. The structure of such a firm is very simple. Essentially it is a one-man business. It has an individual owner, who generally supplies most of the funds required, who directs the firm, and who receives all the profits since he owns and controls the business. Technically, the firm is not distinguished from the man who owns it. It lives just as long as he wishes it to live. If he retires from business, it goes out of existence. Its assets are his assets, and its debts are his liabilities. Thus it is simply the business aspect of a man in business for himself.[32]

The proprietary theory is thus an expression of events from the point of view of the proprietor. It appears to be a reasonable approach to adopt for any enterprise in which a sole proprietor is concerned; it would seem natural for him to adopt the view that he requires an accounting for *his* investment. If we apply Gilman's master-slave illustration, the viewpoint adopted is that of the master, whereas the entity approach reflects the viewpoint of the slave.

It should be noted, however, that the notion of the "firm" in economic study is the counterpart of the notion of the entity for accounting purposes—both are abstractions which are personalised in their respective literatures.

> The typical business firm in our economy [says Tarshis] is most complex. The business firm is anything from the little boy who shines shoes or delivers newspapers to the American Telephone and Telegraph Company. . . . The business firm is the critical unit in our economy. But though its structure is immensely varied, we must not overlook the underlying similarity between firms of all kinds, from the corner drugstore to the largest corporations in the country: the fact that all exist to earn profit, and that *they make all their decisions* as to output, price employment, and so on, with this end in view. It is because of this that we may make useful generalizations about their operations, and accordingly about the way in which the economy functions.[33]

This passage from an introductory text on economics raises questions analogous to those which face students of accounting. The statement that "all exist to earn profit" is reminiscent of Professor Littleton's requirement of the "dedication to gainful activities" of property as the substance of double-entry bookkeeping.[34] The economist makes it clear, however, that he is re-

[32] Lorie Tarshis, *The Elements of Economics* (Boston: The Houghton Mifflin Co., 1947), p. 34.

[33] *Op. cit.,* pp. 46-48. Italics supplied.

[34] Littleton, *op. cit.,* p. 27.

ferring to a particular economy—that of the United States of America at the time at which he is writing; the accountant is less cautious and as a result claims a greater share of universality for his proposition than it would appear to be entitled to.

IV The Two Viewpoints Compared

Professor Littleton has expressed the opinion that

> the proprietorship theory can best be associated with the proprietorship form of enterprise, in which the proprietor (including partners) and business are so inseparable (legally) that an accounting for the one is for all practical purposes an accounting for the other also. The entity theory is well presented in the corporate form of enterprise, for in this the contributions of capital are (legally) so distinct from the business that the term "ownership" loses its force; claims against the assets are so various in degree that the many forms of "indebtedness" shade off into one another without sharply defining the "owners."[35]

Dr. Gilman presents a somewhat different view when he states that

> both the entity and proprietary conventions have value. Like all conventions, each contains an element of artificiality. Either is valuable so long as it is consistently maintained. It is only when an unconscious shift in viewpoint from one to the other occurs that there is danger of false reasoning.[36] [And again], it is believed that much present-day altercation and disagreement with respect to income, costs, expenses, losses and surplus are traceable to an unconscious swaying between these two viewpoints. Thus, it is noted that lawyers as a class seem to be fairly well committed to the idea that a corporation is an entity, i.e., an artificial person. It is somewhat ironic that the lawyers, who have probably done more than anyone else to publicize and popularize the entity convention, do not themselves apply it consistently to all forms of proprietorship, nor in fact are they always consistent in applying it to the corporation.[37]

If both the viewpoints are artificial, the question arises: What is there, about the things which are considered from either viewpoint, that is not artificial? Is there any natural (as contrasted with artificial) viewpoint from which accounting procedures may be regarded?

The illustrations given by Professor Littleton in the passage quoted above present typical examples of each of the two view-

[35] Littleton, *op. cit.*, p. 203.
[36] Gilman, *op. cit.*, p. 50.
[37] *Ibid.*, p. 598.

points which can be readily appreciated, but they are admittedly based upon the legal accident of proprietary organisation. It might easily have happened that in the case of a sole proprietor or a partnership the same distinction between a business on the one hand and the contributors of capital on the other might be legally insisted upon as is the case with an incorporated company. Alternatively, can it truthfully be said that the viewpoint should have changed in the case of companies immediately the incorporation of joint-stock companies was legally recognised? And does a shift in viewpoint occur when a partnership is converted into a company? To answer these question affirmatively is to base the accounting viewpoint upon a legal sanction. If, on the other hand, the answer is negative, we are still left with the task of clarifying the viewpoint for accounting purposes in non-legalistic terms.

The analysis of the entity viewpoint has already been developed to some extent in Section II above. Dr. Gilman's presentation of the hypothetical master-slave relationship is an application of the viewpoint upon a personal plane, and he makes it quite clear that at the personal level the accounting records would be kept to indicate the slave's point of view. He is, however, insistent that this point of view is one adopted merely for the purposes of record-keeping. In considering Professor Paton's reservation about the entity concept, in which he (Paton) states that "to conceive of the business of the pop vendor at a football game as having any distinct existence, to take an extreme example, would obviously be quite fantastic,"[38] Dr. Gilman states that

> fantastic or not, and regardless of whether it is accepted or rejected, it remains true that if the pop vendor at the football game maintains a double entry accounting record, the viewpoint it expresses is that of an entity separate and apart from himself. Even the housewife cannot keep her household accounts in double entry without unconsciously accepting the entity convention.[39]

This appears to be a rather strong expression of a conviction, which is openly admitted in the next paragraph, that the entity convention is of general application.

[38] W. A. Paton, *op. cit.*, p. 477.
[39] Gilman, *op. cit.*, pp. 53-54.

Admittedly this is carrying the entity convention rather far, but it either has general application or is valueless and it seems preferable to think of it as general in order to determine whether it can stand the test of unusual application.

The objection to the entity convention in such a situation as that of the pop vendor may be due to an assumption that the pop vendor must himself recognize the entity convention. This, of course, is not true. The entity exists only in relation to double entry bookkeeping the rules and practices of which many have learned without ever having considered the artificial person whose viewpoint determines the accounting equation.[40]

In considering this matter, we have to be careful not to allow ourselves to be enticed into a ludicrous position by a distortion of the proper use of language. A double-entry accounting record is an inanimate thing, and to say that it expresses a point of view is merely to say that it contains information which reflects the point of view of some person. The question is: Who is the person whose viewpoint is expressed by this record? Dr. Gilman, obviously, would say that it is an artificial, imaginary person—an impersonal "slave." But surely there is some confusion here! He asserts—almost vehemently—the *truth* of the separateness of the "entity" and its viewpoint—a truth which has been ignored and unknown by countless thousands of bookkeepers and accountants in the past (and, perhaps, even a few in the present) who have nevertheless kept double-entry records expressing the view.

Now, of course, this is possible, just as millions of people managed to live (and die) before the discovery of vitamins, and bacteria, and oxygen. Is the "discovery" of the entity point of view then a scientific discovery? Is it a discovery of something that exists in fact, but whose existence was hitherto unsuspected? Or is it a formulation of a notion or theory of something whose existence is not proven, but the assumption of whose existence enables a more adequate explanation to be made of existing facts? If it is the former, then it must have been present in every set of books and we should be able ultimately to isolate it and examine it for chemical and perhaps physiological and who knows what other properties. If it is the latter, then it is surely a principle in accordance with which certain activities of men are carried out. Dr. Gilman, I suspect, would have denied both these possibilities: it doesn't really exist, it is a fiction created by men, but,

[40] *Ibid.*

although it doesn't really exist, it expresses a point of view. But this point of view cannot be its own, since it does not exist; it is not the proprietor's, since this is expressly denied in the case of the pop vendor.

The confusion arises, it would seem, from the widespread practice of attributing personal attributes to impersonal things. This is properly, we should all try to remember, the domain of the poet—and the maker of an animated cartoon. The more pedestrian of us might do better if we didn't overlook the fact that impersonal things are impersonal and if we used abstract nouns only if it is not possible to avoid them and in full recognition of the process of abstraction.

It was suggested in Section II above that, in following the entity concept backwards, we reached the position where an individual was separated into his measurable and non-measurable qualities. If I keep my own set of books, and am cognisant of the entity viewpoint, then I must regard myself in two ways—as something which can be measured and as something which cannot. Either this approaches so closely to the proprietary viewpoint as to be indistinguishable from it, or else it is so unreal and fantastic that, whether true or not, one's sanity must surely boggle at the schizophrenic implication.

We can, however, attempt to follow the idea backward in another way. We can imagine a Roman master, whose slave has been carrying out commercial transactions on his behalf, in conversation with the slave, illustrating in modern English language and currency instead of classical Latin and Roman coinage.

MASTER: Now, Rhubarbus, you say you have been keeping records to prove that you have not been lying to me.

SLAVE: Yes, Master.

MASTER: Well, where are they?

SLAVE: Here, Master, always near my heart.

MASTER: Let me have a look at them. H'm! These are what you call accounts, I presume?

SLAVE: Yes, Master. See, here is the one which shows that I lent Honorus £100 for which he repaid £125, as I told you.

MASTER: Yes, that seems clear.

SLAVE: And here is the one which shows that I handed to Fraud-

ulus (on your instructions and contrary to my advice, you will recall) the sum of £50, which, alas, he has not repaid; ah, woe is me!

MASTER: Stop snivelling, slave. What is this account in my name?

SLAVE: You see, Master, I have to keep a record for you as for everybody else.

MASTER: Why, for heaven's sake?

SLAVE: So that, when all transactions with which you entrust me shall have been carried out, I shall be able to pay you what is due to you.

MASTER: Son of a barbarian dog! Isn't all that you have mine? Have you anything that is yours?

SLAVE: Nothing material, as you say, Master; but only a poor point of view.

MASTER: What do you mean by that?

SLAVE: This record which I keep is my own personal record, and reflects my viewpoint towards you, Master, as well as towards the world in general.

MASTER: But what business have you got with a viewpoint?

SLAVE: I cannot help regarding myself as a distinct person, although I merely follow out your directions; and therefore my records are the kind that any man might make in dealing with another.

MASTER: Then you regard me in the same way as any other with whom you have dealings?

SLAVE: Only for purposes of my record, Master.

MASTER: Now, look here! The money I hand to you is my money and not yours, isn't it?

SLAVE: That is so, Master.

MASTER: And you only do with it what I tell you to?

SLAVE: Yes, Master.

MASTER: If I tell you to lend it to Honorus, it is my money that you lend, isn't it?

SLAVE: Yes, Master.

MASTER: And if he pays back £25 more than you lent him, that £25 belongs to me, doesn't it?

SLAVE: Yes, Master, and so does the original £100. But, as the money passes through my hands, I have to record first, that

I owe you £100, and later £125 when the debt is repaid.

MASTER: And when you hand me the £125, your debt to me is discharged, is it?

SLAVE: Exactly so.

MASTER: And if you lend some of my money to Fraudulus (and stop nagging about your better judgment or your contemplation of a point of view or anything else will be suddenly cut short) and he doesn't repay, that really means that I have lost the money, doesn't it?

SLAVE: Yes, Master, but . . .

MASTER: I know, it acts as a discharge of your obligation to me —from your point of view. Now tell me once again, you do not and cannot own any property?

SLAVE: No, Master.

MASTER: Then these records are not your property, but mine?

SLAVE: That is so, Master.

MASTER: But they are your records, as you said before?

SLAVE: Only in the sense that they represent my point of view.

MASTER: But since they are my records, don't you think they should represent my point of view?

SLAVE: But the idea is mine!

MASTER: But the records are mine, the money is mine, any profit is mine, and any loss is mine. And, from now on, I propose to keep these records myself, to show *my* point of view.

The records taken over by the master would appear somewhat as under:

Cash

Master—Capital	100	Honorus	100
Honorus	125	Fraudulus	50
		Master—Capital	75
	225		225

Honorus

Cash	100	Cash	125
Profit	25		
	125		125

Fraudulus

Cash	50	Loss	50
	—		—

Profit and Loss

Loss on Fraudulus	50	Profit on Honorus	25
		Net loss—transfer to Master	25
	—		—
	50		50
	—		—

Master

Net Loss	25	Cash	100
Cash	75		
	—		—
	100		100
	—		—

He might try to rewrite them, eliminating the slave's point of view, with a result similar to the following:

My Cash

Starting Amount	100	Honorus	100
Honorus	125	Fraudulus	50

My Right Against Honorus

Cash	100	Cash	125
Gain from Loan	25		
	—		—
	125		125
	—		—

My Right Against Fraudulus

Cash	50	Loss on Loan	50
	—		—

Summary of Gains and Losses

Loss on Fraudulus	50	Gain on Honorus	25

At this stage he would be able to see clearly enough that his transactions had resulted in a net loss of £25 and that he had £25 less cash than he had started with; but if he wished to close

off the accounts he would have to credit Cash account and debit some account for himself, say an Investment account, with £75 and debit the same account and credit Summary of Gains and Losses with £25. This would give total debits of £100 in the Investment account, which would have no credit entry until he realised that, of all the entries he had made, the initial one recording his starting amount of cash was the only one that did not have a corresponding entry on the opposite side of another account. By repairing this omission, namely, by crediting the Investment account, he could achieve the symmetry of a closed system.

The Investment account would then appear thus:

My Investment

Net Loss	25	Starting Cash	100
Closing Cash	75		
	100		100

A little contemplation of this account and of the entries by which it was set up would compel him to recognise that he was in fact viewing his financial transactions as something distinct from some other part of himself, even though the accounts reflected his own point of view. If he compared his accounts with those of the slave, he would find them identical in substance, differing only in the titles of the accounts. Thus, if he is to achieve the symmetry of closed accounts at the end of any transaction or series of transactions, he has to set up a record for some kind of unit or person that he must endeavour to think of as being capable of receiving cash. And if he wished to have a complete record of his financial transactions he would find it necessary to set up a capital or investment account, since he would have to record either his first receipt of cash or other material goods and all subsequent receipts and outlays, or else take some starting point in his life and list his material possessions in an inventory in accordance with the procedure set out vividly by Pacioli so long ago:

> He must then make his diligent inventory in the following way: He must first of all write on a sheet of paper or in a book aside, all that he has in the world, his personal belongings and household goods, estate, etc., and always begin with the things that are more valuable and easier to lose. These consist of ready cash, jewels, silver, etc., because estate, such as houses, lands, lakes, valleys, ponds, and the like, cannot be mislaid as are personal belongings and

household goods. He must then write down, successively, the other things, always putting down first, in the said inventory, the day, the year, the place, and his name. The whole inventory must be completed on the same day as otherwise it would give useless trouble in future handling.[41]

A somewhat different illustration, at what is possibly an even simpler level than that of the master-slave relationship, may be considered in order to emphasise the difference between the two points of view. Suppose that a child is given, say, £1 with which he can do whatever he likes. If (as is most unlikely) he is not familiar with the idea of ownership, this idea will have to be explained to him before he can appreciate the gift. But, having a notion of ownership, he will think (i) "Here is £1"; and (ii) "This £1 is mine." These thoughts comprise the essence of the proprietorship viewpoint and of double-entry, for, if the child were a born accountant, he would express the same thoughts as (i) "There exists an asset;" and (ii) "I have a proprietary interest in that asset." That is to say, the £1 is regarded from two aspects: (i) as something that exists—an asset; and (ii) as belonging to somebody—*my* asset.

Suppose further that, until the child can decide what he will do with the £1, he puts it in a money box. The entity theory can be introduced here by personalising the money box—it involves adopting the point of view that the money box now has the £1 and owes £1 to the child.

The distinction between the two "theories" is thus clearly drawn, but put in this way a further question is raised, namely, Surely the child owns the money box? In just the same way the master owned the slave. The entity theory cannot escape an ultimate basis of ownership, and it is this basis of ownership which also underlies the proprietorship point of view. It is unthinkable to have a money box without an owner, or a slave without a master, or a business without a proprietor, or a company without shareholders, or a club without members. It is a particular relationship—the relationship of ownership—which is the basis of both proprietorship and entity viewpoints, and the basic differ-

[41] Pietro Crivelli, *An Original Translation of the Treatise on Double-Entry Book-keeping by Frater Lucas Pacioli* (London: The Institute of Book-keepers, 1939), p. 4. United States readers may find another and more recent translation available: R. Gene Brown and Kenneth S. Johnston, *Pacioli on Accounting* (New York: McGraw-Hill Book Co., Inc., 1963), p. 27.

ence between them is that this relationship can be viewed as through a hollow tube from either end according to whether we wish to see the things owned from the owner's point of view or the owner from the point of view of the things owned.

We are not concerned with the ethics of property, a subject which has been a ground for political and social discussion at least since Plato wrote, but rather with the notion of ownership. Fortunately, we are not committed to a detailed study of the legal concept of ownership, in all its variations and uncertainties and subtle distinctions. However, although we are concerned rather with the notion of ownership as a social phenomenon, we cannot altogether ignore its legal aspects and some of the difficulties which lawyers have found in studying it.

As to its origin, for example, Professor G. W. Paton has written:

> To attempt to trace the history of ownership is full of peril, for we tend to look at early law through the spectacles of our modern culture and to fill the gaps in our facts with plausible conjectures. The early days of the clan seem very remote from our modern individualism. The *paterfamilias* had power over wife, descendants, and chattels, but rights over persons were not clearly distinguished from rights over property. The social unit governed itself, and it is idle to ask whether the control of the *paterfamilias* is best described as political power or private ownership, for in the realm of beginnings such questions are not asked. What was real was the physical power of the *paterfamilias,* tempered perhaps in its exercise by consultation with others. Within the group, save for articles of personal use, there was little need to distinguish between *meum* and *tuum*—both persons and chattels were considered as belonging in the group rather than to particular individuals. Indeed, until there is some form of organization above the family, it is difficult to see how the question of ownership can arise—within the group it is unnecessary, and until there is a co-ordinating power or the growth of a community, conflicts between groups are determined by force and not by law.[42]

The legal interpretation of ownership is far from simple and clear-cut, and several legal authorities have placed their own interpretations upon the word.

> Salmond treats ownership in its most comprehensive sense as the relation between a person and any right that is vested in him. "That which a man owns is in all cases a right": to speak of the ownership of a material object is merely to use a convenient figure of speech. To own a piece of land means in truth to own a particular kind of right in the land, namely, the fee simple of it. This dictum has been severely criticized by Cook. There are many rights which a person may possess, and to use the word "owner" to express the rela-

[42] G. W. Paton, *A Text Book of Jurisprudence* (Oxford University Press, 2nd ed., 1951), p. 422.

tionship between a person and a right is to introduce unnecessary confusion. In every system there is one method of enjoyment of property which is more extensive than others, and to this relationship the term "ownership" is normally applied. A person *has* rights: ownership is the name given to one particular type of right or, more accurately, bundle of rights. Ownership of Blackacre gives to the owner many claims, privileges, powers, and immunities. What makes Salmond's argument seem plausible is that English law has not confined the term "ownership" to enjoyment of material things. As we have pointed out, the law sometimes speaks of ownership of a copyright or a patent. In both cases there is no material object which is the subject-matter of ownership, for a copyright is merely a mass of claims and powers; but it was perhaps inevitable that the term "owner" should be found a convenient one to denote the person who possessed the claims and powers in question. The Roman notion, however, is simpler since it confines *dominium* to absolute ownership of material things. For jurisprudence also, it is more convenient to define ownership in terms of relationship to a material *res* and to regard the wider use of the term as an anomaly dictated by convenience.[43]

And citing Noyes, *The Institution of Property,* he says:

The learned author points out that if ownership means the separation of *meum* and *tuum,* then we see only the beginnings in the family group; if ownership requires a division between the property of different families, then we require some co-ordinating agency above the family: there was little notion of alienation. The idea was of a politico-economic organism, not of a proprietary fund.[44]

As has already been suggested, things cannot have a point of view, at least not without the help of what grammarians call personification—a figure of rhetoric which, in an extreme form, is known in grammar as the "pathetic fallacy." Perhaps there is little ground for objection to a theory which is based upon a figure of speech, but at least we should recognise the nature of the basis, and realise that when we endow a club or business or company with human attributes we are doing essentially the same thing as Tennyson when, in "Maud," he makes the rose, the lily, the larkspur and the passion-flower as eager as the lover himself to hear or see the maiden come out from the ballroom to meet him "at the gate, alone." Lawyers also have indulged extensively in this sort of game. To take but one instance:

Under the feudal system many interests of different *quality* were enjoyed simultaneously—under the modern doctrine estates may co-exist, provided the periods of enjoyment are different. Had the land itself been the subject of

[43] *Ibid.,* pp. 424-25.
[44] *Ibid.,* p. 422n.

thought, English theory would probably not have become so complex; but once the lawyers began to play with that artificial entity, the estate, it was possible to carve out future interests with great facility.[45]

Even logicians and philosophers have not been guiltless of this procedure. John Stuart Mill, writing on "The Things Denoted by Names," has the following passage:

In consequence of this perversion of the word Being, philosophers looking about for something to supply its place, laid their hands upon the word Entity, a piece of barbarous Latin, invented by the schoolmen to be used as an abstract name, in which class its grammatical form would seem to place it; but being seized by logicians in distress to stop a leak in their terminology, it has ever since been used as a concrete name. The kindred word *essence*, born at the same time and of the same parents, scarcely underwent a more complete transformation when, from being the abstract of the verb *to be*, it came to denote something sufficiently concrete to be enclosed in a glass bottle. The word Entity, since it settled down into a concrete name, has retained its universality of signification somewhat less impaired than any of the names before mentioned [object, thing, being]. Yet the same gradual decay to which, after a certain age, all the language of psychology seems liable, has been at work even here. . . . Every word which was originally intended to connote mere existence, seems, after a time, to enlarge its connotation to *separate* existence, or existence freed from the condition of belonging to a substance; which condition being precisely what constitutes an attribute, attributes are gradually shut out.[46]

Lawyers have apparently experienced considerable difficulty in attempting to resolve the meanings of several of the words in their vocabulary. The notion of personality in law is at least analogous to the notion of the entity in accounting if it is not, indeed, its parent, and it is profitable to look briefly at it. Professor G. W. Paton is of the opinion that it is "a misfortune that the same word, *personality,* is used both in a legal and a philosophic sense.[47] The word is derived from *persona,* which was originally a word to describe the mask through which the voice of an actor in the Greek classical dramas was sounded.

Gradually it came to describe those who could play a part in the legal drama, those who were recognised by the law as being capable of having legal rights and being bound by legal duties. Had this been the only use of the term, much confusion might have been avoided, but when it was desired to translate the technical terms of Greek philosophy which were used to describe

[45] *Ibid.,* p. 423.
[46] John Stuart Mill, *A System of Logic,* Book I, Ch. III, Sec. 2.
[47] G. W. Paton, *op. cit.,* p. 314.

the individuality of a human being the same word *persona* was used. Hence personality may mean, either in a philosophic sense the rational substratum of a human being, or in a legal sense the capacity of being a "right and duty bearing unit.[48]

A brief consideration of this notion of legal personality is instructive because of its strong analogy to that of the entity in accounting theory. The legal position is clearly summarised by Professor G. W. Paton in the following passage:

> Legal personality is an artificial creation of the law. Not all human beings necessarily possess legal personality; thus in early systems slaves were regarded as mere chattels and aliens were not permitted to sue in the courts. Many human beings may possess a restricted legal personality, such as infants and lunatics. Legal personality may be granted to entities other than individual human beings, e.g., a group of human beings, a fund, an idol. The first essential, therefore, to any clear understanding of the nature of legal personality is to distinguish it sharply from personality in the sense which means the rational individuality of a human being. Twenty men may form a corporation which may sue and be sued in the corporate name. An idol may be regarded as a legal *persona* in itself, or a particular fund may be incorporated. In these two cases it is clear that the idol and the fund cannot carry out the activities incidental to litigation of the signing of a contract, and, of necessity, the law is forced to set up certain human agents as representatives of the will of the idol and the fund.[49] But the acts of such an agent (within limits set by the law) would be imputed to the legal *persona* of the idol, and would not be juristic acts of the human agent. This is no mere academic distinction, for it would be the legal *persona* of the idol that would be bound, not that of the agent. Legal personality is a particular device by which the law creates units to which it ascribes certain powers. . . . It would be absurd, but not

[48] *Ibid.*

[49] An example in modern company law of the necessity to set up human agents for companies is provided in the Victorian Companies Act, 1961, Sec. 140, where, in Subsec. (3), it is provided that "a corporation may by resolution of its directors . . . if it is a member of a company, authorize such person as it thinks fit to act as its representative . . . and a person so authorized shall in accordance with his authority . . . be entitled to exercise the same powers on behalf of the corporation as the corporation could exercise if it were an individual member . . . of the company." This is a pretty example of the point at issue. The corporation has the power to authorize, but only by its directors passing a resolution; this surely means, on any realistic and commonsense view, that the directors really make the appointment; the appointee is somebody that the corporation thinks fit to act in the capacity of representative, but again surely this can only mean that it is the directors who determine whether the person is fit to act or not. Having been appointed, however, the representative, as a natural person, can exercise such powers as the corporation would have if it were a natural person. The next subsection carries the fiction even further by providing that, where the representative attends a meeting in the sole capacity of representing the corporation, the corporation "shall . . . be deemed to be personally present at the meeting."

impossible, for the law to award legal personality to trees, sticks, or stones.[50] Hence, from the juristic angle, the legal personality awarded to John Smith is of the same essential nature as that awarded to a corporation, an idol, or a fund. But the nature of these recipients of legal personality differs greatly: John Smith is a human being with certain physical and mental powers (a natural person), whereas the corporation is a group of human beings (an artificial person) and can act only through agents; the idol and the fund are entities with no life and no physical powers of decision or action, and their interests can be protected only by agents set up for that purpose. Naturally the law must take account of these differences by adapting the device to the nature of the recipient, and by making special rules to meet awkward cases. But legal personality remains, in essence, merely a convenient juristic device by which the problem of organizing rights and duties is carried out."[51]

By substituting the term "accounting entity" for "legal personality," the passage, with a few necessary and obvious consequential changes, could be paraphrased to express almost exactly the argument advanced by proponents of the entity theory in accounting. It seems clear that the notion of the accounting entity owes much to the notion of legal personality.

The reference in the above passage to the legal personality ascribed to an idol relates to a modern case[52] in which it was stated that the will of the idol in regard to location must be respected. Professor Paton points out that

normally this will would be interpreted by the guardian, but the law would interfere if the guardian did not act in the interests of the idol, i.e., presumably after consulting the interests of the worshipers.[53]

It is interesting to compare this with the position in the ancient Sumerian civilisation, about some aspects of which archaeologists have been able to determine considerable detail from the unearthed clay tablets which constitute some of the earliest known "written" records.

Though all members of a divine household may have been in theory servants of the god, the conditions of service were very different for the priestly administrators on the one hand and the tenants, wage-earners and slaves on the other. The share farmers and agricultural labourers received only a frac-

[50] The learned author in a footnote points out that "animals have been regarded as legal personalities in some systems. In Germany, during the Middle Ages, a cock was tried for contumacious crowing, and, in 1508 in Provence, the caterpillars of Contes [*sic*] were condemned for ravaging the fields."

[51] *Op. cit.*, pp. 315-16.

[52] Pramatha Nath Mullick v Pradyumna Kumar Mullick (1925) L.R. 52 Ind. App. 245, discussed Duff. *3 Camb. Law Jnl.* 42.

[53] *Op. cit.*, p. 315n.

tion of the produce of their labour. From the surplus collected by the temple the bakers and brewers and other artisans were paid only a modest wage in barley; the slaves who helped them presumably got little beyond their bare keep.

Indeed, before 2500 B.C. the divine households had ceased to be anything like happy families. . . . Favored priests practised various forms of extortion (overcharging for burials, for instance) and treated the god's (i.e. the community's) land, cattle, equipment and servants as their own private property or slaves. . . .

As representative of the "tribal" god the ishakku [high priest] receives the largest plot of the clan lands . . . and "taxes," the civilized counterparts of the gifts customarily offered to a barbarian chief. *On behalf of the god* too he receives a major share of the booty *won by the victorious deity*. The city governor thus came to concentrate a considerable portion of the land's surplus produce. *The gods themselves might be indebted* to the governor's munificence. . . .

. . . Perpetual corporations of priests found themselves charged with the heavy task of administering the unprecedented accumulations of wealth belonging to the Sumerian deities. The administration by such corporations of the temples' revenues on behalf of a divine master required the keeping of accurate records of all receipts and expenditures; a god's servants must be able to give account of their stewardship.[54]

There is here not only the notion of artificial personality attachable to the god, but also, if one wished to use it so, the germ of the idea of double-entry recording itself, in that, while the priest was theoretically a steward for the possessions of the god, the god itself might be regarded as being indebted to the steward. According to Professor Childe, these temple records were the occasion for the invention of writing itself.

The record [he writes] must be intelligible not only to the official who made it, but to his successor and all the partners in the joint undertaking. No private system of reminders like the knot in the handkerchief was any use. The head of the brewery must note down what quantities of barley he received and how much beer and of what strength he delivered and note it in symbols that not only reminded him of something, i.e., meant something to him, but meant the same thing to his successor, to the controller of the granaries and to other colleagues.

The invention of a system of writing was just the agreement on the meanings to be attached to the symbols by the society using them for its common ends.[55]

[54] Gordon Childe, *What Happened in History* (New York: Pelican Books, 1946), pp. 91-96. Italics supplied.

[55] *Ibid.*, p. 96. Compare also the statement by A. N. Whitehead: ". . . for a long time after writing had been invented it was little more than a keeping of accounts; a business of kings and bankers, promulgating orders and computing moneys." *Dialogues of Alfred North Whitehead as Recorded by Lucien Price* (Boston: Little, Brown & Co., 1954), p. 153.

Here, indeed, is an argument for the divine origin of bookkeeping; and there is also, apparently, some ground for considering it the precursor of and the occasion for the development of education:

> Owing to its conventional character the system of writing and ciphering had to be perpetuated by education. To fulfil their duties as administrators priests had to learn to read and write; that is to say they had to be taught the meanings and the phonetic values arbitrarily assigned to the characters by their colleagues just as every child has to be taught the meanings attached by its society to the sounds of its spoken language. Schools became a necessary adjunct to the temple. Of course they helped to standardize and maintain the approved conventions. Since in every temple and in every city from Jemdet Nasr[56] times the same signs and the same conventions were accepted and employed, the priestly corporations must have co-operated at least in their educational work on an "international" scale.[57]

Here is an explanation of the phenomenon which Charles Waldo Haskins remarked on many years ago—the predominance of a commercial bias in the educational curriculum of the schools of ancient Mesopotamia. He pointed out that

> while the Babylonian scribe was taught to aspire to the priesthood or to literary distinction, a large share of his education as a schoolboy was in the direction of fitting him to be an expert in commercial affairs. In the task of familiarizing himself with the many hundreds of combinations of wedge-letters he filled his little copy-tablet, not with child-language, but with words and phrases and sentences which would be of immediate practical use to him in keeping accounts, in drawing up formal agreements between seller and buyer, lessor and lessee, borrower and lender, in the preparation of contracts of marriage and of divorce, in writing out last wills and testaments, terms of adoption, of inheritance and disinheritance, legal decisions of judges, and the formal documents in which disputing parties bound themselves to abide thereby, and in his choice of expressions connected with Mesopotamian business life. In the grammatical study of his mother-tongue, and in connecting its orthography with the still-living word-signs of another and already extinct language, the student, instead of taking the sentimental verb "amo, amas," as we do in our classical studies, was led at once, as it were, into the counting-house, and was taught to write with his little arrow-headed characters some such business word as "he weighed, they weighed, he weighs, they weigh"; and then to attach a suffix and make it read, "he weighed it, they weighed it, he weighs it, they weigh it". . . . Here is the way an exercise-tablet on the word for "income" prepares the young scribe to look after the interests of Shamash, the sun-god of the Babylonians—and let it be premised that this word for

[56] The site of an ancient city from which excavations have produced many articles of great antiquity. "Jemdet Nasr times" would have been from about 3200 B.C. to 2850 B.C.

[57] Childe, *op. cit.*, p. 99.

income means more literally an increase on capital: "Income, his income, to his income, to his income he placed, income of Shamash, income of Shamash is fixed, the income of Shamash he increased, the income of Shamash he places, the income of Shamash he gave, the income of Shamash he returns, without increase, there is increase, there is no income, the income is that of the municipality, the increase has gone by default, the increase of the increase"—that is compound increase or interest—"there has been an increase of increase." Another tablet gives various forms of the verbs "to weigh" and "to measure," and then proceeds with "grain he has measured, he is measuring the grain, they are measuring the grain, he has not measured the grain, he weighs the silver, the silver he weighs and the grain he measures." Thus, step by step, the young man is brought gradually, almost imperceptibly, forward in the use of his syllabary and his long list of logographs until, before he is aware of his own proficiency, he is actually duplicating the commercial literature of his native land, telling how much "silver he weighs out," that "the house for the silver he secures," that "when he had brought the silver he took possession of the house," and that "as long as he lives in the house he is to secure the beams of the house and to keep the walls in repair," all being phrases and sentences that occur in an extensive legal literature.[58]

In considering the accounting entity, it is also of interest to notice the writing of an early nineteenth century author on partnership matters. Isaac Cory's proposals to remedy the deficiencies of the then existing law relating to partnership were to improve the machinery of the courts and, secondly, to recognise the partnership firm as a separate entity. He argued that such recognition was the custom of merchants and accountants already and that it was the law that refused to recognise the separateness of the firm. He was opposed to registration of firms and to limited liability, viewing the latter as little short of fraudulent, and cited French and American experience in support of his opposition.[59] What is particularly interesting in our present context is the indication that the entity notion emerged in mercantile practice prior to its adoption in law (that is, as a company). It suggests that the legal concept were merely a recognition of an existing mercantile state of affairs, and that the latter-day recognition of the theory by accountants dealing with company acounts is an echo of their predecessors' views of partnership.

It may be instructive now to try to carry the proprietorship view-

[58] Charles Waldo Haskins, *Business Education and Accountancy* (New York and London: Harper & Bros., 1903), pp. 184-87.

[59] Isaac Preston Cory, *A Practical Treatise on Accounts* (London: Wm. Pickering, 2nd ed. 1839). See pp. 71, 111, 216-17.

point "forward" from the case of the sole proprietor towards more complex forms of multiple ownership.

The case of the sole proprietor has already been described[60]; in the words of Tarshis, "the firm is not distinguished from the man who owns it"; in those of Littleton, "bookkeeping is viewed as an accounting by the proprietor for his own property in detail and in total."[61]

Adopting this viewpoint, liabilities are regarded as negative assets, proprietorship is consequently regarded as "net worth," that is, the excess of positive property (assets) over negative property (liabilities), and profit (or loss) is an increase (or decrease) in net worth other than specific contributions (or withdrawals) of proprietary capital, that is, what is called profit represents an increase in the proprietor's command over possessions and rights against other people.

If, as has been sometimes suggested, the proprietorship viewpoint is, equally with the entity viewpoint, "valuable so long as it is consistently maintained,"[62] it should be possible to extend it to explain the characteristics of accounting for types of enterprise or organisation other than that of a sole proprietor.

Consider first the case of a partnership. How would the proprietorship viewpoint be applied in this case? The essential legal characteristic of a partnership is joint control of the property of the partnership by the partners, accompanied almost invariably by a right of each partner to share in the profits made or a liability to share in the losses incurred through the joint operations, and, in most cases, by a contribution of material resources by each partner. In other words, two or more individuals agree to share in the task of directing the use of property and other possessions and to share in the results of such direction. A partnership is recognised as a distinct entity in some aspects of law but not in others. For example, in bankruptcy proceedings, a statement of affairs is prepared for the partnership as well as for the individual partners, with the partnership creditors having a primary right against partnership assets for settlement of their claims, and secondary re-

[60] See Section III above.
[61] Littleton, *op. cit.*, p. 191.
[62] Gilman, *op. cit.*, p. 50.

course against the assets of the individual partners only if the partnership assets are insufficient to meet their claims. Similarly, the creditors of individual partners have primary rights against the assets of the individual partners and secondary recourse against those of the partnership. On the other hand, taxation authorities do not tax the partnership as such, assessments being levied only on the individual partners.

To apply the proprietorship viewpoint consistently to a partnership, we have to accord recognition of as many proprietary viewpoints as there are partners in any given case. It is conceivable that each partner should keep or cause to be kept his own record of the joint transactions. For example, consider a firm of three partners. It would be necessary, for our present purposes, for each to account "for his own property in detail and in total." This would involve a separate set of books kept by (or on behalf of) each partner for his partnership interest. This is not at all impossible, neither is it impracticable; but it would not be very convenient. It would involve a dissection of all the partnership revenues and outlays, assets and liabilities, in appropriate proportions. If the partners were equal partners, the amount of each transaction would have to be divided into thirds, and each third recorded in the appropriate records for the partner concerned; if the partnership rights were not equal, the fractions of each amount would have to reflect the respective rights of each partner. By this means the records of each partner would reflect his proprietary interest in the partnership activities and it would not be necessary to maintain any records for the partnership itself at all. Further, the records of any one partner could include his extra-partnership interests, so that the whole story of his financial activities would be recorded together. This procedure, however, would be cumbersome by comparison with the current one of accounting in the first instance for the activities of the partnership with a periodical assessment of the rights of the several partners; it would entail a great deal of duplication (or, in the given instance, triplication).

The point that is important for our present purposes, however, is that, apart from historical tradition, it is a matter of convenience rather than of logical necessity to have one set of

books recording the net result of all the partnership transactions and allocating this net result from time to time and at the termination of the (legal) condition of partnership between the partners. It should be noted that, analytically, this type of record does *not* strictly reflect the legal or the taxation attitude towards partnership, whereas individual records would. In accounting for the partnership as such the notion of proprietorship turns into that of entity, or better perhaps, the notion of entity is superimposed upon that of proprietorship.

A similar procedure to that for a partnership might be conceived for a company. The modern joint-stock company has evolved in large part from the partnership, and a procedure that is conceivable for the earlier form of organisation is conceivable for the later, despite its greater complexity. However, although it is conceivable, the keeping of a separate set of books by each shareholder in a company would be quite impracticable except for those relatively small companies which are, except for legal recognition, partnerships in effect.

This does not, however, bar the way to application of the proprietorship viewpoint to companies. What is required to apply it without distorting practicability is simply to regard all the shareholders in a company collectively, that is, as a group. We can consider the whole group of shareholders as one collective proprietor, and the accounting is then not by but on behalf of the group for its own property. It is submitted that this is permissible so long as we recognise the process of abstraction that is involved. For under modern conditions it might well happen in any given case that a shareholder in a company with widely dispersed shareholdings is acquainted with none of his fellow shareholders; at best he would probably know only a few. Further, individual members of the group frequently terminate their membership and others take their places through the acquisition of shares, while the actual number of shareholders may be subject to continual variation. This means that the group does *not* exist as a cohesive collection of individual human beings; it rarely acts as a group. Admittedly, these individuals (or sufficient of them for the purpose) may be brought together in a case of emergency, such as a proposal to wind up the company or to effect its reor-

ganisation. But even in many of these cases the opinion of the "group" is not obtained as that of a group, but as that of an aggregation of individual opinions. The use of proxies, for example, may ensure that a sufficient number of shareholders express their opinions on a given proposal, but it does not provide the means of intercommunication of ideas or emotions which is one of the essential characteristics of a cohesive group of people.[63]

Subject to these restrictions, however, it is possible to extend the proprietorship viewpoint to a generalised, conceptual group of shareholders. But such a view is not altogether consonant with the legal recognition of the company as a distinct person, capable of doing things in its own name which in reality can be done only by human beings. Under the proprietorship viewpoint, the directors and managers of a company act as trustees of the shareholders, not as servants of the company. The directors themselves may view their position in either of these two ways, and their interpretation of their functions may differ widely according to which of the two views they adopt. What is important is to apply consistently whichever viewpoint is adopted for a given purpose and to recognise its implications. It was possibly something of this sort that Dr. Gilman had in mind when he remarked that an unconscious shift from one viewpoint to the other creates the danger of false reasoning.[64]

The legislature and the courts have not been helpful in this respect. To take an example almost at random from the Victorian Companies Act, 1961, it is enacted in one section[65] that "the company shall retain the records . . . for seven years after the completion of the transactions or operations to which they respectively relate," implying a clear recognition of the existence of a distinct person capable of retaining records, while the next section provides that "the directors of every company shall cause to be made out, and to be laid before the company in general meeting, . . . a balance-sheet."[66] While the company has to retain the records,

[63] For some of the inadequacies of presently existing conditions in the U.S.A. relating to proxies, see Lewis D. Gilbert, *Dividends and Democracy* (Larchmont, N.Y.: American Research Council, 1956), pp. 28-31, 222-25.

[64] Gilman, *op. cit.*, p. 50.

[65] Sec. 161 (2).

[66] Sec. 162 (3).

it is the directors who must have the balance sheet made out; further, it may be asked whether the company which (or who?) retains the records is the same company before which (or whom?) the balance sheet is to be laid. Again, in another section of the same statute, in one sub-section "the company shall cause a meeting of the creditors of the company to be summoned" while in a later sub-section (of the same section) "the directors of the company shall . . . cause a full statement of the company's affairs . . . to be laid before the meeting of creditors."[67] There appears to be at least some wavering between complete and partial adoption of the entity view in the minds of our legislators.

In the celebrated case of *Salomon v. Salomon & Co. Ltd.*,[68] which has been described as "perhaps the most important case in company law,"[69] the separate legal personality of a company was unassailably established in English law. It may be well to recall briefly the facts of this case, as it is instructive for our purpose. *S* had a boot business, which he sold to a company that he formed with a capital of £40,000. The necessary seven persons to constitute the company under the existing company statue were *S* and his wife, daughter and four sons, each taking one £1 share. *S* afterwards had 20,000 shares allotted to him. Debentures forming a floating security on the assets were issued to *S* in part payment of the purchase money for the business. As a result of depression and strikes in the boot trade, the company was wound up. The assets of the company amounted to only £6,000, while the liabilities were £10,000 due to *S* and secured by debentures, and a further £7,000 due to unsecured creditors. The liquidator claimed that, as *S & Co.* was really the same person as *S*, he could not owe money to himself and that the unsecured creditors should be paid their £7,000 before he could have any claim on the assets.

Vaughn Williams, J., and, later, the Court of Appeal held that the company was merely an agent for *S*, who must indemnify his agent against the losses it had sustained by paying the £7,000

[67] Sec. 260, sub-secs. (1) and (4).

[68] Broderip v. Salomon (1895) 2 Ch. 323; Salomon v. Salomon & Co. Ltd. (1897) A. C. 22.

[69] Alfred F. Topham, *Principles of Company Law* (London: Butterworth, 6th ed., 1924), p. 6.

himself; but on further appeal it was held by the House of Lords that once a company is incorporated it must be treated like any other independent person, and the motives of those who promoted it are irrelevant. The company could not in this case be agent for *S,* for either (i) it was a legal person, and so acted for itself, or (ii) it was not a legal person, and therefore could not be an agent at all. The company was not defrauded, as all the shareholders knew all about the transactions, and the result was that the assets available were used as part payment of *S's* claim under the debentures, leaving nothing for the unsecured creditors.

This case clearly and unequivocally established the point that a company is, at law, a different person altogether from the subscribers to its memorandum of association, or from its shareholders from time to time, thereby settling the legality of the "one-man" company and making the benefits of incorporation available to the individual trade and small partnership as well as to the large enterprise. The decision, however, also showed

> that it was possible for a trader not merely to limit his liability to the money which he put into the enterprise but even to avoid any serious risk to the major part of that. . . . The experienced business man with his trade protection associations can take care of himself, but the little man, whom the law should particularly protect, rarely has any idea of the risks he runs when he grants credit to a company with a high-sounding name, impressive nominal capital (not paid up in cash), and with assets mortgaged up to the hilt.[70]

The legal fiction of separate corporateness may indeed be, in some cases, a "persona" in the Greek sense of the word—a mask —behind which schemes of ingenious unscrupulousness may be prepared and perpetrated. In the *Salomon* case, even though the loan was *bona fide,* and even though *S* may have lost more then he gained, it seems harsh that creditors, who had parted with their goods and rendered services to a company which, to all except legal intents and purposes, was of the same identity as the man who was running the business, should have had their claims for payment deferred (and in this case utterly destroyed) beyond the settlement of a loan by the principal shareholder in the firm.

The separateness of legal personality has been taken to what appears to be its extreme limit in another case[71] in which it

[70] L. C. B. Gower, *The Principles of Modern Company Law* (London: Stevens & Sons, 1957), p. 65.

[71] Lee v. Lee's Air Farming Ltd. (1960) 3 W.L.R. 758.

was held that a person who is the governing director of a company and its controlling shareholder can yet be a servant of the company. The facts are that *L* had formed a company to carry on the business of aerial top-dressing. He was the controlling shareholder and the sole governing director of the company; he was employed by the company at a salary as its chief pilot under a contract negotiated by him, as agent of the company, with himself. As sole governing director and controlling shareholder he was able to exercise complete control over the company's operations. While carrying out aerial top-dressing operations, the plane he was piloting crashed and he was killed. As there was no doubt that his death arose out of his employment, his widow claimed compensation under a policy effected by the company to indemnify it against its liability to pay workers' compensation; this claim was contested on the ground that the deceased was not a "worker" employed by the company within the meaning of the Workers Compensation Act 1922 (New Zealand), which defined a worker as "any person who has entered into or works under a contract of service . . . with an employer . . . whether remunerated by wages, salary or otherwise." The New Zealand Court of Appeal held that he was not a worker because he had both the duties of giving and obeying orders, which it regarded as incompatible offices; the company had no control over him and the absence of control destroyed the possibility of a master-servant relationship between the company and him. This decision was, however, reversed by the Judicial Committee of the Privy Council, which emphasised the point that the deceased and the company were separate legal entities; the position of the deceased as sole governing director did not make it impossible for him to be a servant of the company in his capacity of chief pilot, because he and the company, being separate legal entities, could enter, and in fact had entered, into a valid contractual relationship. Further, the fact that they were separate legal entities enabled the company to give orders to him, and the Committee saw nothing incongruous in one person functioning in dual capacities and acting in one capacity to give orders to himself in another capacity. (W. S. Gilbert, of course, had foreshadowed this situation many years before in his creation of the character of Pooh-Bah in "The Mikado.") The conclusion reached by the Committee was that the

relationship between the company and the deceased in his capacity of chief pilot was that of master and servant, a contract of service existed and operated between them, and the deceased was a "worker" within the meaning of the Act; the widow was therefore entitled to the compensation claimed.

In another case, however, a somewhat different view was presumably implicitly in the minds of the judges.[72] In this case, *B* was a director and chairman of directors of a company and was in fact acting as managing director, although he had not actually been appointed to this latter position. *R,* acting in good faith, paid to *B* certain cheques representing amounts which he (*R*) owed to the company. These cheques were made payable to *B* or order, but *R* believed that *B* "owned" the company and that in dealing with *B* he was dealing with the one and only person in the company who had any authority to do anything at all. The articles provided that the directors might delegate powers, authorities and discretions. On the question whether, by paying *B* the cheques, *R* in fact discharged his debt to the company, it was held that he was so discharged. The court was of the opinion that it could not be said that to receive payment in cash is beyond the power of a managing director or chairman, although, of course, he is not the usual person to receive such sums.[73]

In both the *Salomon* case and the *Clay Hill Brick and Tile* case, third parties (creditors in the former, a debtor in the latter) had dealings with what they considered (rightly) to be "one-man" companies, but whereas the director in the latter case was debarred from saying that he was not acting as an agent for the company, in the former the creditors were debarred from saying that the company was acting as an agent for the director. If the test applied in the *Salomon* case had been applied, *mutatis mutandis,* to the *Clay Hill Brick and Tile* case, namely, that either *B* was a legal person and so acted for himself or he was not a legal person and so could not be an agent at all, then the result must surely have been different: the law—and justice or injustice—would have been made consistent.

[72] Clay Hill Brick and Tile Co. v. Rawling (1938) 4 A.E.R. 100.

[73] For a consideration of "judicial inroads" into the corporate entity principle, see Gower, *op. cit.,* Ch. 10; the author points out that such inroads are few compared with examples of application of the principle.

It appears to be a well-established legal postulate that directors of a company are fiduciary agents for it—"fiduciary donees of their powers,"[74] and it has been laid down that

> no agent in the course of his agency, in the matter of his agency, can be allowed to make any profit without the knowledge of his principal; that that rule is an inflexible rule, and must be applied inexorably by this Court, which is not entitled, in my judgment, to receive evidence, or suggestion or argument as to whether the principal did or did not suffer any injury by reason of the dealing of the agent.[75]

If the question be asked: How does the will of this principal, "the company," become known to the agent?, the answer appears to be not a little complicated. Unless the articles of association specifically state otherwise, the statute provides that the business of the company shall be managed by directors who may exercise all the powers of the company except those specifically required to be exercised by the company in general meeting. Thus, for all day-to-day matters and subject to the decisions of the shareholders in general meeting, the will of the directors is the will of the company. But the directors are accountable to the shareholders in general meeting: in matters such as the declaration of dividends, consideration of the accounts, balance sheet and report of the directors, the election of the directors and auditors,[76] the shareholders in general meeting constitute "the company."[77] Thus it would appear that ultimately the will of the company is the will of a gathering of individuals, a sufficient proportion of whom are of a similar opinion on a given matter. The legal entity is thus reducible to terms of individual proprietors. But there are limitations upon the powers of these individuals even at such a gathering; they are bound by the articles of association, and, as an example, unless the articles provide otherwise, they cannot increase the amount of dividend recommended by the directors, although they may reduce it. Further, their net proprietary interest is not altogether theirs to deal with as they will: some profits of a so-called capital nature, such as premiums received by

[74] Per Rigby, L. J., in Alexander v. Automatic Telephone Co. (1900) 2 Ch. 56, at p. 72.

[75] James, L. J., in Parker v. McKenna (1874) 10 Ch. App. 96, at p. 124.

[76] Vict. Companies Act, 1961, Fourth Schedule, Table A, art. 46, 73.

[77] Furs Ltd. v. Tompkies (1935) 54 C.L.R.; 25 Augt. Digest 578, see p. 592. Also Regent (Hastings) Ltd. v. Gulliver and Others (1942) 1 A.E.R. 378.

the company on the issue of shares, must be credited to a "reserve" and cannot be distributed to members except on the company's termination.

It seems reasonable to suppose that it is the transferability of shares in a company, making for an exceedingly fluid ownership in terms of individuals, that lies behind most of the restrictions upon the shareholders at any given time, and, concomitantly, that justifies the emphasis upon the entity point of view, particularly in law. For, even though proprietorship be regarded as the characteristic of a collective individual, if its personnel is continually changing, it would be not only inconvenient but impracticable to try to account for changes in each individual's share of such proprietorship when, in many cases, some shares change hands each day and sometimes more than once in one day. It would become virtually impossible to have a determination of the affairs of the company to suit each shareholder's requirements of share transfer.

In the absence of transferability, however, there seems no greater justification (other than the existence of the legal fiction) for insisting upon the entity point of view for a company than for a partnership. And, indeed, in the case of "one-man" and proprietary companies, wherein transferability of shares is in fact no greater than the disposability of a share in a partnership, the relation of the shareholders to the property of the business is so little different from that of partners to the property of their business that, from the point of view of debtors and creditors, it is indistinguishable except for the incidence of the limitation of liability which the formality of registration endows upon the former.

Even the legal recognition of a company as a distinct person or entity does not confer upon it all the characteristics of a natural person—the powers of a company are determined by the terms of the statute under which it is formed or by the memorandum of association which is a step away from a separate constituting statute. Despite a strong tendency to enlarge the powers of companies, a company still cannot be a complete substitute for the human beings concerned in it; although a company may be fined, it cannot be imprisoned for breaches of law—but a director can.

We have to look behind the entity to the human being if we really want to inflict a penalty that will affect his person as distinct from his financial position. In short, a company only exists by virtue of a socially accepted fiction for certain, relatively limited, purposes.

In comparing the two viewpoints (entity and proprietor), if we take that of the entity far enough backward we arrive at a stage where we depersonalise a person. If we take that of the proprietor far enough forward we reach a stage where we personalise a non-person. What we have to recognise is the fact that a "business" or a "company" or a "government" or a "council" or a "club" or a "society" does not exist except as a generalisation or shorthand expression of relationships, not of active beings. What do exist are persons and things. Even rights are only *recognised*—that is, they are rights against other persons; the existence of a right lies essentially in its recognition.

Some confusion has arisen because the word "entity" has been used by accounting writers in at least two different senses. In one sense it is used to mean a social unit in terms of which it is convenient to carry out accounting procedures; it is not particularly appropriate for this use and if we used "unit" or the expression "social unit" or "economic unit" some of the confusion would surely be dissipated. The second sense is that of the "pure" entity theory, in which it is used as a substitute *concept* for human persons—that is, a "being," but a fictional or notional rather than a human one; it is suggested here that it is not necessary to use either concept or word in this sense.

Is there any necessary conflict between the proprietary theory and the entity theory? The view that confusion arises when either is not consistently adhered to may not necessarily be true. What is true is that the proprietary theory is difficult of application to a partnership, and well-nigh impracticable in the case of a company with more than a few shareholders. It would also seem to be inapplicable to trusts and governments, in which the element of proprietorship in the sense of legal ownership is absent. What this amounts to is that the proprietary theory is of limited validity and application, but not that it is untrue. Within the area of its applicability, there are proprietors and the assets which are ac-

counted for are the assets of the proprietors and are looked upon as such. The entity theory, on the other hand, is of particular applicability to the corporation, because of its legal recognition as an instrument of ownership. But it is a fiction and can only be regarded as valid in other spheres by superimposing a fiction upon a human being—liquidating him and dealing, in effect, with his ghost. But is the entity theory any more valid than the proprietary theory for trusts and governments? Is the entity theory *ever* true? It is, perhaps, admissable as an expository device, and to this extent it may be regarded as "valid." However, this is not the same sort of validity as that which applies to the proprietary theory. Further, it leads to sub-entities and super-entities, and loses its original virtue of precise applicability to the relation of legal recognition. It become increasingly unnatural, and when it does, it is certainly not an explanatory theory. Often, facts are made to fit the theory, instead of the theory explaining the facts. This at least does not arise with the proprietary theory: where the proprietary theory does not fit the facts, it is agreed that it is inapplicable, and there the theory reaches the limits of its validity; there is not the same attempt to jiggle the facts around to fit the theory. The conclusion suggested by this is that the two "theories" are not conceived at the same level, and, if this is so, there is little reason to hold that they are in conflict. Of course, it may turn out that the entity theory can be dispensed with altogether—or that both may be; this will be argued in a later section. At the least, however, it seems possible that they are not necessarily and completely irreconcilable and incompatible, as some writers have strongly indicated.

V The Fund Theory

In 1947 Professor Vatter published a book[78] in which he advocated the use of the fund as the basic concept around which accounting thought and practice should be developed. In his preface he described the work as a "little excursion into some untried and rather speculative areas of accounting thought" and "an attempt to set up a framework around which the ideas of account-

[78] William J. Vatter, *The Fund Theory of Accounting and Its Implications for Financial Reports* (Chicago: University of Chicago Press, 1947).

ing may have better and fuller expression and from which may develop a broader application of certain accounting techniques which now have but limited uses."[79]

After a brief discussion of the salient characteristics of the proprietary and entity theories, he rejects them both because each of them "adopts a personality as its focus of attention,"[80] the difference between them being whether the person is a human being, namely the proprietor (or proprietors), or an abstract being in his (or their) place. In any case, he argues, the demands being made nowadays upon accounting records and reports—by management, by social control agencies and by investors and creditors—are too varied to be served adequately by adopting any single personality, whether human or fictional, as the theoretical basis for accounting practices.[81] In place of any such personality he puts forward the notion of a fund as the unit of business to constitute the area of attention for accounting. A business unit, he says, "is not a thing that can be defined universally and with rigid precision"; accounting needs some such unit, but it must be a unit "devoid of personal implications and at the same time sufficiently definite to make clear just where its boundaries lie."[82]

The fund which he appears to advocate is very like that in government and eleemosynary institutions—not merely cash resources, and more than a collection of assets set aside for a particular purpose; it takes account of restrictions upon assets (equities) as well as assets themselves. It is this notion which for Vatter becomes the unit of accounting, in terms of which accounting records and reports are set up and maintained. He defines a fund as "a collection of service potentials [that is, assets] that have been brought together for some functional purpose—administrative, entrepreneurial, or social."[83] Services are put into a fund and "directed at the objectives specified in the purpose of the fund";[84] these "impounded" services are converted and ultimately released. Expense thus becomes "simply the draining-off or the release of converted services . . . during some period of

[79] *Op. cit.* p. iii.
[80] *Ibid.* p. 7.
[81] *Ibid.* pp. 8-9.
[82] *Ibid.* p. 10.
[83] *Ibid.* p. 18.
[84] *Ibid.* p. 22.

time,"[85] but they are not all necessarily revenue-producing; revenue "is observed from the addition of new assets . . . [which] are completely free of equity restrictions other than the residual equity of the fund itself."[86] Expense and revenue are flows and not specific effects of individual assets.

On the basis of these ideas, he develops a system of reporting—and, presumably, recording—in terms of funds. The funds for a typical manufacturing concern, as he presents them in an extended illustration, are Cash and Banks Fund, General Operating Fund, Investment Fund, Sinking Fund—Current, Sinking Fund—Investments, and Capital Fund. What he arrives at is fundamentally similar to the "double account" system, but somewhat more elaborate than the method as it was developed during the nineteenth century to allow the relation between receipts of long-term capital investment and outlays on long-term assets to be readily discernible from the published reports of companies, especially railway and public utility companies. In its purest form of application, the double account "theory" ignored depreciation; this is probably one of the chief reasons why it was gradually discarded during the twentieth century. It viewed investment in long-term assets as sunk costs. Although this proposition does not appear to be widely held now, it still has a good deal of validity: from the investment point of view, the outlays made upon many long-term assets *are* sunk; they are "fixed" assets in the sense that the outlay made on them is a "once-for-all" outlay, it is intended that the assets shall be held and used for a relatively long time in the form in which they are acquired, and it is not intended that the initial outlay should be recovered by disposal of the asset itself but through the disposal of goods or services which it was acquired to produce.

The notion of a fund is clearly of value in some circumstances, and, as Vatter points out, it is already in use as a unit of accounting in certain contexts; but it is a long step from this to its adoption as a unifying concept for all accounting theory and all accounting practices—a step which nobody appears to have followed Professor Vatter in taking. One important reason for this would ap-

[85] *Idem.*
[86] *Ibid.* p. 25.

pear to be that the fund "theory" as expounded by him is not an explanatory theory at all. The argument appears to be that if we adopt the fund as the fundamental concept in accounting then the logical outcome is a set of reports (and probably records) very different from those which have been in use in accounting, in business, in institutions, and even to some extent in governments, for many years, and which have been developed through a long historical process. It does nothing to explain these present reports and records, but is purely advocative of a very material change in procedures. Thus, looked at in this light, it is not so much a theory of accounting as a piece of doctrinal advocacy.

The fund, defined in terms of assets and equities which constitute it, is just as much an abstraction as the entity. The fund "theory" provides no more help than the notion of the entity in explaining the procedures of analysis or interpretation of accounting reports which constitute a function of accountants just as much as recording and reporting.

Professor Vatter does not make it clear why the unit of accounting must be devoid of personal implications, as he asserts. After all, the processes and procedures of accounting are carried out by persons and they do relate to persons and to things and rights owned or controlled or handled by persons; it is difficult to conceive how any aspect of accounting can be divorced entirely from *all* personal implications—"devoid" and "implications" both have very extensive ranges of meaning. He himself appears to be fairly satisfied that the proprietary theory, which clearly has "personal" implications, was (and presumably still would be) adequate for sole proprietorships.[87] If it is not adequate for other types of economic or social organisation, this inadequacy may not necessarily be due to the fact that it is a "personal" theory; it may turn out that a "personal" theory could be adequate for other forms of organisation if we could discover the appropriate person.

A further matter for concern is that the criteria for determining what funds should be established—even for accounting purposes only—in a given case are not clearly indicated. The area, so to speak, of the fund depends on somebody's view of what it is de-

[87] Cf. *op. cit.*, pp. 2-4.

sired to account for; and, in particular cases, different accountants might have different views on what funds are constituted in the activities carried out. It would thus appear that the very constitution of these funds depends upon a personal selection and viewpoint; if this is so, it can hardly be maintained that they are devoid of personal implications altogether.

Thus, apart from likely practical difficulties[88] which would probably be a serious obstacle to an extension of the notion of the fund to all types of enterprise, there are conceptual difficulties which militate against its acceptance as a theory of accounting.

The notion of funds in a very similar sense to that propounded by Vatter was not unknown to economists of the nineteenth century. For example, Wicksteed said in 1888 that

> one of the benefits of accurate account-keeping consists in the help it is found to give in keeping the distribution of funds fluid, and preventing an undue sum being spent on any one thing without the administrator realising what he is doing.[89]

The notion behind expressions such as "depreciation fund" and "reserve fund," which were still found in statutes, economic writings and even accounting literature until a relatively short time ago, is that of a kind of fund accounting, admittedly not as sophisticated or as well developed as the propositions put forward by Vatter, but nevertheless in blood relationship with them. It could be argued, however, that any of these requirements, including those of Vatter, could be met by a suitable classification of accounts and an elaboration of them with re-grouping as required, within any of the existing systems of accounting, irrespective of the point of view adopted for their compilation.

To put this in another way, a fund as envisaged by Vatter could be interpreted as a venture in the terminology of the previous chapter in this work. The notion of the venture is significant in accounting theory, but, as an element or unit of activity, it is only one of the fundamental concepts in accounting; it is not in itself sufficient for a theory of accounting. In the same way, while the notion of a fund may well be significant in some cases

[88] Some of these are suggested by E. C. Moyer in his review of the book. See *Accounting Review,* October 1948, pp. 440-41

[89] P. H. Wicksteed: *The Alphabet of Economic Science* (Macmillan, 1888), p. 130.

and for some aspects of accounting, it is scarcely in itself sufficient to base a superstructure of accounting practice on.

We can say that Vatter has made a strong onslaught on the entity theory, although, if we are to judge from the writing since his book was published, his attack has by no means destroyed it. But even if we accept the validity of this attack, the fund theory that he advances is hardly an acceptable substitute for the notion of the entity since it brings us no nearer to reality and leaves us in the aether of fictions.

VI The Managerial Viewpoint

When we say that a man has a growing or profitable business, we usually mean that certain of his activities—which have an element of coherence in the pursuit of gain, that is, his "gainful activities"—have the result of an accretion of "capital" or an increase of "net assets," that is, an increase in that property over which he can exert socially recognised rights; there is often also implied the proposition that he has an increased "income," that is, an increase in his socially recognised rights to the enjoyment of services provided by other people and by the property of other people.

When we apply this concept of "growth" to a large-scale company, it is apparent that it is only under the direction of managers that any such increments arise. There is a rather loose connection of appointment between managers and shareholders.

We have seen that the proprietary theory would involve an accounting from the point of view of shareholders, as it does an accounting from the point of view of the sole proprietor; the entity theory envolves an accounting from the "point of view" of the company or of the business. But what of the point of view of the managers, that is, of the activating force in a (large-scale) company? Since the day-to-day control of property, as distinct from its ultimate ownership, is vested in the managers, should we not attempt to account for such control of property instead of or in addition to our endeavours to account for its ownership?

As we have seen, a director is legally in a fiduciary position, but not only is he a trustee, in a sense, for the shareholders (or ultimate owners) and has to account to them for his trust, but also,

under modern conditions, he is a trustee for and has to account to a taxation authority (who represents, in this respect, the "community in general"), future shareholders (on whose behalf the integrity of "capital" must be maintained), possible shareholders (that is, the "investing public"), creditors and others. In the case of the sole proprietor, this function and that of owner are merged in one individual, and so any difference in point of view is, as a matter of actual fact, immaterial, even if it is conceivable. But the divergence in point of view of manager and owner has developed to such an extent in corporation activity, that in recent years a whole new field of study, going under the name of "management accounting," and an ancillary literature have grown up, in which the emphasis is laid upon the meeting of the demands which managers may make upon accountants for information to enable them (the managers) to carry out their function of control of property with a view to its increase.

We might pursue this line of thought to a somewhat extreme and perhaps illogical conclusion by imagining a managing director to compare himself with Louis XIV, whose "L'etat, c'est moi" he might paraphrase with an identification of the company with his own overpowering individuality. However, although in some cases, especially, for example, in those of "one-man" companies, the managing director or president owes his position to the "divine" right of owning a preponderating majority of shares, in many cases, among which are those of the biggest and economically most significant enterprises, he does not hold his position by any such "divine" right, his tenure being—at least in theory—that of a limited and, for the most part, a constitutional monarchy.[90] But monarchy it is, and, as monarch for a greater or shorter period, his point of view (which includes that of his ministers of state, that is, his co-directors and other executive officers) is unquestionably significant enough to warrant consideration.

[90] Cf. Paul P. Harbrecht, *Pension Funds and Economic Power* (New York: The Twentieth Century Fund, 1959) p. 277: ". . . the present-day corporate managers . . . have control, but not ownership, of great wealth, yet their tenure in power is in fact limited by their continuing ability to perform a service. The service on which their tenure is dependent is not clearly defined by written contract. . . . But there is, nevertheless, a certain standard of performance below which they cannot fall without incurring the wrath of the public and the displeasure of consumers."

The operations of corporations under modern conditions are sometimes so complex that at least one writer is of the opinion that the executive managers of some corporations select themselves and that it is not at all clear that they are responsible to anyone else.[91] Others point out that the boundaries of the corporation are often nebulous and that, from the point of view of the managers, the shareholders as well as the creditors are outside the organisation which they are concerned in operating.[92]

In what follows, the term "managers" is used to include all those officers of a company or other enterprise who are in a position of exercising executive or administrative powers and responsibilities in connection with dealings on its behalf, whether at the top or the lower ranks of management or in between, the term thus including directors, secretaries, accountants, technical officers, supervisors, foremen and so on according to their functional duties in any given case.

Managers are, technically, employees of a "company," being appointed directly or by means of delegated powers, by the shareholders acting in concert. In some types of enterprise, such as state-operated instrumentalities, the appointment is made by the government of the day, acting, theoretically at least, in what it considers to be the best interests of the members of the community to whom it owes its position of power. The active operations of a large enterprise, whether publicly or privately owned, and whether conducted by members of the public (or civil) service or by a team of privately recruited executives and administrators, is a complex field of study, with numerous and diverse ramifications. It would appear, however, that the principal executive officers, in a great many cases at least, have a sense of fairly direct responsibility to the "public," that is, in the case of a company, to the shareholders from time to time and to others in the community, and, in the case of a state instrumentality, not quite so directly, perhaps, but through the government of the day, to the members of the electorate. The junior executive officers are almost invariably directly responsible to the principal executives

[91] Cf. E. S. Mann (ed.), *The Corporation in Modern Society* (Cambridge, Mass.: The Harvard University Press, 1959), p. 5.

[92] Cf. Richard Eells and Clarence Walton, *Conceptual Foundations of Business* (Homewood, Ill.: Irwin, 1961, p. 149.

who in most cases (though not in all) have the right of hiring and firing them; even in those cases where this right is not possessed by the principal executives, they can usually, in practice, engineer a transfer or demotion of junior executives with whom they may have had occasion to find serious fault.

According to James Burnham,[93] the control of the world has been passing out of the hands of the possessors of wealth, who provide the resources for economic and other social activities, into the hands of those who, possessing technical, executive or administrative skill, control those activities.

During the past several decades [he says] the *de facto* management of the instruments of production has to a constantly increasing extent got out of the hands of the capitalists. . . . At the very least, the managerial prerogatives of the capitalists are being progressively whittled down. . . . Even so-called skilled work today usually needs no more than a few months' training. But, conversely, at the same time today a small percentage of tasks requires very great training and skill. . . . Within the process of production, the gap, estimated both in amount of skill and training and in difference of type of function, between the average worker and those who are in charge, on the technical side, of the process of production is far greater today than in the past. . . . All the necessary workers, skilled and unskilled, and all the industrial scientists will not turn out automobiles. The diverse tasks must be organized, co-ordinated, so that the different materials, tools, machines, plants, workers are all available at the proper place and moment and in the proper numbers. This task of direction and co-ordination is itself a highly specialized function. . . . It is a mistake . . . to confuse this directing and co-ordinating function with the scientific and engineering work. . . .

It is this . . . type of function which, in the fullest and clearest meaning, I call "managing;" and those who carry out this type of function are they whom I call the "managers." Many different names are given them. We may often recognise them as "production managers," operating executives, superintendents, administrative engineers, supervisory technicians; or, in government . . . as administrators, commissioners, bureau heads, and so on. I mean by managers, in short, those who already for the most part in contemporary society are actually managing, on its technical side, the actual process of production, no matter what the legal and financial form—individual, corporate, governmental—of the process. There are, to be sure, gradations among the managers. Under the chief operating executives of a corporation like General Motors or U.S. Steel or a state enterprise like the TVA there are dozens and hundreds of lesser managers, a whole hierarchy of them. In its broader sense the class of managers includes them all; within the class there are the lesser and the greater.[94]

[93] James Burnham: *The Managerial Revolution* (New York: John Day, 1941).
[94] Burnham, *op. cit.*, pp. 78-81.

Several later investigators have taken up this theme and several aspects of its development have been examined. One writer asserts that "ownership itself as an operating reality is diminishing" and that

> in the financial institution the concept of ownership has reached a dead end and no longer has any functional meaning, whereas the control over property which resides in the managers of these institutions is a dynamic and powerful force.[95]

It is not necessary here to consider these propositions in great detail or to pass judgment—favourable or unfavourable—upon the trend of development. But it is necessary to recognise the fact that in most enterprises and in all the important and significant ones there are people who direct its activities and are not necessarily its owners. These are the people who in fact today carry out the entrepreneurial functions which are the subject of study by economists; it is they whose decisions and expectations are significant in the economic field, and it is they on whom economists impose the task of maximising profits as their primary objective.[96]

As a slight digression, it may be noted that, while these managers are, in the last resort, employees of those who provide the resources which they (the managers) control and deploy, they wish, presumably, to remain in their controlling positions for as long as possible. To that end it is to their advantage to keep shareholders (in the case of a company) quiescent. They *may* aim at maximising profits, as prescribed by the economists, or they may aim at maintaining the profits of their company at a rate sufficient to pay dividends at about the same rate as in previous years without greatly impairing the original contribution. It may well happen, if endeavours to maximise profits involve great risks, that, in large and old-established companies in particular, any conflict between such risks on the one hand and the security of a safe course on the other will be resolved in favour of the latter. Further, it has been suggested that the goals of business corporations are changing, and that in certain cases

[95] Harbrecht, *op. cit.*, p. 4.

[96] For a summary of the views of a number of economists in this respect, see Thomas R. Prince, *Extension of the Boundaries of Accounting Theory* (Cincinnati, Ohio: South-Western Publishing Co., 1963), pp. 104 ff.

the objectives of the large corporation extend to include such goals as maintaining the economic system, developing a desirable public image of the business, and providing for the education of the youth of the nation.[97]

Our main thesis, however, does not lie in that direction, but rather in this: that, admitting any divorce of the entrepreneurial function from the function of ownership, is it necessary to recognise the possibility of a difference in emphasis between accounting for managers and accounting for ownership? From the managerial point of view, monetary symbols are relatively insignificant; at best, they are secondary. For managers, in carrying out their purely managerial function, want to know primarily what (physical) quanta of goods and equipment are available and required to carry out technical processes, not so much to provide a profit for the legal owners, but to enable them to carry out with technical efficiency the co-ordinating processes of production and distribution. This is an aspect of accounting in which non-monetary units may well become of paramount importance, but discussion of this may be deferred until we come to consider the unit of measurement. What it is desired to emphasise here is that the manager's thoughts should run primarily in terms of physical output, physical materials, and so on. Even when the managers are concerned with the supply of monetary resources—as they are in the area of "financial management"—these represent a means of acquiring the goods, equipment and services which they need for carrying on the physical activities with which they are primarily concerned. Operating assets constitute a more significant concept for them than current assets or fixed assets. They may find it necessary to use monetary symbols at times because of the present lack of any other co-ordinating and equating measure of heterogeneous non-monetary items; but they are not concerned with proprietorship as such, nor, indeed, with finance except so far as it is necessary to provide means of production and distribution. To them, intangibles such as goodwill are not worth anything at all for purposes of control; on the other hand, efficiency of organisation and administration, loyalty and skill of staff, are highly valuable intangibles.

[97] Norton M. Bedford and Nicholas Dopuch, "The Emerging Theoretical Structure of Accountancy," in *Business Topics* (Michigan State Univ.), Autumn, 1961, p. 63. Cf. also Eells and Walton, *op. cit.*, pp. 166 ff.

In current accounting practice there are indications of a recognition of this management function as a governing influence on accounting procedures. A great amount of emphasis has been applied by numerous writers on accounting, especially in recent years, upon the needs of management and the function of accounting as an aid to management. Indeed, the expression "managerial accounting" or "management accounting" is often used to describe a field of study and activity in which the basic proposition is that much of the accounting procedure is or should be concentrated upon preparing and presenting data for the use of executive officers. Not only cost accounting, but much of so-called financial accounting also, is interpreted as part of this field and evidence of the recognition of the need to satisfy managerial demands is afforded by the fact that cost accounting data, which were originally obtained from a distinct set of records and had to be reconciled from time to time with the results shown by the "financial" records kept on the traditional basis, are now, in both text-book exposition and practice, derived from records of cost determination which are an integral part of the whole accounting system, which is thus designed to serve the needs of both owners and managers.

If managers are to be regarded as trustees, even in a broad sense of trusteeship, it will be useful to examine some of the aspects of trustee accounting. In some works on accounting[98] trustee accounting has been regarded as an example of agency accounting, and, as such, a relic—in terms of point of view—from the Middle Ages. But the position of the trustee of a deceased person's estate or the guardian of an infant or a receiver appointed under bankruptcy or company liquidation proceedings is not quite that of an agent. An agent must owe legal allegiance to a principal who can direct him in the carrying out of activities on his (the principal's) behalf. Despite the fact that a trustee under a will is charged with the duty of carrying out the intention of the deceased as expressed in the will, it seems to be stretching the facts to argue that he is an agent of the deceased, for this involves imputing a personality to an individual who no longer exists and who is thus incapable of actively directing an agent. The

[98] For example, in A. A. Fitzgerald and L. A. Schumer: *Classification in Accounting* (Sidney: Butterworth & Co., 2nd ed., 1962), p. 57.

trust is a legal instrument peculiar to the English system of law and there are doubts even among lawyers concerning the precise legal status of the trustee. For example, "the powers of a guardian are somewhat vague and there is no clearly developed theory of agency by which the guardian can exercise the will of the infant."[99] Under a so-called protective trust, it may be provided that, if the beneficiary "should attempt to assign his interest or should become bankrupt, his rights cease, but that thereafter the trustee shall have an absolute discretion to apply the income for his benefit."[100] It is difficult to see how cases such as these can be regarded as agencies, since

> agency is created by a juristic act by which one person (the principal) gives to another (the agent) the power to do something for and in the name of the principal so as to bind the latter directly. If the agent acts within the terms of his authority and contracts in the name of an existing principal, then, in general, the agent is not personally liable on the contract—he is . . . a mere pipe through which legal relations flow."[101]

The trustee is scarcely in this position. Once the trust is created, the donor steps off the contractual stage, and the trustee acts on his own initiative, with all the responsibilities of trusteeship on his own shoulders. These responsibilities are not to be treated lightly; for example,

> trustees who sign a lease on behalf of a club must take care, for, while they have a lien on any existing club property for reimbursement of any expenses properly incurred, there is no right of recourse against the individual members,"[102]

while the personal and individual liabilities of trustees for breaches of trust are well known. Far from being an agent who steps aside when his liaison activities are completed, he is rather in the position of a manager who takes over from the individual or individuals who appoint him, and controls the trust property in their place but not necessarily on their behalf. He is neither the agent of the creator of the trust nor that of the beneficiaries, and far from his status being that of a relic of a medieval past, it has rather, perhaps, been that of a forerunner of the future.

There is some apparently supporting evidence for this point of

[99] G. W. Paton, *op. cit.*, p. 244.
[100] *Ibid.*, p. 402.
[101] *Ibid.*, p. 245.
[102] *Ibid.*, p. 280.

view in legal writings. One author,[103] protesting against the likening of directors and trustees, writes as follows:

> Reference has continually been made by judges and text writers to a director's liability for breach of trust. Admittedly, such reference has been confined to cases wherein the question was whether the directors concerned had been guilty of misapplication of company funds in some way or other. And it is true that in so far as directors do have control of funds to be administered for the benefit of others, they are in one sense like trustees. But there the analogy to trusteeship stops, or ought to stop. Directors are not trustees and all of the incidents of the office of the latter do not apply to the office of the former. Two points will suffice to make this clear. In the first place, directors are not in the onerous position in which trustees are placed, for the good reason that the latter's function is to preserve the assets under their control and not subject them to risk whereas the former may act knowing that risk is of the essence of many commercial dealings; and, in fact, it is a commonplace that directors continually subject the assets under their control to risk in order to achieve the dominant object of their company, viz., the acquisition of profit. . . . In the second place, trustees have title to the trust property, whereas directors, being agents, do not have title to the property of their principal, the company, although they may have powers with respect to that property.

Reading on, however, we come to an extract from the "classic judgment" of Romer, J. in *The City Equitable Fire Insurance Co.* case in which it is stated, *inter alia,* that

> the care he [a director] is bound to take has been described by Neville, J. in the case referred to above[104] as "reasonable care" to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf. In saying this, Neville, J. was only following what was laid down in *Overend and Gurney v. Gibb,* as being the proper test to apply, namely: "Whether or not the directors exceeded the powers entrusted to them, or whether, if they did not so exceed their powers, they were cognisant of circumstances of such a character, so plain, so manifest and so simple of appreciation that no men with any degree of prudence, acting on their own behalf would have entered into such a transaction as they entered into?"[105]

And when we read this passage we are reminded very strongly of the fourth duty of a trustee, in Augustine Birrell's enumeration, which reads: "The fourth duty of a Trustee is to take as much care of the trust property as being a prudent man of business he is accustomed to take of his own."[106] There may indeed be considerable

[103] S. R. Brown: *Company Directors* (Sydney: Law Book Co. of Australasia, 1951), pp. 137-38.
[104] In Re Brazilian Rubber Plantations and Estates Ltd. (1911) 1 Ch. 425.
[105] S. R. Brown, *op. cit.,* p. 143.
[106] Augustine Birrell, *The Duties and Liabilities of Trustees* (London: Macmillan, 1920), pp. 25-26.

differences in the legal status of directors and trustees, but in this respect at least, that is, in the measure of their legal functions, the law has found (or imposed) a common factor.

It is, moreover, just this common factor which is significant from and gives point to our present proposition, namely, that directors and trustees, having effective control over property, are enjoined to act as if it were their own without being the beneficial owners of it. In other words, they have the management of the property without its ownership. It seems worth while, therefore, exploring a little the accounting viewpoint of trustees to see whether it provides a clue to the viewpoint of managers.

In its essentials, the duty of a trustee is to care for a collection of assets—the estate—in such a way that they will continue to yield income from time to time which can be distributed to beneficiaries. In the case of a deceased person's estate, the beneficiaries may be "tenants for life" who are entitled to periodical distributions of such income as accrues from time to time, or "remaindermen" to whom, at a certain point of time, the estate is handed over to deal with as they will (the handing over of the estate operating as a final discharge of the trust), or "legatees" to whom part of the estate is, in accordance with specific instructions in the will of the testator, handed over by the trustee at the earliest reasonable opportunity. It may, of course, happen that one individual may be a beneficiary in a given estate in all of these three categories. In the case of a trust set up for, say, the benefit of a minor, the estate is commonly held in trust during the minority of the beneficiary to whom or for whose benefit the income received during such minority is distributed and to whom the estate is handed over on his attainment of legal majority. There may be numerous variations on these general themes, but the point that is germane to our argument is that the trustee is under a duty to conserve the estate, to distribute the income from time to time, and to hand over the estate itself at the appropriate time.

In fulfilling this duty, the trustee has to be careful to distribute as income no more and no less than the income derived from the assets which comprise the estate, under penalty of personal liability for failure. A trade or business carried on by a deceased person is terminated by his death and an executor or administrator

of the deceased's estate has (subject to specific and positive directions in the will) no right to carry on such business except so far as may be necessary to enable him to wind up the business beneficially and, if necessary, to sell it as a going concern; if he does more than this, he is personally liable for the debts incurred, with no right to be reimbursed out of the estate. A list of authorised investments is recognised by statute and it is normally mandatory for a trustee to convert personalty into these investments without undue delay, even though he may consider the existing forms of investment to be more remunerative than any of the authorised investments.

A trustee, then, has to conserve the estate which is the subject-matter of the trust, seeking (broadly) neither its increase nor decrease. Increase and decrease in an estate there may be, through profit or loss on realisation of an investment; such variations, however, are "capital" increments or decrements, arising from what might well be regarded as fortuitous circumstances existing at the time of changing the investment from one form to another. And in the face of such a circumstance as diminishing purchasing power of money, a trustee stands helpless, powerless to help the beneficiaries on a fixed income by a change of investment into more remunerative directions, even though, as a prudent man, he would and may, indeed, so vary his own investments. As trustee, he may be compelled to deal with the subject-matter of the trust even more cautiously than he would, even with his customary prudence, deal with his own affairs. The beneficiaries may indeed suffer hardship, but the trustee must protect the estate property safe from risk, except the risk of falling purchasing power of financial resources.

The relevance of this discussion lies in the fact that, although the estate capital or corpus, together with the income accrued, do, in a sense, constitute a semblance of proprietorship in a commercial venture, they do not constitute the kind envisaged by Professor Littleton—a proprietorship, the increase of which is the prime concern of the proprietor of the concern. If the records of a trust estate are considered to be maintained from the proprietary point of view, it is a singularly emasculated proprietorship. If they are regarded as being kept from the entity point of view,

we have a set of records maintained, as in the master-slave illustration, by the custodian of assets but not reflecting the existence of the custodian in any way. Ultimate ownership of the assets may reside in the beneficiaries but, so long as the trust endures, they have virtually no part in the handling of them.

VII The Commander Theory

What the lengthy argument in the foregoing sections amounts to is this: Neither the entity nor the proprietary theory (or convention) is wholly satisfactory in explaining the point of view from which accounting procedures—using this term in a wide sense to include reporting and interpretation as well as recording and designing—are carried out. Each is based, fundamentally, on the notion of ownership; ownership, however, is a nebulous concept and is extremely difficult to define and analyse in any way suitable for use as a basic accounting notion. Rooted in the early history of social organisation, it is, as a legal notion, complicated although basic, and to adopt it as a fundamental idea in accounting on an assumption that it is simple to understand is to provide a very unsure theoretical foundation for theory building.

There is, however, a more fruitful concept readily available—one which, at the same time, can be more surely based on observation. Ownership of resources is sometimes, but not always, accompanied by effective economic control of those resources, and this function of controlling or managing resources can be thought of as distinct from the legal or even social ownership of them. The modern corporation has emphasised this distinction for all to observe and it is continually being pointed out in current literature as a prime example of the divorce between ownership and control.

What we should comprehend in such expressions as "corporation," "company," and the like is a series of relationships between individual human beings; that is, each of these terms is, in a sense, a shorthand expression for a complex of human beings and relationships between human beings. If we could always bear this in mind when we used the terms, many difficulties might be avoided. But, once established and accepted, such a term tends to attain a "personality" of its own and to supplant the specific referents from

which it originated. The personalisation of these abstract "entities"—in law and in accounting—has tended to make us lose sight of the realities that lie behind them in fact.

Although it may be convenient for many purposes to speak of the business, the company, the club, the government department and so on as separate social, economic or legal "entities" and to think of them as engaging in activities, it is important not to lose sight of the fact that it is human beings who actually undertake such activities "on behalf of" these "entities"; more correctly, the fact is that certain human beings undertake these activities on behalf of other human beings and the decisions involved are those of specific individuals or groups of individuals. It is therefore suggested that, instead of focussing attention upon the corporation as a distinct but abstract entity and endowing it with human capacities, e.g., for ownership—as is now legally and fiscally common—we should direct our attention to the function of control which can only be exercised by human beings. It is therefore submitted that the unit of experience and outlook for accountable activities is a human being or small group of human beings who has or who have the power to deploy resources over which they have economic and, in certain cases, legal control, whether or not such legal control constitutes a right of ownership.

Since the terms "controller" and "manager" have developed particular connotations in business and accounting terminology, a neutral word is desirable, and the term "commander" is here used to signify the person who has such command over resources. This notion enables us to arrive at a realistic interpretation of the purposes and functions of accounting without recourse to artificial abstractions such as an "entity" or a "fund," although these may still be useful in certain restricted areas of consideration.

In the case of a sole proprietor, the functions exercisable by the commander over resources and the investor of resources are combined, that is, "embodied" in one human being. In earlier text-book approaches to accounting theory, it was frequently propounded that if the proprietor should list his possessions at successive points of time the difference between his net assets according to the lists would measure his financial success or reverse

in the intervening period.[107] The emphasis was placed on ownership. Owner of his possessions he was, of course, but what was overlooked in this approach was the fact that these possessions were also completely under his control and that it was by his being able to command them, that is, to direct, arrange and manipulate them that they became capable of accretion or diminution. Ownership is a legal relationship, while control is an economic function; if there were no concept of ownership there would still be one of control. Ownership, after all, is a somewhat static or passive concept; it is the doing things with one's possessions that leads to change in their character and quantum, that is, that leads to increase or decrease in the *measure* of ownership.

Thus, in the early days of development of the proprietary approach, as there was no distinction between owner and commander, concentration upon the owner covered also attention to the commander, and the distinction between the functions would have had no practical value. It is not surprising, therefore, that the function of command was not seen as anything distinct from that of ownership. Nevertheless, the functions have always been distinct—and the more significant function economically was, and still is, that of command. For to exercise command over resources is to act economically, that is, to make a choice between alternative uses of the resources. It is as commander rather than owner that the entrepreneur carries out his functions, even though he may be rewarded as owner.

In a corporation, on the other hand, the functions of commander and investor are sharply distinguished. The investor has command over his resources until he becomes a shareholder in a company; at that moment he transfers his command over the quantum of resources invested to those who have control over the affairs of the company, that is, to the directors and managers. He remains the owner of shares, that is, of certain (usually restricted) rights

[107] For example, Roy B. Kester, *Accounting Theory and Practice* (New York: Ronald, 1919) ". . . the first problem of accountancy is the determination of how much wealth is invested in a given enterprise and what ownership or proprietorship exists at different periods of time, so that by comparison the increases and decreases may be known" (p. 13). See also his approach in Ch. V of that work. Cf. also Sir Arthur Lowes Dickinson, *Accounting Practice and Procedure* (New York: Ronald, 1913), p. 32, or Earl A. Saliers and Arthur W. Holmes, *Basic Accounting Principles* (Chicago: Business Publications, 1937), p. 19.

to participation in periodic distributions of the company's "profits" and in the final distribution of its assets; in this sense, he is a part-owner of the company's resources, but he has no command over the resources which his shares purport to represent. Hence, while he has an ownership interest in the resources because of his share-holding, and to this extent has command over his shares, he has no direct control over any specific resources of the company. In order to regain command over specific resources, he must cease to be a shareholder, that is, he must either sell his shares or, with other shareholders, put the company into liquidation; and even then he gets command not over the resources he invested in the company but over an equivalent or greater or less quantum.

At the same time, investors retain command over other resources and, of course, have command over the resources distributed to them as dividends. They are thus commanders over their own resources, but not over those of the company. The command over the company's resources is exercised by a hierarchy of commanders—every manager has a more or less limited command over these resources, with one or a very few commanders having general command over the whole of the company's resources. Thus, while it is admittedly the shareholders who have taken over the position of the sole proprietor as owner or investor, it is the chief executive officer who has taken over his position as manager and controller of possessions. In every social enterprise, whatever its form or organization, there is some one individual who has or some very few individuals who share the supreme responsibility for the conduct of its affairs.

In the case of a trust, the trustee is the commander of the resources constituting the corpus of the estate; it is his responsibility to deploy those resources within the terms and conditions laid down in the trust deed. Although he is the "legal owner" of these resources in the eyes of the law, he may not have the same freedom of command over them as he has over his own resources; in most cases he may not deploy them so as to subject them to serious risk of loss as he is free to do with his own personal resources. He is none the less the only person who has any kind of effective command over them and, within the limits set by common law, statute and the instrument which appoints him, he undertakes the re-

sponsibility of determining how the resources of the estate shall be used.

The liquidator or the trustee in bankruptcy is in a somewhat similar position. He is not the owner of the resources entrusted to his care, but, once appointed, he is a commander of resources which it is his responsibility to realise and turn into a form suitable for distribution firstly to creditors and residually to shareholders or bankrupt; the residual claimant is the "owner" of the resources in the ordinary sense of the term.

The receiver appointed by a creditor or creditors of a firm is likewise commander of the firm's resources during the period of his receivership. He takes over the command from the normal commanders, whose activities have resulted in an insecure financial position for the firm. When his receivership ceases, he hands back to the same or other managers of the firm the command over its resources which he held temporarily.

In government affairs, there is also a hierarchy of commanders. Ministerial heads are at the top level of command, taking decisions in accordance with general cabinet policy. It is true that in many cases ministers are guided in both their policy and their decisions by the permanent heads of departments, and the latter are effective commanders in this respect as well as in the executive capacity and responsibility for carrying out policy decisions. At lower levels of command are the officials of the several departments who are charged with the task of deploying resources within the scope and limits laid down for them by budgeting considerations and financial appropriations.

Even in the case of the sporting or social club, the president or a small committee has command over the resources of the club, and the members stand in a similar functional position as shareholders in a company. The fact that the office-bearers are elected annually does not alter their functional duties and responsibilities.

In all cases there is somebody or some few people who has or who have supreme managerial responsibility, whether appointed by shareholders or members or creators of trusts or representatives of the people: it is he (or they) who stands or falls in a personal way by the success or failure of the enterprise. A similar consideration applies down the line to departments, branches, territories, and the like.

In effect, then, everybody who has resources to deploy is a commander in the sense in which the word is here used.

VIII The Commander Viewpoint

Once the position of the commander is recognised, it becomes clear that accounting functions are carried out for and on behalf of commanders. Accounting reports are reports by commanders to commanders, that is, by commanders at one level of command to commanders at a higher level, so to speak, along a whole chain of command;[108] accounting records are set up and maintained to enable effective reports to be made and to provide documentary evidence for decisions to be made by commanders. Accounting reports are useful because they can be used to *control* activities relating to resources and enable decisions to be made by those in a position to control them, that is, by commanders. Accounting analysis is undertaken so that commanders of resources may be put in a position where they can made decisions on a basis of reasoned interpretation rather than guesswork.

Accounting thus becomes a matter chiefly of recording, reporting, analysing and interpreting events relating to resources for the benefit of informing those people who are commanders of such resources. Accounting records are kept, accounting statements are prepared, accounting reports are analysed, by people on behalf of people for the benefit of people. Other functions, such as those of verifying or designing of procedures and systems, are ancillary to these primary functions.

It is submitted that such a definition, while specific in indicating both the purpose and scope of accounting, at the same time is not restrictive as to the methodology (double-entry or single-entry; historical or prospective—that is, budgetary—procedures, etc.) or the area of attention (business enterprises, governments, trustees; sole proprietors, partners, corporations, etc.). Further, attention becomes focussed on people and events and we are no longer obliged to try to force people's activities into a mould shaped for

[108] At many levels, the control exercised by commanders over others is direct, but at certain levels the control is diffused, and in some cases reporting may well become a matter of providing data for the formulation of an informed "public opinion," which, vague and nebulous as it usually is, can nevertheless be a real and significant instrument in modifying activities of particular commanders in relation to the resources under their control.

a shadowy entity, which may be a convenient legal or social fiction but is nevertheless an unreal and incorporeal chimera, even though, by an ironic quirk of our language, it may be legally "incorporated."

Accounting procedures are carried out from the point of view of the commander rather than from the point of view of the owner or from a hypothetical point of view of an artificial entity. It is not necessary to set up such an artificial entity to explain the accounting for a corporation, if we are prepared to look behind the legal fiction.

If we look at the entity notion in terms of the master-slave exposition with which it has been supplied, it can now be seen that the slave in that exposition is not the personal counterpart of a business or of any other abstraction, but of the commander of resources which legally belong to the master. And when we consider the functions of the proprietor in the original proprietary theory, we see, on a little reflection, that they are two. The sole proprietor is both investor in and manager of his business affairs. In the corporation these functions are divorced, and are usually carried out by different individuals. It appears as if the failure to distinguish between these two roles has put an undue emphasis on the sole proprietor as investor, with the concomitant effect that his activity as commander of his own resources has been overlooked. With a partnership, there must be more than one individual involved, and even the legal test of partnership is joint control rather than joint ownership; and when the number of partners becomes at all large we find senior partners and junior partners, with the former having a preponderating influence over the partnership's affairs.

It must not be inferred from all this that the interests of investors are to be regarded as negligible. In the case, say, of a company, the directors act in both a managerial and a fiduciary capacity. These two functions are not entirely divorced from each other in practice, but they do have different implications.

In his managerial capacity, the director, as commander of resources, should view the economic unit comprised by these resources as an instrument of management and he is in a position of being able to determine the various ways in which these re-

sources may be handled in order to promote the objectives of management, and, what is more significant perhaps for the practice of the accountant, he is or should be in a position to determine what information is best suited to his managerial purpose.

In his fiduciary capacity, however, the director must transpose his point of view to that of the investor. The individual investor is the commander of his own resources as an instrument of investment, and is faced with the problem of disposing them in a manner consonant with the objectives he has in mind. A director of a company, of course, cannot be expected to know the objectives of a shareholder in the company, since these are a result of subjective evaluations; but, as the shareholder's fiduciary agent, he has to report to him from time to time, and, for the purposes of carrying out such reporting function, he must at least endeavour to assess these objectives in some way. There is a generally accepted attitude that an investor is interested in the conservation and accretion of his invested resources; and the courts have insisted that an agent in this regard must act with the prudence of a business man with such an interest. Having regard to this fiduciary relationship, the director should report to the investor in terms which are of use to the investor or which may be readily translated into terms useful for the investor, so that, as the commander of his resources for purposes of investment, the investor shall have intelligible and reliable information on which to base his investment judgment.

A somewhat similar situation obtains in respect of reports to taxation authorities and government agencies. The director is as much a fiduciary agent of the government as of the investor, but the requirements of the two are not necessarily identical. Nevertheless, one of the director's responsibilities is to direct or enable reports to be made in terms which will be of use to the recipient or which can be readily translated into such useful terms.

The accountant, in adopting the point of view of the commander, has to bear in mind the complexities of the situation which arise in those cases where command and ownership of resources are clearly divorced from each other.

We thus come to a functional view of accounting. As long ago as 1922 Professor W. A. Paton had a glimpse of this position.

> The conception of the manager [he wrote then] must be exactly that of the business entity as an economic unit; and if, as is repeatedly said, the most important purpose which modern accounting can serve lies in the rationalizing of business administration, *the accountant must of necessity adopt the viewpoint of the manager* in large measure.[109]

He was, however, apparently intent then on introducing and emphasising the concept of the business entity, and his whole treatment was geared to the business corporation; hence the potentiality of this view for accounting theory remained undeveloped.

Another of the earlier writers on accounting advanced a somewhat similar argument:

> Parenthetically it may be pointed out here that since accounting is essentially a tool of management the point of view of accounts must be that of the manager. The scope of the accounting system must be co-extensive with the authority of the management. In matters of the determination and execution of policies the business enterprise must be a unit even if it include within its scope a great many different corporations. Without unity its effectiveness would be lost. When management overreaches the bounds of the individual corporate organization so does accounting. Unity of the accounting system is necessary to consistent and intelligent management.[110]

However, the idea does not appear to have been developed in that work and remained a parenthetic observation.

We can now see that the accountant in his records is accounting from the point of view of whoever it may be that initiates the events that he records. He reports from the commander's point of view on the events that have taken place; the reports may be directed to different bodies of people—shareholders, taxation officers, legal functionaries, even to the manager or commander himself. To whom he reports is (in our present context only, of course) relatively unimportant; what he is reporting is what, in effect, the commander has done.

As an illustration of the way in which this theory would "work out," we may briefly consider the balance sheet. If we allow ourselves to become imbued with the notion of ownership as the basis of accounting, the balance sheet becomes a statement of "values" owned and owed; and the question of who owns and who owes is controversially but inconclusively raised. If, how-

[109] W. A. Paton, *Accounting Theory* (New York: Ronald Press, 1922), p. 478. Italics supplied.

[110] DR Scott, *Theory of Accounts* (New York: Henry Holt & Co., 1925), p. 18.

ever, we adopt the position that the balance sheet is prepared by or on behalf of and from the point of view of a commander—the chief executive officer, be he the proprietor himself or the small group of partners or the president or managing director—it can be seen as a statement of the sources from which he has (or they have) derived resources and the directions in which those resources have been applied and it is therefore more directly a statement of stewardship than of ownership. That is, the accountant prepares on behalf of and from the point of view of the commander—a real person and not a hypothetical entity—a statement dealing with resources with which he (the commander) has been entrusted, which he controls and can deploy but which he does not necessarily own. The resources are handled not by an abstract entity but by people—the chief executive and his team in a hierarchy of command; they are provided by people—creditors and investors; and they are used to acquire things and rights against people or to satisfy claims of people. The balance sheet is thus perceivable as a statement of accountability, with the manager in a quasi-fiduciary role.

Further, the statement is prepared for the information of commanders of resources, which are not necessarily the specific resources represented in the balance sheet itself. For example, as already suggested, each shareholder in a company is a commander of resources, part only of which is normally composed of the shares in the company held by him; in so far as the company's balance sheet is addressed to him, it is addressed to him as a commander as well as a part-owner of the company's shares. This distinction between ownership of and command over shares may not appear to be very significant in the case of most individual shareholders, but it may well be important for large institutional shareholdings where the shares are held in the name of the institution while the decisions in relation to them have to be made by individuals representing the institution.

As another example, take the profit and loss statement. This is or purports to be a summary and a measure of events during a period—events which have been initiated not by an artificial entity but by people. We can reasonably put ourselves in the place of the commander for reporting purposes, whereas it is ex-

ceedingly difficult, if not utterly impossible, to consider ourselves as an artificial entity. Hence the accountant prepares the profit and loss statement as an act of communication and as an explanation of the result of the activities in a given period and a summary of them. The net result indicated by the statement is or purports to be a measure of the period's events. If it is asked—as it sometimes is—to whom does the net profit of a business belong, the answer is that it does not belong to anybody because it does not exist as such; neither is a loss to be borne by anybody. What does exist and belong to somebody is the accretion of net assets of which the net profit is a measure; what has to be borne by somebody is the decrease in net assets. All who have studied a little accounting—and some among those who have studied none—know that a profit is not necessarily identifiable with increased *cash* resources. But a profit does mean that net assets have increased, and it is the transfer of net profit to proprietorship which translates the measure of result into a measure of ownership. So, in the profit and loss statement, the commander, or the accountant on behalf of the commander, is expressing results from his (the commander's) point of view: he is explaining in some detail, but still in summary form, what types of expenditure he, as commander, that is, as manager and custodian, has incurred and with what result. In the accompanying balance sheet, the net result is incorporated in the proprietorship; this last item only is a measure of ownership, the others are measures of command.

A complementary statement of a basic similar character is often prepared in the form of a funds statement. It is similar in that it, too, is a summary of events, but it is expressed more directly in terms of variations in specific kinds of resources. In effect, what the manager is saying in this statement is that during a specified period he has derived resources in divers ways and he is reporting on the way he has applied them. The resources do not necessarily belong to him and every item of source has its concomitant and simultaneous item of application. He has conceivably—but only conceivably—an instant of choice between acquisition and application of funds; in fact, of course, the choice will have been made beforehand, and resources derived must be simultaneously applied *somehow*.

The "theory" here suggested may be regarded as a neo-proprietary theory in the sense that it seems to focus attention upon people, but it seems more appropriate to regard the proprietary theory as applicable to special cases within the present theory, namely, those cases in which the functions of control and ownership are fused in one person.

The commander theory does not destroy either the entity notion or the proprietary theory, but it can be used to reconcile the two. The entity, notional as it is, is significant for the commander but not for the proprietor. The significant thing for the proprietor—the owner—is proprietorship. A shareholder, for instance, is not basically concerned with the assets or the liabilities of the company of which he is a member; his concern is with shareholders' funds. He is not basically concerned with profit but with dividends, not with the rate of profit to sales but with return on capital. Any interest he may evince in assets, liabilities or profits is secondary. The commander, however, is concerned with all these as a matter of basic and primary interest, for they are the resources over which he has command or the results of his handling of them. The commander, then, is justified in setting up a concept, if he wishes, to cover the totality of the resources (positive and negative) which it is his task and responsibility to handle—and it is this which constitutes the entity. If accounting is carried out in terms of an entity, it is for the information of the commander.

If people are satisfied that a given entity "exists," then accounts and reports may be prepared which say something *about* the entity. But they would not be accounts and reports prepared for the entity in the sense that the entity may make use of them. Prepositional ambiguity may have been responsible for some confused thinking here. Expressions like "accounts of the entity," "accounts for the entity," "entity's accounts," may be interpreted in more than one way. "Of" and "for" have many meanings—not only according to the particular context, but virtually governing the context. "Accounts of the entity" may mean accounts saying something about the entity or accounts belonging to the entity—and so on. But to say that accounts and reports are *about* an entity may tell us something about the entity but does not tell us

anything about the accounts and reports—that is, it does not explain why we want accounts and reports about an entity, nor who wants them, nor who prepares them or on whose behalf they are prepared. Similar considerations arise with the fund theory. It is submitted that it is just here that the commander theory fills a gap—a gap left by the inadequacy of the proprietary theory as usually expounded.

Thus, the notions of entity and fund have their place within the present theory; for example, where one commander has diverse entrepreneurial and control interests and it is desired or necessary to delimit the several areas of interest, each such area may be designated a distinct entity or fund if this is considered to facilitate thinking about it, but in such usage there should be no suggestion of according any kind of a personality or artificial existence to the area of interest under consideration.

Neither is it intended here to eschew completely the notion of an enterprise—the business, the company, the club, the state, the government, all these do exist as social concepts, some of them as legal units, and to this extent have a useful intellectual function. It is submitted, however, that for accounting purposes it is neither necessary nor desirable to endow them with a personality and a point of view that they do not possess in fact when a more realistic and equally satisfying hypothesis is available.

The present argument is further submitted as part of a theory of accounting and not merely as a theory of double-entry recording. The latter is discussed in Chapter 11. The source of a satisfactory theory of accounting should be in social phenomena, but not in any one aspect only of social phenomena. Even an economic basis may prove to be not broad enough. The commander theory *is* based on social facts—(i) that different people have control or command over different resources, and (ii) that every person has command over *some* resources. These are also facts of economics, but the resources need not be scarce to be accountable, although in fact they are so almost invariably.

The Unit of Measurement

I Basic Characteristics of a Unit of Measurement

MOST, IF NOT ALL, writers on accounting appear to presume that accountants are concerned wholly with events that are measurable in monetary terms, and, while a great deal of attention has been directed towards an examination of the effects of the "instability" of a given monetary unit, little effort appears to have been expended in examining the basic characteristics of an accounting unit of measurement as such.

It was briefly postulated above[1] that meaningful accounting statements might be prepared even where different units of measurement are used within the one accountable unit, and it was suggested that the adoption of a unit of measurement is, basically, a matter of subjective evaluation.

To illustrate the point a little more specifically, consider a case which is somewhat, but not wholly, divorced from the practices of everyday activities. Suppose that *A* sets up a trust and appoints *T* as trustee for a specific, rather long period, say, twenty-four years. The trust property comprises, say, five hundred government, interest-bearing bonds with a currency of twenty-five years from the date of the trust deed. The deed further provides that within that period *T* shall have the power to buy and sell bonds of this particular issue, so long as (a) he shall have on hand at the end of the trust the same number of bonds as he was originally entrusted with, and (b) any interest received from time to time and any cash surplus at the end of the period shall be paid to *B*, a beneficiary.

[1] See Chapter 3.

It is clear that during the period of the trust a number of things will occur which will constitute events for accounting purposes—the initial handing over of the bonds, the periodical receipt of interest, any buying and selling of bonds, and the final handing back of the bonds. Another feature is that *T*, as trustee, is not the owner of the bonds, but has command over them during the period of the trust. His position is that of a commander as indicated in our earlier discussion.

It is also clear that it will be desirable that *T* keep records of (a) the bonds themselves, and (b) the interest on the bonds. The question arising in the present discussion is: What unit or units of measurement should he adopt in his records?

So far as the interest received and paid is concerned, he must record it in money because it will be expressed in monetary terms. But what of the bonds? If he does not exercise his power to sell and buy, it is possible that he will not need any record of them at all, although most accountants would probably argue that it would be wise to record the initial receipt of five hundred bonds and their final disposal. This would constitute a purely quantitative, non-monetary record, in which the attachment of any monetary evaluation, whether it be cost, market price at any given date, face value, or any imputed figure, would, strictly speaking, be irrelevant and superfluous. If, on the other hand, he does sell some of the bonds—presumably when their market price is considered to be higher than normal—and buys back an equal number—presumably when the market price has fallen—he will find a quantitative record of these events necessary as well as a monetary record. Because he is responsible for a given *number* of bonds, he will find that a numerical record is necessary; and because he is responsible for a determinable sum or sums of money, he will find that a monetary record is necessary.

The point of this illustration is that it suggests that the unit of measurement is governed by the purpose of the accounting, and the essential question that needs to be resolved is: What are the minimum requirements or desiderata in a unit of measurement for accounting purposes?

The unit of measurement to be adopted for accounting purposes must have some qualitative content. That is, in accounting

we do not deal in abstract number. There is always something to be measured: an event which has a relationship to one or more other events is measured in respect of the qualitative characteristics which indicate this relationship. Arithmetical procedures are applied in accounting, but always in respect of something which has a positive measurable content, not in respect of numbers divorced from qualities. Thus, in the above illustration, *T* has to account for five hundred *bonds* and not simply for five hundred, or for five hundred of anything else.

Secondly, the unit of measurement must be significant for the commander. The accountant will recognise as the relevant qualitative content of the events he is measuring such relationships as are, or are thought to be, significant for the commander concerned with the events. If our trustee, for example, were to sell one hundred of the bonds at £105 and, later, buy eighty at £95 each and twenty at £108, these events in terms of the *number* of bonds would necessarily be significant, and any record maintained would certainly include reference to the movement of the number of bonds. In terms of monetary units, the events would very likely be significant, and the record would probably be designed to include reference to the amounts of money involved in the events. If, however, he neither bought nor sold any bonds during the period of the trust, any price at which they might have been bought or sold at any time would be irrelevant for him as trustee and commander of these resources, and thus the monetary content, so to speak, of the bonds need not be considered as a unit of measurement. (Of course, the monetary content of the interest would be significant, but this is a separate matter.)

Thus, the primary function of a unit of measurement for accounting purposes is to enable events within and comprising a given venture to be brought into meaningful relationship with each other. In any given case, what constitutes a meaningful relationship may depend upon such things as the intention of the commander, the natural or physical content of events, the desire of or the necessity for the commander to indicate to others the results of ventures, and so on.

At this (analytical) stage, the unit of measurement may conceivably be different for each venture. The basic requirement is

that it shall be uniform for the several events constituting the one venture; strictly speaking, no more is required to account for any given venture.

In the absence of external considerations, these seem to be the criteria for accounting measurement. It is thus possible for an accounting party to use a number of different units of measurement for events—in the extreme but unlikely case, as many distinct units as there are ventures; each unit would be indicative of different qualitative attributes of events of which accounting cognisance needs to be taken. It is not essential that all events be reduced to a single common denominator for purposes of adequate measurement. Indeed, it frequently happens that an event has a multiple relationship to other events and should be measured in more than one unit; that is, it may be a part of more than one venture. Consider the common case of the use of a raw material in manufacturing. If 100 units of material *M* are acquired, of which 12 units are used for Job *J*, the issue of these twelve units constitutes an event which comprises a part of the venture of acquiring and disposing of the 100 units of *M*; at the same time, it is part of the venture of carrying out and disposing of Job *J* and should be brought into relationship with the other components constituting the completed work. Hence, for the purpose of accounting for the disposition of material *M*, this issue should be recorded in terms of the "physical" units involved—yards, ounces, gallons, and so on; while, for the purposes of determining, say, the cost of Job *J*, the issue should be recorded in terms of a monetary unit.

It follows, too, that the unit used to measure the several events which comprise a particular venture should be uniform for all those events, although not necessarily the same as the unit to measure other events in other ventures, or even some of those same events in other ventures. We might call each of these an *individual unit of measurement.*

When it is desired to bring different ventures into meaningful relationship with each other, however, it becomes necessary to use a unit of measurement which will, in some way, generalise the several ventures. It is at this stage that a unit of measurement which can be used as a common means of expression for various

ventures has to be devised. For example, if a person is engaged in, say, cattle-raising, wine-making and timber-felling as three distinct activities, he could account for each in terms respectively of head of cattle, kegs of wine and superfeet of timber. If, however, he wishes to bring the three activities or ventures into meaningful relationship with each other, he will have to do one of two things. Either he will have to translate two of his ventures into the units of the third, or he will have to translate all three into a fourth measure which will serve to generalise the events of the three. It is at this stage that the several individual units of measurement are supplemented or, in some cases, replaced by what we might call a *general unit of measurement.* Such a unit generalises the ventures of one person for that person only, and each person may, if he so wishes, use a distinctive general unit for his own accounting purposes which is different from the general unit used by any one else.

It is only at the stage when a social context is given to the ventures of different persons in a community that it is necessary to adopt a unit of measurement that is common between these persons. Such a unit might be termed a *social unit of measurement.*

II The Social Unit of Measurement

The social unit of measurement arises when communication in respect of events and ventures between different persons is necessary. Communication between partners of a firm, between agent and principal, between taxpayer and tax authorities and between directors and shareholders, provides obvious examples. Another instance would be that in which a person wishes to compare the result of his activities with those of other people; even if he were to use his own general unit of measurement, he could only get an effective comparison if his unit were the same as that of the others, that is, if he were to apply a social unit of measurement.

"Communication" in this context also includes commerce or trading. Where commerce takes place between different people it has been usual to adopt as the unit of measurement the medium of exchange commonly used in such commercial transactions, but this is a matter of convenience and expedience rather than of

necessity. In the conditions with which we are most familiar, the unit is that of the current monetary unit of exchange, but there are at least vestigial evidences that the use of such current monetary unit is not necessarily the only possible unit of account. For example, professional fees are still frequently reckoned in some English communities in terms of guineas, although the guinea as a unit of exchange has long disappeared; and in Germany during the inflation of the nineteen-twenties the unit of account was the mark, although the medium of exchange varied from day to day as the debasement of the currency proceeded.

It is true, however, that the monetary unit has become conventionally recognised as the most important, and, so far as most writers appear to indicate, the sole unit of measurement for accounting. For, when once a social unit is introduced, it tends to oust a general unit: it is readily adopted as a matter of convenience and expedience because it can do all the work that a general unit does, and more. But in any discussion in which the unit of measurement arises, it may be helpful to bear in mind that the use of the social unit to serve as a general unit *is* a matter of convenience and expedience rather than a matter of necessity. It is important to avoid confusing the general characteristics and the social characteristics of the unit of measurement.

III The Measurement of Resources

The commander is in control of resources—either his own resources or those entrusted to him by others—and he is concerned with the measurement of events involving movements in those resources. Each of these movements involves a change from one kind of "resource" to another. This raises a question of definition and classification. What is meant by "a resource," and what kinds of resources are there?

The word "resources" in this kind of context is a collective noun for which, strictly speaking, there is no singular form, "a resource." Nevertheless, it is convenient for our purposes to have a word which will signify any particular or, rather, distinguishable part of the collection of resources from others. In the case of the "elemental" commander—the self-made man at that period of his career when he has but the initial proverbial shoe-string—

the shoe-string constitutes his resources, which he proceeds to change into other resources. An example of this occurs in the story of a nineteenth-century merchant, Samuel Budgett, who told of his start in commerce in the following words:

> The first money I ever recollect possessing, was gained in the following way. I went to Mr. Milks, of Kilmersdon, to school, a distance of three miles. One day, on my way, I picked up a horse-shoe, and carried it about three miles, and sold it to a blacksmith for a penny. That was the first penny I ever recollect possessing; and I kept it for some time. A few weeks after, the same man called my attention to a boy who was carrying off some dirt opposite his door; and offered, if I would beat the boy, who was a bigger boy than myself, to give me a penny. I did so; he made a mark upon it, and promised if I would bring it to him that day fortnight, he would give me another. I took it to him at the appointed time, when he fulfilled his promise, and I thus became possessed of threepence; since which, I have never been without, except when I gave it all away.[2]

The veracity of the story and the validity of the evidence on which it is based need not concern us, as the point is not in its truth but in its suggestion. A horseshoe constitutes resources, the penny for which it was exchanged is equally resources, and, indeed, there is scarcely any limit to the variety of things that might be regarded as resources. It is, perhaps, possible to identify these resources with the "goods" of the economist and to say that anything that has economic "value" constitutes resources. The concept of resources for accounting purposes is as elemental as the concept of goods for economics. Just as economic goods need a factor of scarcity relative to utility, accounting resources need a factor of utility. Despite the fact that before a price can be put on them the factor of scarcity must also apply, it is submitted that all resources can be accounted for (even though, perhaps, this is not generally recognised nor often practised) whether a price factor is involved or not. This has been implicitly recognised in the treatment generally advocated for recording donated resources in the accounting records: where a commercial enterprise receives a donation in kind (as appears to be not uncommon in the United States of America, if one may judge from the accounting texts), a price is usually imputed to, say, land or some other item which has not in fact been the subject of an exchange trans-

[2] William Arthur, *The Successful Merchant: Sketches of the Life of Mr. Samuel Budgett* (London: Hamilton, Adams & Co., 1852), pp. 42-43.

action, and the records are maintained on a basis of "as if" the price had been paid. It is suggested that this is a recognition not merely of the "economic" nature of the item, but also of the proposition that all resources which the commander controls (within a given context) should become accountable; the general adoption of a monetary unit imposes the necessity for imputation of a price. If the price of the land had been donated in cash and the land then bought, there would be little difficulty in recognising the cash and the land as accountable resources. The absence of the cash transaction only raises the problem of what "value" for the land should be imputed; the recognition of the donated assets as resources which ought to be accounted for can scarcely be questioned.

The practice of many firms in writing down assets like goodwill to a nominal figure, coupled with their reluctance to write them out completely, constitutes another instance of this attitude. In fact, because so many of the procedures of accounting have been tied to the monetary unit of measurement, the problem of accounting for non-priced factors, including many "intangibles," has not yet been satisfactorily solved.

The notion of resources is in itself an abstraction and a generalisation. When we say that a man possesses resources, we have implicitly in our minds a generalisation of specific commodities and legal rights. To add these different commodities and rights and call them by the generic term "resources" is to abstract from each of them a characteristic which is not inherent in them naturally or physically, but only by reason of a conceptual and man-made relationship between him and it. It is a relationship of potential or actual usefulness, in a broad sense of the word "usefulness." When we come to measure the particular items within the general category, we have to use a unit which, somehow, expresses this relationship; this is one of the highly significant functions of a monetary unit.

What is really involved in the use of a monetary unit in accounting is the application of a measure which is itself a means of abstraction and generalisation of the particular factors constituting "resources." The only way in which we can add unlike resources is to translate them into some kind of common measure;

and to this process of addition other mathematical processes have been added. Thus, by translating a machine or a building into, say, its cost (an arithmetical expression), we can apply the further arithmetical process of division to it and assess an amount for "depreciation" over a number of time periods. But we cannot and do not divide the machine or building itself; as "a resource" it is indivisible. We cannot with propriety say that one-tenth of the weight of a machine or one-fortieth of the number of bricks in a building is used up or disappears in any given year, or needs to be replaced, because this kind of statement is patently in conflict with the physical facts. Nevertheless, in much of the writing on "depreciation" there appears to be an underlying implication that at least the physical usefulness of a particular item of resources is impaired by the fact of its use or by the passage of time or by other influences more or less clearly envisaged, and that a periodic charge for depreciation measures this. Since we cannot account for the physical unit except in terms of its unity, we must, if we wish to apportion any of its characteristics, use a measure which is capable of division. It is this requirement which the monetary unit satisfies so admirably.

IV The Possibility of an Alternative Unit of Measurement

One question which suggests itself in relation to the unit of measurement for accounting purposes is whether the monetary unit is the only possible one which satisfies the relevant conditions. It is not proposed to explore this question very far here, but one line of investigation may be appropriately suggested as an indication of a possible direction for some future thinking. While it is indeed difficult for us, conditioned as we have been by centuries of monetary use, to conceive of an alternative unit of measurement, we should seek or devise or discover it if it is considered that the monetary unit is not fully satisfactory. The alternative, however, must meet the criteria of a unit of measurement at least as well as the monetary unit does.

Karl Marx, for example, postulated "abstract human labour" as a basic component of goods and services, the quantum of which fixed their "values"; this notion, however, remains and will probably always remain at the conceptual level because it appears to be

incapable of measurement—at least by any means at present known to us. Even in the Soviet Union the initial impulse to abandon money and replace it by a labour unit as the unit of account did not last very long, although there are still occasional suggestions that the labour unit will eventually become the unit of account.[3] For some purposes, however, a measure in terms of human effort may well prove desirable, and it may be of interest to examine briefly the possibility of devising it, whether it is practicable at our present stage of development or not, and to see whether its (imagined) operation would have any particular accounting implications.

The matter may be approached in this way. Given the desirability of a measure expressing human effort, we can first postulate that effort is expended over time. The efforts of different human beings have, of course, qualitative differences, but several countries now have adopted a basic wage rate for unskilled labour. In Australia there has been a fairly clear basic wage concept since at least 1906, when Mr. Justice Higgins enunciated it in the "Harvester" case.

> Initially the concept was interpreted as the "minimum" or "basic" wage necessary to maintain an average employee and his family in a reasonable state of comfort. However, it is now generally accepted "that the dominant factor in fixing the basic wage . . . is the economic or productivity factor and that the basic wage must be the highest that industry as a whole can pay."[4]

Even though the weekly basic wage itself was not necessarily applied widely in the initial stages, it has been expressed and given a measure for nearly fifty years. The *weekly* basic wage itself has not remained a constant concept: the size of the family unit on which it was based has altered, the hours in the working week have varied, a loading added in 1922 complicated it, and the capacity of industry to pay has been introduced as a factor into subsequent calculations. Nevertheless, if we reduce the weekly basic wage to a basic-wage hour, it becomes a measure of payment for unskilled labour, which is a fairly steady concept, during an hour, which is a constant.

As our next step, we could translate any of the present monetary expressions or "prices" into terms of time by application of the

[3] See Robert H. Campbell, *Accounting in Soviet Planning and Management* (Cambridge, Mass.: The Harvard University Press, 1963), p. 12.

[4] Commonwealth of Australia Year Book, 1957, p. 166.

basic-wage hour. To take an example, in 1941 the basic wage in Victoria was £4/8/- for a week of 44 hours, i.e., the rate of pay for unskilled labour was 2/- per hour. At that time the price of, say, a house was £2,000, an equivalent of 20,000 unskilled-labour hours. If now we wish to make a comparison, in terms of effort, between a commodity in 1941 and the same or a similar commodity in, say, 1961, the steps necessary are:

(i) determine how many unskilled-labour hours are represented in the price of the commodity in 1941;
(ii) determine the price of an unskilled-labour hour in 1961 by dividing the basic weekly wage by the then standard weekly hours; and
(iii) determine how many unskilled-labour hours are represented in the price of the commodity in 1961.

Suppose, by way of illustration, that a house was bought in 1941 for £2,000 and sold in 1961 for £7,800; the basic wage in 1961 was, say, £13 for a working week of forty hours. This means that the unskilled-labour hour rate in 1961 was 6/6 and that the selling price represented the effort of 24,000 such hours. In terms of effort, therefore, the difference between the purchase and sale prices is measurable at 4,000 hours. If this is translated into monetary terms at the rate applicable in the year of sale, 1961, the resulting figure of £1,300 represents the "effort gain" involved in the venture. The remainder of the purely monetary difference, namely, £4,500 (selling price £7,800 less cost £2,000 and less "effort gain" £1,300) is a measure of monetary inflation during the period of ownership.

The illustration could, of course, be made more complicated by introducing such things as the "effort cost" of improvements during the period, each at its appropriate translation from price to hours, but the principle of application would be the same as in the simple illustration.

It is submitted that by the use of a unit of measurement of this nature, whereby prices could be translated into effort, the same commodity could be compared at different times, different commodities could be compared at the same time, and different commodities could be compared at different times, with consistency and validity.

If people were ever to become used to thinking in terms of unskilled-labour hours, the further step could be taken, as a social development, of using a currency based on chits or certificates representing unskilled-labour hours, and accounting would then, of necessity, have to be carried out in those terms.

For our present purposes, the question whether the use of such a unit would have advantages over the use of our present monetary unit is not strictly relevant, for the change is not being advocated at the moment; our purpose is to determine whether such a unit satisfies the conditions of a unit for accounting purposes. The answer to this latter question appears to be affirmative. As a unit, the hour is capable of being subjected to the mathematical processes just as the pound or the dollar is; it can be divided, multiplied, added and subtracted; all the accounting procedures could be carried out by means of its use—it could be used, equally as well as the monetary unit, as a means of abstraction and generalisation.

Thus, while the monetary unit may be at present the only one in use which satisfies the accounting requirements of a unit of measurement, it is not the only conceivable one. Whether there would be advantages in the substitution of the suggested alternative—or some other—over the present unit may need to be debated at length; this, however, is not the place to become an advocate: it is sufficient for our present purposes to have shown the possibility.

V The Problem of Price-Level Changes

A second question which arises is this: Granted the desirability of translation of non-monetary items into monetary expressions, to what extent is it valid, after mathematical processes in monetary terms, to attempt to re-translate the result back into non-monetary terms?

In considering this question, we must accept the present situation in which the monetary unit is used as the means of expressing diversified events. By the use of a common unit, statistical operations are possible and the events can thereby be brought into useful relationships of significance for various commandership or control purposes. Having done this, can we and should we con-

vert these relationships back from their monetary expression into a non-monetary expression? Some examples will serve to make the problem clear and indicate some of its implications.

The profit and loss statement (using this term in a generic sense) is one in which monetary expression is used to provide a summary of events during a stated period. The events comprise, on the one hand, such things as the acquisition of materials, their fabrication into commodities or their conversion into services through the expenditure of labour effort and the application of machinery, the acquisition and use of services of various kinds, and other outlays which may or may not be represented by services or benefits; on the other hand, and set in comparison with those already mentioned, are events such as sales of goods and services, that is, the disposition of the end-product. Leaving out of consideration any complicating factors, let us consider the relatively simple case. Having expressed each such event in monetary terms, and having applied the mathematical procedures of addition of appropriate events and subtraction of irrelevant events (that is, irrelevant, for example, to the particular period under review), having performed the statistical trick of comparing diverse events on one hand with diverse events on the other, a result ("net profit," "net loss," "income," "deficiency," etc., etc.) is determined in terms of the monetary unit. Can this result be legitimately reconverted into non-monetary terms, and, if so, how and under what conditions?

Advocates of the view that the result should be translated into non-monetary terms are plentiful—the recent literature of accounting contains many examples of the proposition that the profit as determined by the accounting procedures is not a "real" profit and that, to arrive at the latter, correction through an index-number—usually reflecting purchasing power—ought to be applied. The impetus behind this proposition appears to have originated in the writings of economists who seem to be anxious to get at the "reality" behind money transactions.

There is, indeed, as we have already seen, a reality behind the money transactions, if we regard the monetary expression of events as the use of a general unit of measurement. But, once having used such unit and carried out statistical and mathematical

processes through its means, the original reality is, in a sense, lost, in that each event recorded and brought into relationship with other events is unique. No matter how similar two events may be, they are not identical; the purchase of a ton of steel as raw material for a particular kind of machine is not identical with the purchase of any other ton of steel, even if the only difference is one of time, or of supplier, or of conditions of delivery, or of price; neither is any one of the completed machines identical with any other, even though they are made to the same pattern and by the same processes. Hence the result achieved as reported in a profit and loss statement by comparison in monetary units over a period cannot be reconverted into the *same* events from which it is derived.

What, then, does this monetary result mean in non-monetary terms? If, over a given period, all the events were treated on a cash basis, and there were no elements of accrual or allocation, the result would represent an increase or decrease of the cash resources from what they were at the beginning of the period. In this case, it might be practicable to regard a profitable result as providing extra cash which would be available for spending and it might be considered legitimate to translate this monetary result into a measure of spending capacity or, in the more usual terminology, into purchasing power. This could be done by applying to the result an index-number such as has been adopted for several purposes, purporting to generalise price movements of articles comprising a selected "basket of commodities."

Even in these simplified circumstances, however, we might have some misgivings about the absolute validity of such a procedure. For one thing, an index-number is an instrument of measurement prepared on the basis of prices of a selected sample of commodities and/or services as at a particular point of time; on the other hand, the result arrived at through the accounting procedures is an expression of the events over a period of time. To apply an end-of-period "correction" or interpretation to a period result can be, at best, an approximation and therefore subject to the errors and dangers of approximation. Admittedly, it has been held legally that the profit of a business for a period must be regarded as having been made as at the end of the period, but this legal conception does not alter the fact that each venture under-

taken makes its contribution of profit—positive or negative—and that the periodic result is the cumulative effect of these individual contributions and represents a summarised and concentrated expression of the events during a period.

Further, an index-number applied to a periodic result at the end of a period does not necessarily give the same result as its application to the events during the period. To illustrate this point consider the following example. Suppose the summary of events of a given business on a cash basis over four unitary periods was as under:

	Period				
	1	2	3	4	Total
	£	£	£	£	£
Sales	100	150	160	200	610
Purchases	40	90	90	100	320
Other Costs	20	40	40	50	150
Profit	40	20	30	50	140
Drawings	20	20	20	20	80
Cash Increase	20	—	10	30	60

Suppose, further, that the general price index-number moved from 100 at the beginning to 150 at the end, with intervening measurements of 100 at the end of period 1, 120 at the end of period 2 and 130 at the end of period 3.

If we apply the index of 150 to the profit for the whole period (£140), the resulting figure of "real" profit is £93.3. But if we apply the index at the end of each intervening period to the profit for each such period we get a very different "real" profit, namely, £113.0. The comparative results may be shown thus:

	Period					
	1	2	3	4	Total	Total
Index-number:	100	120	130	150		150
	£R	£R	£R	£R	£R	£R
Sales	100	125	123	133.3	481.3	406.6
Purchases	40	75	69.2	66.7	250.9	213.3
Other Costs	20	33.3	30.8	33.3	117.4	100.0
Profit	40	16.7	23.0	33.3	113.0	93.3
Drawings	20	16.7	15.4	13.3	65.4	53.3
Cash Increase	20	—	7.6	20.0	47.6	40.0

The results in the last two columns may be compared. Which of the two sets of figures is the "real" representation—the totals of the interim results or the final result on the basis of conversion at the end of the period? Is it any more legitimate to add the results of the four interim periods on the converted bases of £R's ("real" pounds) than to add them on the basis of the recorded pounds? It is submitted that the answer to this question is negative.

There is, however, one important respect in which the application of the index-numbers may be legitimate and valuable. If we wish to consider the position of the owner (that is, the person who gets the drawings in the above example) as consumer of the kind of products which enter into the calculation of the index-number, we can legitimately say that his drawings during the whole period, while they amounted to £80, would only have bought for him, if he spent the amounts as he withdrew them, the same quantum of goods and services (entering into the construction of the index-number) as £65.4 would have bought at the beginning of the period, or, if he refrained from spending any of it until the end of the period, the same as £53.3 would have bought at the beginning. Similarly, the increase of cash of £60 will only buy the same quantum of goods and services entering into the construction of the index-number as £40 would have bought at the beginning.

Thus, if an index-number is based upon a final consumer's "basket of commodities," it can be legitimately applied only to those amounts which are relevant to final consumption and to the extent that the individual's consumption is represented by the basket of commodities. If, for example, the cost of one hundred cigarettes is included in the construction of the index-number and I am a non-smoker, to that extent the index-number is falsified for my personal consumption and its application to my cash income or resources is to that extent irrelevant. Purchasing power is a consumer concept, not a trading or production one, and should not be applied to purposes for which it is not intended and for which it is not fitted. To the extent that it is applicable to business affairs, it could perhaps be used, with recognition of its limi-

tations, for the conversion of drawings and dividends, but not of profit.

A concomitant consideration is that an index-number is inevitably arrived at after the events it is to be used to measure, and that, in large measure, those very events enter into the construction of the index itself. The price of bread may well be affected, sooner or later, by a variation in the cost of rubber used in the manufacture of tyres used on the delivery trucks used in the distribution of the loaves. More directly, the price of bread at a given moment is likely to be affected by the wages paid to bakers in the period prior to that moment. Hence, if a periodic result for a particular firm is to be "corrected" by the use of an index-number in the construction of which the price of commodities or services in which it deals has entered, either directly or indirectly, the corrected result can only be truly and fully valid if the prices of those commodities or services are rigidly controlled. But if prices are to be rigidly controlled, the need for the use of index-numbers for this purpose largely disappears, for there will be little, if any, variation in the "reality" of the monetarily expressed accounting result.

It is therefore submitted that, in the case of the profit and loss statement, even where the events are dealt with on a cash basis, the use of index-numbers designed to reflect purchasing power has, at best, very limited application. Where the accrual basis of accounting is adopted, the restrictions on its applicability must surely be even more severe.

When we turn to the balance sheet, which is a statement frequently used to assess position as at a given point of time, it might be thought that some of the factors considered above obviously do not apply. For example, the difficulty of applying a point-of-time instrument to a period-of-time statement should not arise, for the balance sheet is a point-of-time statement. However, a little consideration shows that the difficulty is still there. If we take the figures in the simple example given above and trace their effects on the balance sheet items, the difficulty will soon become apparent. Assume a commencing capital figure of, say, £100; that is, at the beginning of period 1 the cash available for the subse-

quent events is £100. At that point, the balance sheet items are (i) cash £100 and (ii) capital £100. Since we have postulated the cash basis for the series of events, the balance sheet at the end of the fourth period, using the monetary unit, would comprise (i) cash £160 and (ii) capital £160.

If, however, we take cognisance of the fact that the index-number is now 150, we must correct both of these amounts by converting them to two-thirds of £160, that is, we should show both the cash and the capital at £R 107, since the purchasing power of the £ has fallen by one-third.

The item of capital in the final balance sheet, however, ought to have been expanded to show, under "orthodox" accounting presentation methods, some such information as under:

Capital at beginning		£100
Add Profit	£140	
Less Drawings	80	60
Capital at end		160

If we apply the index of 150 to each of the items in this expanded statement, we shall, of course, reach the figure of £R107 quite simply as follows:

		£R
Capital at beginning		66.6
Add Profit	93.3	
Less Drawings	53.3	40.0
Capital at end		106.6

But the assumption in this treatment is that the profit and the drawings have both been "attained" instantaneously, so to speak, as at the end of the fourth period, whereas each has been determined during each of four interim periods. If we apply the hindsight we now have at the end of the fourth period to the periodic figures for each of the four periodic results we would arrive at the following figures:

		£R
Profit for period 1, £40, converted at $\frac{100}{150}$	i.e.	26.7
Profit for period 2, £20, converted at $\frac{120}{150}$	i.e.	16.0
Profit for period 3, £30, converted at $\frac{130}{150}$	i.e.	26.0
Profit for period 4, £50, converted at $\frac{150}{150}$	i.e.	50.0
	Total	118.7

Drawings for period 1, £20, converted at $\frac{100}{150}$	i.e.	13.3
Drawings for period 2, £20, converted at $\frac{120}{150}$	i.e.	16.0
Drawings for period 3, £20, converted at $\frac{130}{150}$	i.e.	17.3
Drawings for period 4, £20, converted at $\frac{150}{150}$	i.e.	20.0
	Total	66.6

To give effect to these results, our statement of the capital item should appear thus:

		£R
Capital at beginning		66.6
Add Profit	118.7	
Less Drawings	66.6	52.1
Capital at end		118.7

There is a discrepancy, arising from differences in purchasing power conversions, of £R 12.1 between this figure and the corrected cash amount of £R 106.6.

It is thus apparent that, applying the same set of index-numbers to a simple set of figures, on the simplest basis of cash transactions, three different figures for profit are possible, ranging, in

the particular example given, from 93.3, where the final index-number is applied to the total profit, through 113.0, where the then current index-number was applied to the profit figure in each period as it was determined, to 118.7, where the last available index-number was applied hindsightedly to each of the periodic amounts. Which, if any, of these is the "real" profit? One is tempted to ask, "Is there, indeed, any such thing as 'real' profit?"

One fact which emerges—and which is, indeed, already well recognised—is that the balance sheet, although it is represented as an "as at" statement, is in fact the result of and incorporates the results of events over a period. Yet this feature is sometimes overlooked in writings which portray the balance sheet as a "static" document merely because it is labelled "as at." In truth, a balance sheet is surely just as "dynamic" a statement as the profit and loss statement or a funds statement, both of which summarise events during a period; the balance sheet admittedly states a position at a point of time, but that point of time is not entirely divorced from previous points of time, and the position portrayed is a result of events which have occurred at previous points of time.

Other difficulties arise when we consider just a few common balance sheet items. Take the following simple list of items of a company which has, let us assume, operated for four periods:

Assets		
Cash	£ 600	
Debtors	800	
Inventories	400	
Equipment	300	
Buildings	1000	
		£3100
Liabilities		
Trade Creditors	700	
Long-Term Loans	1200	
		1900
Shareholders' Funds		
Capital Paid In	500	
Undistributed Profit	700	
		1200

The capital was paid in at the commencement of activities when the general price index was 100; it is now 150. Cash, debtors, inventories and trade creditors are all of recent date and the index of 150 is applicable; equipment was acquired when the index was 120 and the buildings when it was 130. The long-term loans were incurred largely to finance the acquisition of the buildings, so that the index of 130 is appropriate. The profit has been a regular £250 during each of four periods; the whole of the profit of the first period was retained, but thereafter a dividend of £100 per period, representing 40% of the profit, was distributed.

Applying "appropriate" index-numbers to each of the balance sheet items in order to show "current values," the statement would appear as under:

	£	Conversion Ratio	£ Current	
Assets				
Cash	600	150/150	600	
Debtors	800	150/150	800	
Inventories	400	150/150	400	
Equipment	300	150/120	375	
Buildings	1000	150/130	1154	
				3329
Liabilities				
Trade Creditors	700	150/150	700	
Long-Term Loans	1200	150/130	1385	
				2085
Shareholders' Funds				
Capital Paid In	500	150/100	750	
Undistributed Profit	700	see below	494	
				1244

The undistributed profit is a residual figure, but it can be explained, or at least expanded, in the following way, using the hindsight method of applying the appropriate index-numbers:

	£	Conversion Ratio	£ Current	
Undistributed Profit				
Profit Period 1	250	150/100	375.0	
Profit Period 2	250	150/120	312.5	
Profit Period 3	250	150/130	288.5	
Profit Period 4	250	150/150	250.0	
				1226.0
Less Dividends Period 2	100	150/120	125.0	
Less Dividends Period 3	100	150/130	115.4	
Less Dividends Period 4	100	150/150	100.0	
				340.4
				855.6
Less Difference on Purchasing Power Conversion				391.6
				494.0

The "difference on purchasing power conversion" can be explained in part by reference to the falling off in purchasing power of the amounts retained in each period, as under:

	Amount Retained	Ratio of Increase in Price Index	£ Current
Period 1	£250	50/100	125
Period 2	150	30/120	37.5
Period 3	150	20/130	23.1
Period 4	150	—/150	—
			185.6

The remaining £206 represents the net difference on conversion of the other balance sheet items (namely, Capital £250 plus Loan £185 less Equipment £75 and Buildings £154). Whether this sort of statement would be more significant to anybody than the original one is open to question; it would certainly require a good deal of explanation and, indeed, justification, for it is based fundamentally on the notion that the two sides of the balance sheet must balance and in order to make it balance one item is to be treated as a residual. Thus we are introducing into our reporting the idea of a suspense item—an idea which would

probably not be countenanced in any properly constituted recording system. Five hundred pounds had been contributed in period 1 and these would be worth £750 in current prices, but what does this mean? Twelve hundred pounds were borrowed in period 3 and these would be worth £1385 in current prices, but what does this mean? Both of these categories, equally with the undistributed profit, have been "invested in" assets of one kind or another. What justification is there for making undistributed profit the only residual to be adjusted in order to make the two sides of the balance sheet agree arithmetically? Certainly the education of those customarily using balance sheets would be required before the acceptance of such a treatment could be assumed.

When we ask whether such a statement conveys any greater sense of "reality" than that from which it was derived, the answer is similarly one of doubt. If it is desired to express events in terms of purchasing power, a totally new unit is required, based on the "basket of commodities" entering into the purchasing power unit, rather than a series of index-numbers; only by some such means could each event be translated *directly* into the required unit and the effects of translation into money and later conversion into a "neo-monetary" unit be avoided. It is agreed that this is not impossible, but it is submitted that it is not a problem in accounting; that is, it is not a function of accountants to *devise* a new unit, for their function is to carry out the required procedures in terms of whatever unit is adopted. Under present circumstances, that unit is a monetary one, and the fact that the monetary unit is not stable in terms of something else, be it wheat, labour, rent, or a basket of commodities, can scarcely be laid on the doorstep of accountants. What accountants perhaps could do is to help make a dispassionate and rigorous analysis of this complicated and difficult problem, and endeavour to bring its characteristics and implications fairly to the attention of *all* commanders concerned. This is, roughly, what the main professional bodies of accountants, at least in the English-speaking countries, have decided; but it might be suggested that the accounting profession as a whole has not carried out its obligations in this respect as vigorously as it might have. Many individual writers on accounting have advanced "solutions" to the problem, but it is open to

question whether all of these have been based on a sufficiently dispassionate and rigorous examination of all relevant facts and, equally important, of objectives. The first question in an investigation of this kind should be: Why and for whose benefit is it to be carried out? It may turn out that the "solution" may vary according to the answer to this question; it is submitted that at least it does not appear to have been faced clearly enough yet.

As an accounting statement the balance sheet is often put to more than one use, and the point of view from which it is prepared may be different from that from which it is read and studied. In any case where the commander is not the same person as the investor, and this applies particularly to the modern corporation, the balance sheet is prepared by or on behalf of the commander to exhibit the result of his activities in the fiduciary capacity in which he is appointed or assumes office and responsibility. It thus becomes a statement which sets out, on the one hand, the resources over which he has control and, on the other, the sources from which they have (broadly speaking) been derived.

From this point of view, the very concept of purchasing power is rarely valid. It is true that when a shareholder invests money or a long-term creditor advances a loan of money the commander is thereby put in command of resources which do represent purchasing power in general, but these resources are not intended to be and are not usually in fact used for buying the kinds of commodities and services which are taken into account in measuring purchasing power. The objects for which the corporation has been formed place certain restrictions upon the kinds of commodities and services upon which the money can be spent. Some of these may indeed be of the same sort as some of those comprising the consumer's basket of commodities, but others will surely be quite different. Furthermore, the resources which a commander derives from trade creditors are not of a monetary kind; they are goods and services specifically supplied to him and his team. The monetary expression attached to the item "trade creditors" represents not a general command over goods and services, that is, not purchasing power, obtained from suppliers, but the prices of specific goods and services which have been supplied by the creditors

but have not yet been paid for. The "reality" behind the item is not purchasing power, but events involving specific commodities.

When we consider a few of the most common and, for the ordinary commercial concern, the most typical assets, we find that the concept of purchasing power is again of limited application. To be sure, cash in hand or in a bank account may be regarded as an embodiment of purchasing power—the very function of such monetary resources is to give command over commodities and services in the way that is deemed the most useful, practicable or profitable from time to time.

Amounts owing by debtors are, on the one hand, rights to receive cash resources at some future time and in this sense represent an embodiment of deferred purchasing power. On the other hand, however, these amounts are not historically divorced from the events which gave rise to them, and they are a result and an epitome of dealings in goods and services which may or may not bear a relation to the items included in the "basket of commodities" on which the measure of purchasing power is based. For example, if I am a dealer in jewellery, my figure for debtors will, on the one hand, represent a future command over the food, clothing, rent and the like which are represented by a consumption index, if I choose to spend the money on those things; but, on the other hand, it arises from the sale of jewellery which does not enter into the consumption index and, if I choose to spend the money on replenishing my stock of jewellery, a consumption index is no guide whatever to the "reality" of my dealings in that commodity.

The figure for inventories is directly an expression in monetary terms of commodities which can be physically handled. Within the present context it may be possible to use for this expression either the cost of the goods or what they can be sold for. To apply any sort of index is tantamount to saying: We possess certain goods, but if we had chosen certain other goods we should have something different in monetary amount. But this is not in accord with relevant facts, since the goods we have on hand are simply the goods we have on hand and no others. And their selling price cannot be positively known until they are in fact sold, so that any

expression in terms of selling price is necessarily an imputation or interpolation from similar events which have already occurred. On the other hand, in some cases their cost in monetary terms may be directly determinable, in others it must be estimated, again on the basis of certain imputations and allocations.

With regard to plant, equipment, buildings and other so-called fixed assets, the balance sheet has reference to specific items of machinery, furniture, vehicles, equipment, etc. and to specific structures, so that any expression which does not identify itself with them is a departure, to the extent that it does not do so, from the specific events in which the assets originated.

If, then, we consider the point of view of the commander, the balance sheet is a statement of resources entrusted, whether by himself as proprietor or by others as investors, to him as commander, and of the way he has used them. What have been entrusted to him are pounds and goods and services. The resources he commands are pounds and goods and services. It is his task to manipulate this mixture in a way consonant with his managerial responsibilities. From his point of view, only part of the reality of events is expressed in monetary terms; the remainder lies in goods and machines and equipment and buildings and the like. Hence it seems unlikely that his purposes would be served by any sort of index based on or related to consumption.

The position may be somewhat different from the point of view of the investor, to whom, in all cases of open publication and in many cases of limited circulation, the balance sheet is directed. So far as his own affairs are concerned, he is just as much a commander of *his* resources as the managing director of a company is of the resources invested in it. An investor, it must be remembered, is a human being who spends part of his cash receipts on his personal and family requirements and is therefore obviously a consumer, but who, in addition, has resources available to entrust to somebody else to handle for him and, as he hopes, to his pecuniary benefit. When we draw a distinction between, say, the commander of the resources of a company and an investor in the company, we are drawing a distinction between functions rather than between human beings. The commander, as a human being, is a consumer of goods and services for his personal and family requirements, as well as the director of resources en-

trusted to him by the shareholders of the company; and, further, he may himself entrust part of his resources to commanders in other companies, becoming a shareholder or debentureholder in them or a lender to them. It is nevertheless necessary to distinguish between the functions of commander and investor, the capacities in which each carries out his activities.

Thus, looking at the investor *qua* investor, we see his problem as one of making decisions as to whether he should or should not provide or continue to provide resources—usually cash resources—for given undertakings, whether he should invest his resources in the shares of a company or in freehold property or in government loans or spend them on pleasures and palaces. He is the commander of his resources, only part of which, in the typical case, is likely to be invested in any one company or enterprise. Thus the relationship between commander and investor is a relation between commanders of, for the most part, different resources with, in the typical case, a relatively small quantum of resources common to them both as individuals.

The investor, then, may well be interested in a purchasing power interpretation of the statements submitted to him in relation to his investment. Especially will he be interested in a purchasing power interpretation of the one item which he can use to purchase anything, namely the dividends or interest (for lenders) paid and/or payable. Since dividends are intimately related to profits, from which their amount is derived, it is also likely that the investor will be interested in a purchasing power expression of profits.

One of the responsibilities which face the commander of an enterprise for which the resources have been supplied by others is that of reporting periodically to those suppliers, that is, the investors. In doing this it is not unreasonable to expect that the reports will be prepared in such a way as to provide the investors with the information they require to enable them to formulate an informed judgment about their investment. Hence it is apposite to ask whether the application of a purchasing power or any other index would provide a means of thus better informing investors about their investment than the present method of current money reporting.

Assume a company to have been formed in 1946 with an issue

of ordinary shares of £1 each to the public, of which an investor, *A*, took up 100 at par. In 1951 it made another ordinary £1 share issue of which *B*, another investor, took up 100 at par. In 1956 a dividend of ten per cent is proposed. Suppose further that the purchasing power index stood at 100 in 1946, 150 in 1951, and 200 in 1956.

Under current monetary measurement, a dividend of £10 to each of *A* and *B* would represent a ten per cent dividend on the shareholding of each of them. But this would not represent a ten per cent return on the "real" investment of either of them. Since *A* made his investment in 1946, when the index stood at half the figure of 1956, it would require a dividend of £20 to yield him a "real" return of ten per cent. In the case of *B*, who invested in 1951 when the index stood at 150, a dividend of 200/150 of £10, that is, £13.3, would be required to yield a "real" return of ten per cent. It may not unreasonably be suggested that such differential dividend payments would need a considerable amount of convincing argument to satisfy *B* that he was not being dealt with inequitably. Even though it is conceived that this may not be beyond the persuasive powers of the chairman of directors of the company, is it to be regarded as one of his functions to do so? If so, the calculation of a multitude of such differential dividends must be contemplated by the accountant of each public company, and their checking must be envisaged by its auditor.

Further, what of the case of *C*, who bought, in 1953 when the index was 160, one hundred shares for £140 from *D*, who had taken up the shares in 1946? Is the dividend to *C* to be calculated on his investment of £140 in 1953 or on *D*'s investment of £100 in 1946? If the former, the dividend will be calculated on an amount of resources which the company did not handle at all; if the latter, *D* will receive £20 return which would represent a "real" return of 11³⁄₇ per cent, since his investment of £140 when the index was 160 is equivalent to £175 in 1956. To give *C* a "real" return of ten per cent on his investment of £140, a dividend of £17/10/- should be paid to him, but this would not represent a payment of ten per cent on the "real" resources received by the company in 1946.

It is submitted that these are not utterly unrealistic illustrations.

For a company whose shares are at all active on the stock exchange, the physical task of computation of differential monetary dividends to give expression to such "real" returns is one that would probably require the use of an electronic computer. The declaration of dividends would need to be accompanied, for some time at least, by an intensive publicity campaign among shareholders to convince them of the accuracy, validity and equity of the amount each is to receive. Further, it would require considerable revision of the legal rights of shareholders.

A much more feasible answer has already been suggested in the pronouncements of some of the leading authoritative bodies of accountants, such as the Institute of Chartered Accountants in England and Wales and the American Institute of Certified Public Accountants. These bodies, while recognising the existence of an interpretative problem in published company reports in periods of changing price levels, have been wisely hesitant about rejecting out of hand the existing procedures of reporting. This may be due to what some may regard as undue conservatism or veneration of the past, but it is at least an expression of a considered opinion by practising accountants of wide experience, and cannot be lightly disregarded in any consideration of the problem. While coming down on the side of orthodoxy, however, these pronouncements have not closed the door to better adaptations of reports to the purposes of investors. They encourage the addition of supplementary information to assist the readers of company reports to exercise their judgment in relation to the activities of the enterprise in which they are interested; at the same time, the American Institute has suggested that experiments in alternative treatments be carried out in this field of company reporting.

It is suggested that the requirements of investors in interpreting their "real" return might be met by including in each company's report more information about the *dates* of events (for example, when fixed assets were acquired and when long-term indebtedness was incurred) and, as an addendum or appendix to the usual financial statements, a statement of index-numbers related to purchasing power year by year from the date of the company's inception (if this is practicable), so that the individual

shareholder or bondholder, as a recipient of dividend or interest respectively, may be enabled to convert his return into "real" terms by application of the index-number which is appropriate to his own personal investment. No doubt some examples of the arithmetic involved would be a desirable feature for inclusion in the report and, apart from any other benefit, would provide a means of economic education of a growing number of people —not only investors, but also employees and customers. Only one proviso is to be added to this suggestion, and that is that there shall be no distortion of fact in order to provide a case for any particular policy. In order to achieve this, it is only necessary, in the countries of the British Commonwealth, to widen the provisions of statutory enactments to include such information as an integral part of company reports, or, in the United States, for the Securities and Exchange Commission to regard such information similarly as an integral part of company reports.

Thus there may be circumstances in which it is appropriate to apply purchasing power or other index-numbers to items in accounting reports. If we do so, however, we should be well aware of the limitations, both theoretical and practical, of the instrument we are using, and we should not only realise what we are doing but make every effort to convey to the readers of any resulting statements the method, manner and purpose of the procedures followed. Whether such statements would be more useful than those which are at present customarily prepared has been the subject of debate for many years, and no conclusive answer can yet be given. At the least, it would be necessary to educate people to understand them; indeed, it is necessary to educate people to understand much of what is contained in current orthodox reports. Perhaps the process of education is the important thing after all; for, if a technique of applying index-numbers were universally adopted, it is conceivable that it would create problems of its own. For one thing, if index-numbers based on consumption are to be consistently applied for consistent results, they cannot, in our present state of knowledge, take changes in the pattern of consumption into account: the introduction of new consumption products—for example, in recent years, television, washing machines, transistor radios, waste-disposal appliances, air condition-

ing, etc.—and changes in existing products, such as automobiles and even milk (which, for example, may be homogenised, pasteurized or vitamin-enriched instead of untreated and untested as formerly), would soon make a series of index-numbers obsolete in a period of rapid technological change.

It must also be recognized that the commander who is faced with the technical problem of making the most efficient use of resources requires measures which are non-monetary in character. Where monetary measures are used in this area, it is because they are assumed to reflect combinations of non-monetary resources or because they are accepted, perhaps reluctantly, as approximations to non-monetary experience. What is really more significant for him, however, are volume relationships, for example, of sales, of production, of power generation or consumption, and so forth; explanations sought from statements in monetary terms are for him analyses in terms of such volume relationships, of product or sales mixes, and the like.

The application of, say, purchasing power units to monetary terms is no real answer to problems of this sort, for what is required is an assessment in terms of specific quantitative relationships, and not the substitution of one kind of generalized expression for another; the application of an index number of prices, whether derived from patterns of consumption or production or trade, to the sales, purchases or costs of an industrial or commercial enterprise give results which are basically no more "real" in relation to the technical problems involving quantities of goods, power, labour hours, machine output, etc., than the monetary figures themselves. For a useful consideration of these problems, specific quantitative measures are required, not generalized measures of any sort. To use the terminology of Section I of this chapter, the individual and general units of measurement for particular ventures are of greater significance for the commander in facing his technical tasks than is the social unit of measurement. At the same time, however, he is apt to be judged by those to whom he is responsible in terms of the social unit of measurement.

The propositions advanced in this section are not intended as an argument for doing nothing about the problems arising from substantial changes in the "value" of money but, rather, constitute

a plea for recognising their complexity and avoiding over-simplification of the situation, and for a more intensive and more comprehensive investigation than has hitherto been undertaken.

APPENDIX TO CHAPTER 10

The analysis, in Sections I and II of this chapter, of the functions of a unit of measurement is presented as a logical rather than a historical account of its development. Its validity could be tested by historical evidence if such were available, but the kind of evidence required would relate to that remote period in man's history before socially accepted and adopted units of measurement became commonplace and certainly to the time before coinage or any other medium of exchange was widely used. Evidence of this sort is extremely difficult to obtain, but it is instructive to consider some of the earliest known records in the history of mankind.

The Assyrians had a highly developed civilisation, many records of which have been most fortunately preserved to us by their method of writing on tablets of clay which were hardened by baking and then stored for reference. Some of these indicate that loans of grain and cattle were not infrequent transactions in the seventh century B.C., in much the same way as in the metayer system of a more recent era. As one writer puts it:

> The owner of the estate supplies to his serfs, who are partly smaller farmers on their own account, partly his servants, a large proportion of their stock. Thus we find the same officials advancing corn, oxen, sheep, oil, wine, &c to people on precisely the same conditions as the money is here advanced.
>
> It was the interest, the duty, of the landlord to find these things for his farmers for a proper time. They were bound to return them at the end of the period for which they had been furnished. They were bound to return them uninjured, or in full measure, or pay for them at market rates. If they retained them beyond the proper period they paid a fine, for the prolonged use of them. The money advanced may have been in lieu of these corn and stock allowances, or for other businesses than farming. The payment of wages is possible, the keep of labourers on some work in hand is also possible. It seems more probable that the borrowers were commissioned to undertake some remunerative works and furnished with the capital. It must have been remunerative or the money could not be returned. It could not be mere wages nor keep for that could not be expected back. If, however, these borrowers had been farmers of the royal estates and the lenders royal stewards, all is plain. The money was advanced to work the farm, repaid from sale of produce, when also the farmer paid himself for his labour and made his profit. . . . Of course

if the farmer had the capital to expend on the farm he would not borrow. . . . On the other hand, if he had no capital to carry on till harvest, he did not go to a money lender and borrow at the ruinous Oriental rates, his landlord advanced the capital and he repaid when he sold the crop.[5]

[Again:] It seems to me that *ana pûḫi našû* describes the responsibility which an Assyrian landlord had, to find stock in trade, and even capital, for his tenants to work their farms, and further to furnish it on easy terms. . . .[6]

Some of these "documents" recording transactions in kind have been rendered into English and some of them are of interest in the present context:

No. 117: Dannaia lends two camels to Iaḫuṭu, Ilu-mukîn-aḫi, and Adadi-aplu. . . . They shall return the camels on the 1st of the month. . . .If they do not return them then, they shall pay six minas of silver. Dated, the 14th of Tišrîtu, B.C. 674. Three witnesses. P.S. If they do not pay the money, interest will be charged at the rate of five shekels per mina.

The translator, after some discussion on the meaning of the hieroglyphs, gives his opinion that

the scribe meant here '2 dromedaries which they call double humped' [and remarks that] it appears these two humped dromedaries were highly valued, three minas of silver apiece . . . they were valued as articles of tribute, and . . . they were evidently rare. One wonders what the three borrowers wanted with a pair of such animals. Were they taking round a menagerie on show? There could hardly be any business demand for them.[7]

No. 118: Dannai lends two hundred sheep, one hundred and fifty goats, two hundred and thirty yearling lambs, in all five hundred and fifty small cattle, to Iaḫûṭu, Ilu-mukîn-aḫi and another. They are to return the animals in a certain month, or pay. Dated, the 7th of Aaru, B.C. 673. Seven witnesses.

On this tablet the translator has the following comments (*inter alia*):

. . . It is noteworthy that although three men are named as receiving the grant, only one, Iahûṭu, seals the acknowledgement . . . the scribe has added up the numbers incorrectly. . . . It is clear that here . . . the animals are consigned to the care of a head herdsman or shepherd. On what terms we may ask? He had to restore them or pay for them and take all due care of them in the meantime. What profit had he, or was he simply a hired servant? It seems to me that a well-known rate of profit was allowed him, which lay at the root of the fine he had to pay for retention of his charge overtime. I think he took the cattle out to pasture, and had to bring them back and then was paid.[8]

[5] C. H. W. Johns, *Assyrian Deeds and Documents* (Cambridge: Deighton Bell and Co., 1901), iii, 19-20.

[6] *Ibid.*, p. 21.

[7] *Ibid.*, pp. 194-95.

[8] *Ibid.*, p. 196.

No. 129: Five homers of corn, belonging to the Crown Prince, were advanced by Taķûni, his agent, to Hamaṭuṭu of the city of Ḥanduate. The corn shall bear interest at the rate of 30 ķa per homer. Dated, the month of Tišrîtu, B.C. 682. Five reapers.[9]

In this case, as in several others, the interest is calculated in kind. (According to the translator: "I consider the homer as possibly 300 ķa. . . ."[10])

No. 130: Five homers 48 *ķa, ŠÊ-PAT-MEŠ,*[11] belonging to the Crown Prince, are lent by Taķûni, his agent; three homers to Iâisi and two homers 48 ķa to Gabbu-ilâni, of the City Ḥanduata. Same rate of increase[12] as in the last case probably. The number of reapers was stated, but is now lost. The date is lost.[13]

No. 134: Baḥiânu advances two homers, *ŠÊ-PAT-MEŠ,* to Nabû-nûr-nammir and one each to Latubašâni-ilu and Sâbutânu, *ana pûhi.* Dated, the 29th of Ulûlu, B.C. 686.[14]

No. 135: Ṣâbutânu and Latubašâni-ilu return the corn borrowed from Baḥiânu, each paying one homer. Nabû-nûr-nammir did not pay. Dated, in Aaru, B.C. 685.[15]

The translator's commentary includes the observation that

the two men who, in No. 134, borrowed each one homer, in Ulûlu, B.C. 686, seven months before, now repay each just one homer. . . . The third person, who on the same day borrowed two homers, does not now repay anything. Probably he had to pay interest later.[16]

No. 138: Baḥiânu lends corn in varied amounts, mostly a homer each, to at least twelve men, *ana puhi.* Dated, in Nisânu.[17]

No. 152: Bêl-dûri, the *bêl paḥâti* of the Crown Prince, advances thirty-two homers thirty *ķa* of corn, *ŠÊ-PAT-MEŠ,* and a cow in calf (?), belonging to the Crown Prince, to Nargî of the city of Bamâtu. In lieu of the corn and cow he shall serve Bêl-dûri. When he shall have served out the value of the advance, he shall go free. Dated, the 28th of Ulûlu, B.C. 656. Eight witnesses.[18]

[Translator:] . . . There is no mention of a return of the advance. On the whole, I am inclined to think that Nargî was to earn the corn and a cow by personal service.[19]

[9] *Ibid.,* p. 221.
[10] *Ibid.,* p. 222.
[11] An unidentified grain, possibly rice.
[12] *I.e.,* interest.
[13] *Ibid.,* p. 225.
[14] *Ibid.,* p. 228.
[15] *Ibid.,* p. 229.
[16] *Ibid.*
[17] *Ibid.,* p. 231.
[18] *Ibid.,* p. 243.
[19] *Ibid.,* p. 244.

Since the corn advanced belonged to the Crown Prince, one is tempted to wonder why the service should be rendered to Bêl-dûri and not to the prince; perhaps service to the agent was equated, in the Assyrian legal code, with service to the principal.

No. 137: Two hundred (homers) of corn, *ŠÊ-PAT-MEŠ, ḳaḳḳadu,* belonging to a *šakintu* are advanced to Ilu-amar, the *râb karmâni.* He shall return them in the month of Âbu, in the city of Dûr-Sargon. If not, interest was probably stipulated for. Dated, in Nisânu (?). Traces of five witnesses.

[Translator:] . . . there is no trace of any money having been paid for the corn.[20]

No. 76: In lieu of money, Bêlit-ittîa, the maid of the *šakintu,* is assigned to the lady Sinḳi-Ištar. As long as she lives, she shall serve her. Dated, the 14th of Aaru, B.C. 652.[21]

There are several respects in which these ancient records are relevant to our present discussion. In the first place, they represent records of a period when, presumably, the society was in a transition towards a money economy. Many of the documents, not cited above, are in the form of a sale of goods or land for a quantitative measure (weight) of silver or bronze, and, although coinage had probably not yet been invented, the precious metals were in use as a general standard of value. But this use was not yet universal, and some of the documents bear witness of non-metallic valuation. For example, in No. 152 above, personal service is valued in terms of grain and cattle. Admittedly, it is possible that behind both the service and the goods in kind there was an imputed money valuation, but there is no evidence of this in the document. On the other hand, where a money valuation is in contemplation, as in No. 117, it has been specifically indicated in the document. There is here at least a suggestion that the unit adopted for the measurement of activities had not then been completely conventionalised and made uniform for the community as a whole but was still to some degree a matter for the individual or individuals concerned.

It is also worthy of note that the "price" indicated in many of the documents is not an exchange valuation, but a penalty valuation. In Nos. 117 and 118, for example, as in many other cases, it appears fairly clear that the lender is really interested in having the borrowed animals returned—the amount of silver indicated

[20] *Ibid.,* pp. 230-31.
[21] *Ibid.,* p. 123.

in the "contract" is in compensation for loss of the animals, and not a price arrived at in a bargaining process.

It is possible, of course, that a duo-monetary system was in operation and that both corn and silver were used as media of exchange with a more or less fixed rate of exchange between them, just as, many centuries later, we had for a time a bi-metallic standard of gold and silver operating in many countries. But even this possibility does not turn all these documents into purely monetary statements.

In Nos. 134 and 135 there is evidence that these loans in kind were in fact returned in kind, so that the penalty money clause was not a mere subterfuge for a sale transaction.

Also interesting is the fact that the same lender appears in several of the documents—Baḫiânu and the Crown Prince through his agent, Taḳûni, are examples. Of the former, Johns writes:

> A very large number of these tablets record the transactions of one man. If we cared to adopt the popular style of some Assyriologists, we might easily write up a "story of an Assyrian corn dealer". . . . As a fact, I believe the corn in every case belonged to the king, and was advanced by some one holding the position of a steward.[22]

In the case of No. 138, the fact that "at least twelve men" are listed on the tablet and the absence of witnesses may be significant in the present context inasmuch as they suggest that this is possibly an account—an aide-memoire at least—rather than a contract; however, it is also possible that the tablet is incomplete and the names of the witnesses now lost. But it is surely not stretching speculation too far to suggest that an agent of royalty, in the capacity of custodian of certain of the royal possessions, would very likely be faced with the statistical problem of keeping track of the possessions in his care, and that some sort of inventory accounting would become necessary.

Another interesting point arises in No. 118 in that different kinds of livestock are equated for purposes of enumeration; sheep, lambs and goats are added to each other within the category of small cattle.

While all this evidence is, admittedly, not conclusive, at least it suggests that the analysis put forward is not sheer fancy or utterly insupportable.

[22] *Ibid.*, p. 217.

CHAPTER 11

The Nature of the Accounting Procedure

I The Unit of Record

IT SEEMS almost certain that, in its origin and early development, accounting was an instrument designed and used as a means of recording events which could be regarded as having occurred in an objective sense. This factual, historical characteristic is still a very significant feature of any system of accounting records and constitutes its basic elements. Any system which is not so based is a structure of imagination, meaninglessness or fraud.[1]

The great majority of events which form the subject-matter of the accounting records of any given unit of experience represent financial transactions between that unit and other units, that is, "external" persons or organisations. For purposes of recording (and reporting and interpretation as well), the events are interpreted according to the way in which they affect or, so to speak, impinge on the unit of experience; and, for example, a set of accounting reports for a given unit is, to a great extent, a summarised presentation of the results of numerous transactions that have taken place between that unit and "the rest of the world."

However, for most social and economic enterprises in present conditions, there are in addition to these "external" transactions —or, perhaps, rather in modification of some of them—many events

[1] There have been instances where such "non-factual" systems of accounting records have been set up. The McKesson Robbins case is an example of fictitious records with criminal intent (see *The New Yorker*, Oct. 22 and 29, 1955, pp. 49-81 and 39-79 resp.); the case of Raymond Marien and Interstate Hosiery Mills, Inc. was an example of presumably meaningless manipulation and falsification of records (see W. T. Baxter, *Studies in Accounting* [London: Sweet & Maxwell, 1950], pp. 49 ff.).

recorded which cannot truly be regarded as transactions with units or persons outside the particular organisation with which the accounting records deal. For example, where a given organisation is the unit being accounted for, the allocation of expenses between departments within the organisation, the recording of a transfer of plant or of partly processed goods from one department to another, and the recognition of a prepaid expense at balance date, can scarcely be regarded as other than events within a unitary organisation that are taken cognisance of for accounting purposes only. In a sense, they are events within the accounting system itself rather than "transactions" of the social or economic unit for which the records are being kept and reports prepared. The payment of wages to an employee is an "external transaction" because the employee is a party to a dealing with the employing unit; the allocation of such wages to various production jobs would be an "internal operation." The purchase of a long-term asset would be an "external transaction"; the allocation of its cost over a number of accounting periods would be an "internal operation." These "internal operations," however, are recorded in the same way as if they were "external transactions,"[2] and are treated no differently for recording or reporting purposes from such "objective" events as a purchase of plant or sale of merchandise or payment of wages or receipt of cash from a customer.

When we look behind the technique at the rationale of this procedure, we find convincing reasons only when we realise that behind such allocation of expenses and such recognition of "intra-unit" transfers is the notion of responsibility or "commandership" accounting. The technique is undertaken as part of the "matching" procedure. The purpose is to relate to the revenue resulting from certain events the charges against revenue which are "appropriate" to it; if it is the revenue for a period, then the charges to be brought into relationship are those which are incurred in the period.

The term "incurred" needs some explanation. It is submitted

[2] A distinction between internal operations and external transactions is propounded in A. A. Fitzgerald and L. A. Schumer, *Classification in Accounting* (Sydney: Butterworth & Co. (Australasia) Ltd., 2nd ed., 1962), p. 18. Some writers, however, appear to deny to "internal operations" any status similar to that of "external transactions"; see, for example, W. J. Schrader, "An Inductive Approach to Accounting Theory," *Accounting Review*, October, 1962, pp. 645 ff.

that in this context the revenue which is recognised represents the completion of a determinate venture or a series of determinate ventures and that the charges "incurred" are those which represent events within these completed ventures. The procedure of periodic matching, if it is to be strictly and rigidly carried out, involves a comparison of revenue and charges against revenue for each venture undertaken during a period and the summation of these to produce a periodic set of figures, representing the total revenue and the total related charges against revenue for the period. The procedure, as it is usually presented, by which allocations of charges (and sometimes of revenue) are made between periods on what are regarded as reasonable bases, constitutes, at best, a short-cut substitute for the procedure of summation. Although it is by no means certain that the results in both cases are necessarily the same, the purport and intention in each case are the same; they constitute an expression of the commander's activities during a period. The position might be expressed in some such form as the following: During period *x*, the commander's activities (or, more fully, the activities resulting from the policy he has laid down) brought in so much revenue. But what expenses and charges did these activities involve in that period? And what was the net result? These are questions that the profit and loss statement is designed to answer. And they are questions on the responsibility and performance of the commander. In a slightly different context the position might be put thus: The commander of Department *A* has been responsible for so much expenses and charges during period *x*. What revenue has been produced by his activities during this period? What has been the financial result of his activities? Again, the problem is one of assessment of an individual's functional responsibilities, including, so far as is practicable, a measure of his administration and organisation of the resources under his command.

It is in this way that the problem of matching can be interpreted as a problem of commandership. The records maintained and reports prepared to enable such matching to be carried out are not an expression of the activities of a purely abstract entity or of a hypothetical economic unit but of those of human beings who can and do bear responsibility for those activities.

The unit of record is the single measurable event, whether it

is an external transaction or an internal operation. If a dealer buys one refrigerator for resale, this constitutes an event which is recorded in the monetary measure of the price of the article. If he buys one hundred such refrigerators at one time from a supplier, this equally constitutes one event which is recorded in the same way. If the articles are delivered at different times, each delivery may be recorded as a separate event, differing from the other deliveries in point of time. If the articles are bought from different suppliers, the purchase of each lot is recorded separately from the others because of this difference. In each case, the record is one of an occurrence which can be distinguished from other occurrences in some material respect, such as time, place, or human identity of the other "party" to the transaction.

If the same dealer buys a delivery vehicle, this constitutes an event which will be recorded in a not dissimilar way. It is, like the purchase of goods for resale, an "objective" event—an external transaction—in that it involves another party, namely, the vendor. However, when the new owner decides that twenty per cent of the cost of the vehicle should be allocated as a charge against the revenue of each of the next five periods, this decision does not involve any outside parties. It is a "subjective" event —an internal operation. But in each of the five periods so involved, a recordable and measurable event nevertheless takes place and, for purposes of recording, no distinction is drawn betweeen such internal operations and the external transactions.

This suggests that the basis of the event to be recorded is a decision, and that whenever a decision is made which can be translated into suitable measurable terms it can be made the subject of record for accounting purposes. For example, the decision to buy an article may be recorded in the form of a purchase order, which might well be the initiating document for accounting records. In an enterprise with a substantial volume of activities, there is much to be said for incorporating in the accounting system a record of commitments arising from such purchase orders, as well as the more usual record of liabilities arising from the delivery of the goods ordered. Again, the requisitioning of materials by, say, a production foreman for purposes of manufacturing is made the subject of record in a well-

designed costing system and is frequently integrated in the accounting system proper.

The accounting records, when looked at in this light, become records of decisions, and it is from this point of view that the way is opened to make them a means of interpreting the soundness or efficiency of managerial activity. It is because of this relation to decisions of the commander that it is immaterial, for purposes of recording, whether the event is an external transaction or an internal operation.

II The Characteristics of Double-Entry

In the period since Pacioli's exposition of double-entry in 1494, this method has gained virtually universal recognition among accountants as the only satisfactory system for financial recording. However, universally acclaimed though it is by accounting writers and practitioners, it is not universally practised in the community. There are undoubtedly many businessmen—especially amongst those conducting small-scale enterprises—who do not operate a double-entry system of recording. This is probably true even for some who are clients of practising and fully-qualified accountants; for example, many of those whom a public accountant sees but once a year for the purpose of preparing an annual income tax return probably do not use double-entry records, neither would the vast majority of wage and salary earners and those in receipt of fixed incomes from investment and/or property.

This suggests two points of interest. In the first place, double-entry is not an *essential* for financial recording, since there are thousands of cases in which financial recording is made without it. Secondly, double-entry is not arrived at spontaneously as a recording technique: that is, it is not "discovered" anew in each generation by numerous people; we are not led to it naturally through contemplation or observation of financial records. In other words, double-entry is a sophisticated technique which we have to learn from some source outside ourselves.

It is therefore pertinent to enquire what are the characteristics of a double-entry system and what advantages its use gives over any other basis of recording.

In *Accounting Evolution to 1900,*[3] Professor Littleton rejects, in turn, the factors of duality of form and equilibrium of results, in favour of that of proprietorship as the central feature of double-entry recording. However, he appears to be thinking principally of double-entry in its modern applications and is quite aware of the difference between this and its earliest forms. For instance, he suggests that

> perhaps two terms are needed, one to indicate a simple regime of internal equilibrium suitable to record agent's bookkeeping and another to designate a complete instrumentality adapted to recording modern corporate activities.[4]

Although he does not give a formal definition, one can easily derive it from his argument as follows: Double-entry bookkeeping is the organised instrumentality for measuring and explaining the tangible results of the ownership of property and its dedication to gainful activities.[5]

In his more recent *Structure of Accounting Theory,*[6] however, he regards income as the basic concept in accounting, which distinguishes it from all other methods of quantitative analysis, and states that the basic importance of income determination, even though it was perhaps not widely recognised by accountants until relatively recent years, is as old as double-entry bookkeeping.[7] He goes so far as to say that "income determination rather than determination of solvency has always been the central feature of double entry."[8]

The second view represents a development and refinement of the first, rather than a different view, and there are passages in the earlier work which appear to imply the later view. For our present purposes, any presumed or superficial discrepancy attributable to a change of view by the learned author is not material and may be left to others to argue about. There are, however, some relevant points involved.

In the first place, so far as the historical interpretation of the

[3] A. C. Littleton: *Accounting Evolution to 1900* (New York: American Institute Publishing Co., 1933).
[4] *Op. cit.,* p. 26.
[5] *Op. cit.* See p. 27.
[6] A. C. Littleton: *The Structure of Accounting Theory* (American Accounting Association, 1953).
[7] *Op. cit.,* p. 26.
[8] *Op. cit.,* p. 27.

origin of double-entry is concerned, we of the twentieth century obviously cannot—at least without great difficulty—think in the same terms and with the same attitude as people of the late Middle Ages. If it is to be held that double-entry recording originated in the thirteenth or fourteenth centuries, the characteristics that constitute it must surely be those that would have been present at the time of origin. If, on the other hand, the essential characteristics are those that obtain at the present time or, at most, have obtained within recent times, then the "double-entry" that is being thought of must surely be of much later origin than five or six centuries ago; "double-entry" in this sense is probably not much more than a century old.

Secondly, the notion of proprietorship in the sense of ownership is not, within the modern context, consonant with the theory of commandership propounded above, but, because of the then predominant fusion between ownership of and command over resources, it could have been appropriate in earlier times. It is thus possible that the concept of proprietorship was, historically, the crystallising notion which produced the final structure of double-entry and of the techniques of duality and equilibrium.

On the other hand, the concept of "income" (in the sense of the net result of a periodic matching procedure) is consonant in the modern context with the theory of commandership, since periodic gain can be regarded as a measure of the disposition of resources over which the commander has control. However, while this is a convenient notion for the present theory (as well as for other modern accounting theories), it is open to doubt whether periodic gain was a significant concept at all in the thirteenth and fourteenth centuries, that is, in the sense that it is something conceptually distinct from the result obtained by comparing wealth at different points of time. If it was, there does not appear to be much evidence of it in the writings of the time; on the contrary, comparison of wealth appears to be more typical of the thinking of the time, one example being the following extract from Florentine records of the year 1335:

1335. In the name of our Lord Jesus Christ, amen. When we settled our General Accounts of two years on the Kalends of July, 1332—that is, from the Kalends of July, 1330, to the Kalends of July, 1332—we found [that we had] gained more than lost, as appears from the accounting made of what we

found is owed us by others and of what we have in merchandise and in other goods—of which we have made the sum here on the side; and as appears from the accounting made of what we found we owe to others—of which we have made the sum further along on folio 421. In totals we find that on the Kalends of July, 1332, we had gained more than lost in the said two years £41,285 s.13 *a fiorini*. And breaking [the profit] down as closely as possible, we saw that from the Kalends of July, 1330, to the Kalends of July, 1331, we had gained more than lost about £22,492 s.9 *a fiorini* up to said day; and from the Kalends of July, 1331, to the Kalends of July, 1332, we had gained more than lost about £18,792 s.4 *a fiorini* up to said day.[9]

Further, the fact that double-entry recording was *not* widespread for several centuries after it was first known, suggests that many commercial enterprises were able to carry on without its advantages. Moreover, it has not yet been demonstrated that, in those earlier centuries after the system of double-entry was made publicly known, those firms that adopted it had unequivocal advantages because of its adoption over those that didn't use it. This does not mean that such advantages did not exist, but, on the available evidence, the case for them appears to be based chiefly on the claims of writers of text-books, many of whom were "scholemasters" and teachers of writing and arithmetic rather than hard-headed, practical men of business. The case is simply "not proven" until we come to much more recent times.

It is suggested that perhaps double-entry originated, not as a utilitarian instrument in the strictest sense at all, but rather because the features of duality and equilibrium appealed mathematically to the early keepers of financial records as an illustration of arithmetical harmony and formal symmetry. At least, it seems possible that its utilitarian potentialities were fully realised only after the lapse of a considerable time after its initial introduction.

After all, we must concede that proprietorship can be measured at any time without using double-entry, and we can arrive at a figure of "income" by comparing successive measurements of proprietorship thus obtained. Alternatively, "income" can be measured through a statistical matching procedure without having recourse to double-entry. What double-entry does is to combine

[9] Robert S. Lopez and Irving W. Raymond, *Medieval Trade in the Mediterranean World* (New York: Columbia University Press, 1955), p. 370. The authors note that the sum of the latter two figures is lower by £1 than the total given.

the possibility of both measures of income and the measure of proprietorship within the one system, and it is this *potentiality* that is the distinctive feature of a coherent system of double-entry bookkeeping. From this point of view, it matters little whether the "proprietorship" represents both ownership and command, as in the earlier and some modern situations, or command only, as in other modern situations; or whether the potentiality was recognised early or not; the significant feature of double-entry is that it contains and has always contained this potentiality.[10]

III *Reporting*

Consideration of the function of reporting raises the whole problem of communication and, indeed, the question of the nature of explanation. While these are matters of logic and philosophy which, it is recognised, need to be explored in relation to this function, it is suggested that we can accept for present purposes the proposition that accounting reports are intended or purport to convey information as a means of communication and explanation.

The expression "accounting report" is open to at least two different interpretations. It may mean a report which is prepared from accounting records only, or it may mean a report prepared by an accountant from accounting and/or other records. This distinction is probably not particularly significant for practical purposes, but it does suggest a point that is sometimes overlooked in much of the current accounting literature, namely, that accounting reports (whichever of the two interpretations is placed upon the expression) are statistical reports and are not

[10] A distinction may be drawn between what might be called double-entry thinking on the one hand and double-entry recording on the other. Double-entry thinking involves the conscious recognition of the fact that an excess of revenue over expenditure, whether it be for a venture or a period, is at the same time an increase in net assets; this recognition is of the essence of modern expositions of the theory of double-entry. Double-entry recording, on the contrary, can be carried out on the basis of procedural rules, and a perusal of text-books indicates that this was virtually the universal mode of exposition until the early part of the twentieth century, even with writers who professed to expound on the basis of reason rather than rules. Thus double-entry thinking—in the sense in which this expression is used here—and double-entry recording have not always gone together; the recording preceded the thinking by some centuries.

dependent upon the existence or maintenance of double-entry records for their production.

The most common accounting reports, hallowed and virtually sanctified by many years of traditional practice, are unquestionably the periodical profit and loss account or statement (or "income statement") and the balance sheet. It is true that these reports have been developed historically from double-entry records, but, functionally, a statement showing the revenue for a period and the appropriate charges against that revenue, and another marshalling the assets and liabilities at a point of time, can be prepared from information which is not organised into a coherent double-entry system. Cases in which this has to be done occur in practically every practitioner's experience. The advantage of using double-entry records for such reports lies in the possibility of a complete reconciliation between the information contained in them and an increase in their potential reliability through the elimination of the need to use a "balancing" or suspense residual. However, the recognition of the reconcilability of the two statements amounts to cognisance of the very basis of double-entry, so that, although double-entry records may not be used in a particular instance, any attempt at reconciliation of the two statements is, in effect, an exercise in double-entry thinking.

Other reports—such as statements showing sales, costs, volume of production, movements of merchandise or materials, variations from standard performances, sources and disposition of "funds," or any other of the multifarious types of information which may be required or may be deemed to be useful—are also capable of being prepared from any suitable statistical sources, whether kept on the double-entry basis or not. Again, the advantage of having double-entry records as the source of information lies in the presumption of reliability in such data which they provide.

It must be recognised, however, that the results obtained from double-entry records are no more reliable than the information that is put into them. The kind of reliability which such records gives is purely an arithmetical reliability. Hence, when an accountant carries out the function of reporting in the sense of preparing statements from double-entry records which will impart useful information to the reader, he can rely on the double-entry

records as such for the arithmetical safeguards they provide, but not for any essential validity of the information they contain. To ensure such validity, they must be verified from appropriate evidence outside the records themselves.

The criteria to be followed and the standards to be adopted in preparing accounting reports have received a considerable amount of attention in recent years. The form and contents of reports of companies for public distribution have been examined empirically[11]; they have also been the subject of legislative or regulatory control[12] which has shown a distinct trend towards requiring the publication of an increasing amount of information about a company's financial dealings.

The preparation of accounting reports for use by executives within an organisation has equally attracted attention, and illustrations of types of reports for various levels of executive responsibility are common text-book material, and "principles" of reporting are frequently set out.[13]

Hence it is not necessary to discuss in detail here the standards to be adhered to in preparing accounting reports. These standards may be summed up by saying that there appears to be fairly general agreement amongst writers on the subject that such reports should be clear, accurate, adequate and prompt. Clarity consists in submitting the information in a form that will enable significant relationships to be determined as easily as possible, and embraces the appropriate classification of items. The information itself, it is generally postulated, should be accurate, but what constitutes accuracy is not usually discussed at length. Adequacy involves some consideration of the reader's requirements and is sometimes expressed by saying that a report should contain

[11] See, for example, *Accounting Trends and Techniques* (American Institute of Certified Public Accountants, yearly); A. A. and G. E. Fitzgerald, *Form and Contents of Published Financial Statements* (Sydney: Butterworth & Co., 1960); R. J. Chambers, *The Function and Design of Company Annual Reports* (Sydney: Law Book Co., 1955); articles in accountancy journals examining financial reports of specific companies.

[12] As in the Companies Acts of the United Kingdom and other countries, the regulations of the Securities and Exchange Commission in the U.S.A., the regulations of Stock Exchanges.

[13] See, for example, J. Brooks Heckert and James D. Willson, *Controllership* (New York: Ronald Press, 1952), Ch. 21, in which an exhaustive list of points is set out.

all relevant information which is material to the purpose for which it is intended, but should not include a mass of detail which is immaterial or irrelevant. It also covers the matter of terminology which should be capable of being unequivocally understood by the reader. Promptness is one of the self-evident virtues which has greatly promoted the use of mechanical and electronic devices in recent years, and appears to have become almost a fetish with some organisations.

One or two points of enquiry may be raised, however. On the matter of accuracy, as already pointed out, the information contained in reports prepared from written records cannot be any more accurate than that which is recorded, and, if inaccurate data are put into the records, the reports prepared from them cannot themselves be accurate. It may be noted that the form of many audit reports required by statute[14] or regulation requires an affirmation that the statements examined and reported on by the auditor are in accordance with the books of account. Under English company law, however, it has long been recognised as one of the duties of an auditor not only to go beyond the books of account, if he considers it necessary, to ensure the correctness of the financial statements presented to shareholders, but also to ensure that the books of account do show the company's true position.[15] But there is, perhaps necessarily, considerable elasticity in the interpretation of what constitutes truth in this context.

Another point is whether or not there is, in fact, an intention to inform the reader of information relevant to his decisions. This doubt may rarely arise in connection with "internal" reports for executive officers of an organisation, but it may be real in respect of published reports. The *Royal Mail* case[16] has become a classic instance of absence of intention to give full information to shareholders about the relevant financial facts of their company. Even though there may be no fraudulent intent in concealing full information; even though, indeed, it may be considered that such

[14] For example, the U.K. Companies Act, 1948, Ninth Schedule, whereby one of the matters to be expressly stated in the auditors' report is "whether the company's balance sheet and . . . profit and loss account dealt with by the report are in agreement with the books of account and returns."

[15] Cf. *In re* London and General Bank (No. 2) (1905) 2 Ch. 673.

[16] Rex v. Lord Kylsant and Another (1931) 101 L.J.K.B. 97.

concealment may be in the shareholders' own interests, the fact remains that in such cases there is an intention that there should be revealed to shareholders something less than all the information with which they could be supplied without irrelevance. The argument that the provision of more information in published statements would unduly benefit competitors is perhaps not so widely advanced in favour of secrecy as formerly. Under the incidence of compulsion, persuasion and example, much more information is now being made public than would have been thought "prudent" two or three decades ago, and a common experience is that, far from being put at a serious disadvantage by competitors, many companies have found that their liberality in giving information has proved to be good public-relations activity, not only with their own shareholders but also with their customers, their creditors, their employees, the investing public and the general public. And the sort of information they would have wanted to conceal from their competitors has generally been found to have been exaggerated in importance or, as has probably more often been the case, already known to their competitors by other channels of information.

Nevertheless, the question of how much information to provide in an accounting report is one that has to be answered every time a report has to be prepared, and no formula has yet been devised that can be applied to give an answer to the great variety of circumstances surrounding both the preparation and the use of accounting reports. An accounting report is a summary, and, as such, its preparation involves selection and arrangement of data and this involves an inescapable element of judgment for which formulae have not been devised and can form no substitute. Thus an answer can only be given in very general terms, such as that the report must be adequate to the use to which it is to be put, avoiding inadequacy which would arise through the inclusion of much irrelevant detail as well as through the exclusion of relevant data. It should provide the answer to the question that is asked of it; this applies to reports at all levels, including published reports. In some cases, however, this question is not clearly formulated, in some cases it may be a many-headed question not permitting of a clear and unequivocal answer. Hence, it is not always

the fault of the preparer of the report if his product does not answer all the questions that are asked of it; this also applies to reports at all levels.

It should further be noticed that sometimes there may legitimately be a difference (amounting, in extreme cases, to a conflict) of interest between the "reporter" and the recipient of these reports. This difference, which, for the most part, is probably not consciously felt or realised by either the reporter or the reader, may affect the extent to which appropriate information is provided. For example, the point of view of the chief executives in a company is orientated toward building up and maintenance of the company as a progressive organism, so to speak, whereas the shareholders may well be primarily interested in the return on and security for their investment. Even if the two points of view are reconcilable, as they often are, it does not follow that a report prepared from the one point of view will necessarily provide the information most adequate from the other. One aspect of implicit recognition of this difference of interests lies in the trend towards insisting on greater disclosure in published company statements, whether by statute (such as company legislation) or regulation (such as the rules laid down by the Securities and Exchange Commission). Apart altogether from the question of protection of investors against possible dishonesty or greed of directors, such requirements constitute a recognition of the fact that, so far as knowledge and control of the affairs of a company are concerned, the directors are in a stronger position relative to the shareholders. It is this consideration which also provides much of the justification, in the circumstances of today, for the auditing of company records on behalf of shareholders.

It should be emphasised that the fundamental aspect of this function of reporting is the conveying of information. Every report is a communication of some information. Whether the information is reliable or misleading, useful or valueless, apposite or redundant, adequate or insufficient, depends on the reconciliation of the views and interests of the reporter (and recorder) and the reader. Whether, in particular cases, reports are suited to convey information on the discharge of responsibilities of specific persons or groups of persons is a matter of adaptation of the records and reports to the requirements of the prevailing circum-

stances. The development of suitable "responsibility reports" is a matter of refinement, amplification and/or adaptation of the information-carrying function of all reports and is applicable to practically the whole field of reporting.

IV Interpretation

There are several admirable treatises available on the analysis and interpretation of accounting reports, and the use of ratios and trends discernible from the figures of the reports finds an honourable place in many text books and many accountancy examination papers. The function of interpreting is one that is widely recognised amongst accountants; indeed, it seems to be often regarded as one of the highest order of functions which an accountant may be called on to perform. It is not necessary, therefore, to consider here the details of analysis or the calculations of particular relationships or their use.

We are concerned, however, with certain aspects of the interpretative *process*. In carrying out the analytical and interpretative function as it is usually envisaged in accounting literature, the "interpreter" presumably has to identify himself with the reader (or at least the recipient) of the accounting report under consideration. This brings into sharp focus some of the difficulties of the entity theory. If it is postulated that the entity is the sole accounting unit, then not only are the records kept those of a distinct entity, but the reports of the entity's activities are prepared from its point of view, and the analysis and interpretation are for its benefit. Here, if nowhere else, the entity theory must puff and blow even if it does not break down entirely. And it appears that the fund theory fares little better. For surely the interpretation must be undertaken so that some human agency, and not a hypothetical or abstract unit, may take or refrain from taking certain action. It is submitted that human decisions, that is, decisions made by living human beings, constitute the justification of all the processes of accounting, whether interpretation or reporting or even recording. It is further submitted that the notion of the commander provides a reasonable and factual view of the situation.

We must, however, consider the identity of the commander a little more closely in relation to this process of interpretation.

The commander who receives a given report may or may not be the same individual whose field of responsibility is represented by it. In some (but not all) cases of internal management reports it does happen that they are submitted to people as a means of telling them the results or prospects of efforts that they have made or for which they are responsible. For example, a report to a factory foreman of work carried out in his section and of costs, idle time, relationship to standard performances, and the like, would assist him in the control of his section. In such a case, he is a commander of certain resources, the report is prepared for his consumption, and analysis and interpretation may be carried out from his point of view. Even in this case, however, it is frequently found that a copy of the report also goes at least to his next superior official (for example, the factory manager), who is also a commander with a somewhat wider area of responsibility than that of the foreman. He uses such reports as a check upon the activities and decisions of those under his supervision, and analysis and interpretation of such reports may well be carried out from his point of view also. Indeed, it is possible that analysis and interpretation of the one report may be necessary or desirable at different levels appropriate to different levels of command. By gradations of responsibility, the function of interpretation can be applied right up to the commander or commanders of top policy for the organisation.

The function can be carried even further, however, since reports prepared by or on behalf of the top commanders are also submitted to others. Investors and creditors are themselves commanders of resources, and many of the techniques of analysis have been developed *from their point of view*. "Are the shares in this company a sound investment?"; "Is this firm a good credit risk?"; these are examples of the kind of questions which echo—implicitly, at least, and often explicitly—through the literature of analysis. Analysis and interpretation are undertaken on behalf of commanders of resources other than those which are represented in the report(s) being analysed.

Once this dichotomy of commandership is realised, it is only a short step further to recognise the relativity and subjectivity of the interpretative function. A relationship that may be significant from the point of view of one kind of commander may be

irrelevant from that of another, even though both are interested in the same totality of resources. For example, the tangible asset backing for shares in a company, which may well be a deciding factor in the judgment of one of its shareholders or of a potential investor may have no interest whatever for a creditor or potential creditor who is concerned with the security for his debt rather than with the backing for shareholdings. It is submitted that the interpretative function cannot be performed, in any given case, with anything like complete satisfaction unless the purpose and point of view are clearly known or defined at the outset. This is tantamount to saying that the first point an analyst needs to make clear in a given case is the circumstances of the individual (real or assumed) with whom he identifies himself for the purpose of the analysis; for example, the attraction as an investment of a particular company's shares may be very different for the man who already holds shares in many companies and is looking for an avenue for investing another £100,000, and the widow whose sole resources amount to £5,000.

The management-commander may also be greatly interested in the interpretative function, but the aspects in which he would be interested would be different again from those of either the investment-commander or the credit-commander. As manager, he is (or surely should be) concerned with the use of the operating assets within his command—not only in terms of financial result but also in terms of physical output and efficiency. If he is to be a successful commander of the resources he controls, one of his chief tasks will be that of co-ordinating these resources in such a way that the financial, economic and physical aspects are properly balanced. It is conceivable that a given quantum of resources may be organised in such a way as to yield a relatively high profit and yet be wastefully or inefficiently used. Just as the significance of product-mix and sales-mix has been recognised in recent years, so too there is an asset-mix or factor-mix which may be regarded, at least conceptually, as an ideal towards which the top commanders in a given organisation might be expected to strive. If this were recognised, analysts and interpreters of accounting reports might well find a virtually unexplored field in which to exercise their ingenuity and talents.

Part III

OPERATIONAL PROBLEMS

Introduction

IN THIS PART it is proposed to examine some of the problems with which accountants are continually being faced in their job of carrying out their recognised functions in order to see whether the theory propounded in the previous part can help to throw any light upon them or assist in any way in their solution.

Those aspects of accounting operations which are selected for consideration do not constitute an exhaustive inventory of the accountant's tasks or problems, but they are amongst the most important and most controversial.

The problems of profit, control, valuation and communication have to be considered by accountants as part of their everyday duties, and between them probably attract, in one or other of their facets, by far the greater part of the attention of accountants. None of these problems is simple, none has been satisfactorily solved, and yet each has significant social implications for all of us.

If the treatment in the following chapters does anything at all towards throwing some light on these problems or towards clarifying the issues involved, if it does something towards getting behind the veil of abstraction with which these issues are habitually covered, if it does something towards providing bases for further investigation, it may be taken that this represents an advance upon the existing situation.

CHAPTER 13

The Problem of Profit

I Various Concepts of Profit

THE NOTION of profit is one of the most fundamental ideas with which accountants have to deal. Despite this, profit theory in accounting is inchoate and inadequate and comprises one of the most difficult areas in the whole province of accounting. This is due in part to defects in terminology, which have tended to obscure basic issues, but a large part of the difficulties arises from a failure to examine rigidly enough the concepts involved.

At the practical level, the problem is one of measurement, but behind the measurement is the problem of concept. Different concepts may well warrant and give rise to different procedures of measurement, and very often, though not always and not necessarily, different modes of measurement imply different concepts. It is necessary, therefore, to distinguish between problems of measurement and conceptual problems, and, particularly, to analyse the relationships between the several concepts which are only too often confused with each other. Analysis of these relationships may well give rise to an improved and settled terminology, which can hardly be developed without some clarification of the concepts on which it rests.

As indicative of the present state of confusion in this area, consider the following list of expressions, all of which have some relation to one or more of the others, but in respect of most of which there is little agreed precision between different writers: profits on a series of transactions, profit for a period, divisible profits, income, business income, taxable income, current income, gross profit, operating profit (or income), net operating profit (or

income), net profit (or income). Besides all these, "profit" may be variously considered as a result, as a reward, as an incentive, as a measure of performance, or as a test of efficiency. And, superimposed on them all, is the question of "real" profit and "real" income.

If we turn to the writings of economists, we may get a little assistance, but not very much. There appears to be a fundamental difference in attitude between accountants and economists in relation to the idea of profit. To the accountant, concerned with measurement and following out the accounting procedure of matching revenue which arises from certain activities with the relevant charges against such revenue, profit is a result. The accountant measures the revenue and the charges in order to arrive at a measure of the resulting profit or loss. To the economist, profit is an incentive—the prospect of profit is an inducement to activity. The activity is the important thing for the economist because it can be examined and measured more or less objectively and because it has social results other than the ensuing profit accruing to the persons or groups who carry out the activity.

This is not to say that the notion of profit as a result is utterly unimportant to or overlooked by economists, or that the idea of profit as an incentive is altogether absent from the consideration and discussions of accountants. The point is that there is a primary and predominating acceptance or adoption of the one or other attitude by each group which is not always consistently adhered to and departure from which is not always specifically recognised in discussions. Some confusion in analysis is therefore one of the inevitable results.

Neither does the business man's view of profit seem to be very clear. The following passage, exemplifying a managerial attitude, suggests the kind of generalised view which typically adds little to precision of thought:

> Profit is not a cause. It is the result of the performances of the business in marketing, innovation and productivity. It is, at the same time, the test of this performance. It is the first duty of a business to survive, and the making of profits is essential to meeting this obligation. It is an absolute necessity for the business enterprise to produce, at the very least, the profit required to cover its own future risks, to enable it to stay in business and keep intact the wealth-producing capacity of its resources. Attaining this required minimum profit is a specific function of management, both by setting rigid limits to the

decisions it may make and also by offering tests for their validity. Management, in order to manage, needs a profit objective at least equal to the required minimum of profit, and yardsticks to measure its profit performance against this minimum.[1]

Further, the word "profit" itself is often an emotive word, carrying implications of goodness or badness, desirability or undesirability, according to the context in which it is used and the intention of the user or the audience. For example, to somebody imbued with anti-capitalist attitudes, the word connotes essentially something evil, whereas to another who is a strong supporter of private enterprise it is an instrument of good and the mainspring of beneficial economic activity. To some people, it seems to be a fundamental ethic that one man's profit is another man's loss; to some again, it conjures up an attitude of distrust derived from a contemplation of the biblical questions, "What profit hath a man of all his labour which he taketh under the sun?" (Ecclesiastes), and "For what shall it profit a man, if he shall gain the whole world, and lose his own soul?" (Mark). It is scarcely surprising that emotional undercurrents should sometimes affect the way in which an intellectual argument about profit is presented, and it is necessary to be on one's guard, both in reading and in writing, against any unconscious bias engendered by one's built-in connotations of the word.

The problem of profit needs to be considered at two distinct levels at least. In the first place, it is necessary to consider the concept or concepts in mind when the word "profit" is used, and in the second it is necessary to consider the ways in which this concept or these concepts may be appropriately measured. In the following sections the conceptual side of the problem only is considered. It should be borne in mind, however, that no aspect of a problem is or can be completely divorced from other aspects; nevertheless they can be usefully distinguished for analytical purposes. Further, the whole of the treatment in this chapter is conceived only as a beginning in the analysis of the problems involved; it is fully recognised that much more work by many people

[1] J. Herbert Smith, "The Function of Management," *The Canadian Chartered Accountant,* March, 1959, p. 190. Mr. Smith is president of the Canadian General Electric Company and "a prominent member of the engineering profession."

is necessary before the theory of profit—at least for accounting purposes—might be said to be satisfactory or reasonably adequate.

II Profit on a Venture

It is desirable to distinguish between the concept of a favourable or unfavourable result arising from a given venture and that relating to the activities over a period in which a number of ventures have been undertaken. This distinction is historically valid in accounting: at the close of each venture, the profit or loss arising from it was determined, and the periodical account or statement prepared to summarise activities or the results of activities over a period became known as a profit and loss account, that is, it was a summation of the profits and the losses on ventures brought to completion in the period. In earlier days of accounting development, the periods taken were not necessarily equal or regular as they practically universally are now. It seems a little unfortunate that the term "net profit" came to be used to designate the result over a period shown by the profit and loss account, for the failure to maintain a distinction between venture results and period results has given rise to some confusion of concepts relating to profit. It is proposed here to restrict the use of the terms "profit" and "loss" to determinate ventures, and to designate the periodic result by a different term.

Single events do not themselves give rise to profit or loss; it is only when events are related to each other that a result can be determined. Profit (or loss) is thus a relationship between events. It will be recalled that a venture was defined in Chapter 8 as a series of events linked by a common measure into a meaningful relationship, and, further, that one of the primary, recurring patterns was that of trading ventures which, involving the acquisition and sale of a commodity, result in a profit or a loss. It is necessary now to examine briefly this relationship between events which we call profit or loss.

The simplest case is usually taken to be that of the exchange of cash for goods, that is, purchase of a commodity, with subsequent exchange of the goods for cash, that is, its sale. If the cash available after the sale is greater than the cash available before the

purchase, then a profit has been made. The process may be represented thus:

Cash ⟶ Goods ⟶ Cash

(Note: In the discussion which follows, the term "cash" is taken to include cash equivalents, such as credit available, rights to cash in the form of bank notes, etc.)

There is, however, an even simpler case which has already been suggested in the extract cited from the early life of Samuel Budgett.[2] In that instance, the initial resource, namely a horseshoe, was acquired by finding it, and it was later sold for cash. Hence only the latter part of the diagrammatic representation, namely, Goods ⟶ Cash, would apply here. For accounting purposes, however, the events comprising the venture would have been two, namely (i) the finding of the horseshoe, and (ii) its sale, and if it were desired to assess, in full accounting form, the profit arising from the venture, it would be necessary to record both of these events, even if a nil value were applied to the first of them; the resultant profit on the venture would thus be one penny. Of course, it would be practicable, if it were thought desirable, to impute a charge or cost for the picking up of the horseshoe, or for the carrying of it for the three miles to its "market," and this could be interpreted as affecting the amount of the profit; but this would only represent a refinement in measurement and does not affect the essential notion of profit as resulting from a trading venture which involves an exchange of goods for cash. This illustration, however, does bring out the point that profit is not necessarily or only, even though it may be most commonly, a function of transformation from cash through goods to cash, and a more general formula than one expressed in monetary terms is required. Hence we may say that profit arises in a trading venture when, on application of any satisfactory unit of measurement, the resources at the end of the venture are greater than they were at its beginning. It is conceded, however, that the monetary unit of measurement and the monetary expression of profit are virtually all-pervasive in the normal current interpretation of profit.

[2] Ch. 10, Sec. III, above.

The notion of profit on a venture can be approached through a consideration of what happens in a case of barter. Barter is still operative in certain areas of exchange transactions; for example, it is widespread amongst philatelists, especially junior collectors. It is common for an exchange of different stamps to take place between philatelist *A*, who has more than one copy of the particular stamp he gives up, and philatelist *B*, who acquires one he did not previously possess for one of his own duplicates. Thus each of *A* and *B* adds a stamp to his collection by the exchange of stamps which to each is surplus to his requirements. There is an increase of satisfaction for both, but is there a "profit" in any reasonable sense of the term? It is submitted that, before we can give an affirmative answer to this question, the increase in satisfaction has to be capable of being measured in some acceptable form. Each has parted with one stamp and each has obtained one stamp; in terms of a stamp as unit, both have thus broken even and there is neither profit nor loss for either on the exchange. However, each has exchanged an unwanted stamp for a wanted stamp; if we adopt wanted stamps as the unit, each has made a profit of one wanted stamp, or rather each has a "revenue" of one wanted stamp, against which should be "charged" one unwanted stamp; hence the "net profit" for each is one wanted less one unwanted stamp. This is still, fundamentally, a subjective evaluation; we cannot say that such a net profit has the same meaning or significance for each of *A* and *B* unless we know further that each of them derives the same degree of satisfaction from having a wanted stamp in place of an unwanted one. Before we can equate or compare the net profit for both we need a unit of measurement by means of which we can translate both the stamps into a unit which will be commonly acceptable to both *A* and *B*. A stamp dealer's catalogue provides a list of prices for stamps; if these prices are acceptable to *A* and *B* for this purpose of measurement, then an approach to profit can be made. Suppose, then that *A's* unwanted stamp is catalogued at, say, three shillings and *B's* at four shillings. On this basis *A* would be exchanging a stamp catalogued at three shillings for one catalogued at four and might therefore be deemed to be making a profit of one shilling's worth of stamp; on the other hand, *B's* exchange would be one of four shillings' worth for three, and therefore he would be incurring

a loss of one shilling's worth of stamp. It must be noted here, however, that this assessment of profit may serve to enhance *A's* initial satisfaction or detract from *B's;* only when the catalogue prices are accepted as a basis for making the exchange do they operate as a substitute for the initial satisfaction, or, more correctly, they serve as a social measure of satisfactions. A serious discrepancy between catalogue prices of wanted stamps may even, in similar circumstances, inhibit exchanges, but, if exchange does take place, it is possible to assess a profit *because a suitable and acceptable unit is available for measurement.*

Profit is thus a quantitative concept, that is, the relation between events which it expresses is a measurable relation, and it is necessary for the events to be measured in some common unit before it can be said that a profit, as distinct from satisfaction, has been the result of the events. It is not necessary, however, although it is usual, for profit to be expressed in monetary terms; it is usual simply because exchanges of goods and services for money are such a widespread activity in our form of civilisation.

Although profit is expressed quantitatively, it is none the less an expression, or an attempt at expression, of a subjective, qualitative satisfaction. The person who makes a profit as the result of a transaction thereby gets a greater satisfaction from resources or a greater command over resources than he had before the event; these two are not identical but there is a basic if sometimes indirect connection between them—where such greater command does not directly give greater satisfaction it is a source from which greater satisfaction may be, in the near or distant future, derived and is usually intended to be so derived. It is this subjective substratum to profit (and other) measurement that has given rise to dissatisfaction with monetary expressions in times of changing prices. Suppose I had bought a residence in 1945 for £2,500, and am offered £7,500 for it in 1960; if I sell, I shall make a profit of £5,000 (subject to adjustment for outlays on improvements and the like), but if I cannot get more than equivalent satisfaction with £7,500 than I get from presently owning the house, I should be no better off, and there would be no "profit" in this sense. In a period of any substantial rise in prices of commodities, this is precisely the problem that arises to plague economists, ac-

countants, businessmen, investors and, not least, all other holders of durable goods.

In the context of ordinary commercial ventures (and many so-called "private" events fall into this category), the profit from a series of purchase-cum-sale transactions is expressed in terms of the monetary difference between the purchase price, together with any additional costs incurred, and the sale price; that is, it is expressed in monetary terms.

The essence of the profit relationship between the events within a given venture appears then to be that, in terms of the unit of measurement adopted, the quantum of resources at the end of the venture is greater than that at the beginning; and the exposition

$$\text{Cash} \longrightarrow \text{Goods} \longrightarrow \text{Cash}$$

is a particular instance of the more general series

$$R_{a_0} \longrightarrow R_b \longrightarrow R_{a_1}$$

where R_a represents resources of a given kind and R_b represents resources of a different kind. If R_{a_1} (that is, the resources of the "given" kind at point of time 1) is greater than R_{a_0} (that is, the same kind of resources at an earlier point of time 0), then a profit, in terms of R_a, has been made on this venture; if less, then a loss, again in terms of R_a, has been incurred.

Another particular instance of the process is that of

$$\text{Goods} \longrightarrow \text{Cash} \longrightarrow \text{Goods},$$

that is, where a venture is envisaged as commencing with a quantum of goods of a given kind, which are sold, the proceeds of sale being devoted to acquiring goods of the same kind as those originally held. In such a case, a profit or loss in terms of a commodity —if this is adopted as constituting an acceptable unit of measurement for this purpose—is the result, according to whether the concluding quantum of goods is greater or less than the commencing quantum. It must be noted, however, that the final term of the process must be of the same measurable character as the first. Thus the expression

$$\text{Cash} \longrightarrow \text{Goods} \longrightarrow \text{Cash} \longrightarrow \text{Goods}$$

does not express a complete venture and to argue, as some people do, that the replacement of goods which have been sold is neces-

sary before a "true" or "real" profit can be ascertained is to aver what is only a partial truth; it is necessary to go further still to the completion of the second venture, that is, to the point of converting the second lot of goods to cash before we can get an internally consistent expression of profit over the two ventures. In this case the full expression of the double venture is

Cash ⟶ Goods ⟶ Cash ⟶ Goods ⟶ Cash.

It is conceivable, whether practicable or not in present circumstances, to substitute some other unit, in terms of which both cash and goods are expressible. For example, purchasing power has been greatly discussed in the recent literature of accounting, and if suitable units of purchasing power were available, let us say by the application of an appropriate series of index numbers, we could express the process in the following form, using PP to represent a quantum of purchasing power:

PP (in the form of cash)→PP (in the form of goods)→PP (in the form of cash).

The process could be extended as far beyond two items as is desired, and a "profit" could be assessed at any point, since the unit of measurement is the same throughout. But such profit (or loss) can only be expressed in terms of the purchasing power unit and not in terms of any other. In other words, to achieve such a result would involve accounting in terms of purchasing power units themselves and not in terms of money or any other unit. Another problem would arise here, namely, that of determining at what point a given venture is terminated. It must also be noted that money *is* a purchasing power unit for all the goods and services which enter into exchange transactions (other than barter); and the Cash → Goods → Cash expression is in fact a form of the PP → PP → PP process, with the proviso that where cash can be readily turned into exchangeable goods or services of any kind, goods themselves cannot normally be so treated directly but only through their conversion into cash.

The main purpose of this section has been to establish the point, obvious though it may appear, that the basic concept of profit, irrespective of the means of measurement, relates to the determinate venture. Other concepts of profit or gain are drived from this.

III Periodic Gain

As we have already seen,[3] the notion of an accounting period has a highly important influence on accounting thought and procedures, and our task in this section is to consider whether it affects the basic concept of profit, and, if so, how.

Ventures obviously take place over time. That is, while a given event may be regarded—and is recorded—as taking place at a particular point of time, there is always *some* lapse of time between the initiating and terminating events of any given venture.

One of the most widely recognised tasks of an accountant, and, in modern conditions, one of the most significant, is to formulate and carry out a procedure whereby the results of events during a given period can be ascertained and measured. Fundamentally and historically, as we have seen, this procedure comprises a summation of the results (profits and losses) of individual ventures during specific periods, although there is some danger of losing sight of this characteristic when the task of periodic measurement is actually undertaken.

The problem can perhaps best be understood by a simple illustration. If, in a given period, I buy, say, 1,000 units of a commodity in twelve distinct lots of varying quantities and sell them all in eighty distinct transactions, the result of my activities may be ascertained in any one of three ways. First, the purchase and sale prices of each unit may be compared and the net differences, that is, the profit or loss on each, may be totalled to give the result for the period. With this method, the purchase-cum-sale of each unit constitutes a determinate venture and the result for the period is a summation of the several venture results. Secondly, the total acquisition cost of the thousand units may be compared with the total of their selling prices and the difference between these indicates the net result for the period. Thirdly, my sources at the beginning of the period, that is, immediately prior to the purchase of the first unit may be compared with my resources at the end of the period, that is, immediately after the sale of the thousandth unit, and the difference between them indicates the net result for the period. In a period in which only determinate ventures are undertaken and completed, the result

[3] Ch. 8, Sec. V.

from all three methods is the same. For convenience, the three methods may be styled respectively (a) the summation, (b) the periodic matching, and (c) the *ex post* net asset comparison, procedures. All, however, are directed towards the same objective and are valid alternatives in relation to each other.

This can be expressed algebraically. If C represents the cost of each unit and S its selling price, then the result for the period can be expressed as $1000 (S - C)$ or, more generally, $\Sigma (S - C)$, while the second method is indicated by the expression $1000 S - 1000 C$, or $\Sigma S - \Sigma C$. Obviously, these expressions give the same result. The third method can be expressed by introducing R_0 to represent the resources at the beginning of the period and R_1 those at the end; then $R_1 = R_0 - 1000 C + 1000 S$, or $R_1 = R_0 - \Sigma C + \Sigma S$, and $R_1 - R_0 = \Sigma S - \Sigma C$. This results from our recognition of the fact that the profit (or loss) on a given venture represents and is measured by the increase (or decrease) in the resources involved in that venture.

In practice, the second method has gained widest recognition among accountants and is generally adopted as the matching procedure related to a period. The third method, however, is also recognised as being applicable in some circumstances; for instance, where the records are not kept in sufficient detail to enable the summation of the relevant revenue and charge items to be made, a comparison of resources at the beginning and end of a period may be adopted as the basis for determining the periodic result, allowance being made for known transactions, such as a specific contribution or withdrawal of capital, which might have affected the resources but would not normally be recognised as entering into the events to be matched in arriving at the result for the period. This method is now generally regarded as inferior to the second one and only to be applied where the other is inapplicable or, in cases of doubt, where a check upon the result obtained by the other is required. If the early text-books on accounting can be accepted as a guide, the first method was in general use in the eighteenth century and at least the early part of the nineteenth century, but appears to have given way to the other methods by the latter years of the last century.

It may be of assistance in analysis if periodic result were given

a different expression from the result on the venture, and the term "gain" is suggested as an appropriate expression. We may thus speak of "profit" to indicate a favourable result on a particular venture (that is, an increase in resources resulting from the venture activities) and of "gain" to indicate a favourable result over a period, in which a number of ventures would have been undertaken and completed. A corresponding distinction is desirable for unfavourable results, reflecting a decrease in resources, and it is suggested that while "loss" might be used in relation to specific venture results the term "wane" be applied to the periodic result. The statement summarising the character and effects of activities over a period can thus legitimately be designated by its traditional name of Profit and Loss Account (or Statement) and the periodic result shown therein styled "Net Gain" or "Net Wane." It is recognised that the latter expression may seem a little strange and unconventional at first acquaintance, but it is submitted that it has not only the advantages of euphony and distinctiveness from the overworked "loss," but also that of reminding us that the cumulative effect of unfavourable results is a decline of resources.

It must be emphasised that, while the same result should be obtained whichever method of assessment is adopted, the primary procedure is one of summation, that is, the first of the three methods outlined above. If one were to use this method in practice, it would be necessary, of course, to take into consideration and make allowance for any ventures not completed at the end of any given period, and this is, in effect, the purport of the so-called balance-day adjustments which the accounting student learns at an early stage of his career and which the accountant himself is so familiar with. The multiplicity of transactions and the spilling over of ventures into more than one accounting period operate to complicate the procedure of computation of periodic result; indeed, in most cases the problems arising from these factors are sufficient to make the summation procedure exceedingly difficult and virtually impracticable, so that the substitute, matching procedure (or, occasionally, the net asset comparison procedure), becomes necessary. Nevertheless, this should not blind us to the fact that the basic procedure is one of summation and the

basic concept that of venture profit or loss. The matching procedure as generally described and the concept of periodic gain or wane are derived and not primary.

IV Profit, Gain and Income

The words "profit" and "income," and especially the expressions "net profit" and "net income" are often used synonymously in accounting, economic and business literature. In many cases, the context of use makes the meaning clear, but it is possible and desirable to distinguish at least two concepts which are sometimes confused because of the apparent interchangeability of these two words.

The word "profit" has the antonym "loss," and, as we have seen, the sense in which these words may properly be used is that of a result of activities, a positive result, so to speak, being a profit and a negative one being a loss. The same kind of sense applies to the suggested use of the words "gain" and "wane." By contrast, the word "income" has no true antonym and there is a concept in which a negative income has no place. This concept is based on spendability of resources. Strictly, a person cannot spend what he hasn't got, although the operation of various forms of credit enables him to spend his "income" in advance of receiving it. However, when we analyse such credit transactions, what can be seen is not that he spends or disposes of future income but that he engages in a legal obligation to apply a certain amount of his future income, when he does receive it, to a particular direction of spending or disposition. Again, for a given period a person may appear to spend more than he has received by way of income, but on analysis the excess outlay is seen to be met by his drawing on existing "capital" resources which represent an accumulation of income of previous periods which has not been spent previously, or by borrowing resources which represent somebody else's accumulation of unspent income of previous periods. In the latter case, he again usually "mortgages" some at least of his future income for subsequent particularised disposal as interest and repayment of the loan.

This notion can be taken one stage further. An individual may have a business and certain other interest-bearing or dividend-

bearing investments. If, in a given period, his business is operated so as to produce a gain, this is usually added to his investment income in arriving at his total income for the period. It is assumed, in this case, that he has both the business gain and the investment income at his disposal. But if the business gain is in the form of non-cash assets, realisation of those assets must take place before he can dispose of such total income. There is a difference between such a business gain and the "income" which it represents.

This distinction is in fact realised when drawings are considered in relation to gains. If, say, the proprietor of a business withdraws an amount less than the amount of the gain, this is often described as leaving "profits" in the business or "ploughing back profits." It is submitted that, while the notion is sound conceptually, the mode of expression is open to clarification. It is suggested that there is a difference between these gains ascertained as the result of business activities on the one hand and the amounts withdrawn by the proprietor on the other. The word "income" could be applied to the latter, but a new word would be greatly preferable because of the confusion which would be likely to arise at this late stage if the attempt to restrict the meaning of "income" in this way were not universally adopted. There does not appear to be a satisfactory word at present in the English language, and it is therefore suggested that the term "reddito" be adopted from the Italian, since it would be free, at least in English contexts, from overtones and connotations from which "income" now suffers.

We can now restrict the words "profit" and "gain" to represent favourable results of activities, with their antonyms "loss" and "wane" respectively for unfavourable results. "Reddito" can be restricted to what a person has as resources coming in to him (other than capital withdrawals) from whatever source and which he can spend or save according to his necessities and desires. Reddito for any given period may be nil, but there can be no negative reddito. If, in the case suggested above, our friend's business losses (that is, net wane) exceed his income from investments, his reddito would be measured by the sum of his withdrawals, if any, from the business and his investment income. If he did not with-

draw anything from the business, he would still have his reddito comprising the investment income.

The clarification of this concept enables us to see a relationship which is often obscured by the current use of the terms "profit" and "income." For now we can see that neither profit nor gain is the same as reddito, but either may form a basis of part of a person's reddito through its relation to withdrawals. Continuing the example of the individual, as a commander of business resources the result of his activities is represented by venture profits or losses and, over a period, the business gain or wane; but as a commander of his personal resources his reddito is composed of his withdrawals from the business together with any other income he might obtain. He is thus a commander in at least two respects—as a business entrepreneur and as a private citizen; and his commandership functions are somewhat different in each category. This does not necessarily imply that he has a dual personality, but simply that he has a dual role, the duality being sometimes obscured because of the ready interchangeability between the business and private resources.

In the case of a company, the distinction is more clear-cut. The results of the activities of the company's commander(s) are again its profits or losses on ventures, its gains or wanes for periods; but the shareholders, as commanders of their own resources, to which each one's reddito makes its contribution, are concerned with the dividends they receive, for it is these which form a part of the reddito and therefore a part of the resources which they can command.

In the case of a trust, the "income" from the trust property is the result of the trustee's efforts as commander; what he distributes to the beneficiaries is part at least of their reddito, and it is this which they can deal with as commanders.

Reddito for a particular individual for a given period is not necessarily the same as the total of his spendable resources, for these latter might include certain elements of capital which it is desired to exclude from our new concept. Thus reddito is that part of spendable resources which has an "income source."

We now have the following distinguishable concepts:

Profit (or loss), which is the net result of activities in relation to a venture, usually but perhaps not necessarily expressed in financial terms.

Gain (or wane), which is the net result of a period of activities in relation to a business, institution or fund.

Income, which includes, for an individual, business profits and amounts derived (that is, "earned" rather than received) from other sources.

Spendable resources, which are the amounts actually received by an individual over a given period, from whatever source, that is, whether capital or income.

Reddito, which is that part of spendable resources which is of an income nature, that is, received income, but excluding accrued income.

It is suggested that, whatever names may eventually be agreed upon for these concepts, it is important to recognise the distinction between them and to clarify the relation of each to the others. The first two—profit and gain—are applicable to venture and period activities of businesses and institutions; the last three—income, spendable resources and reddito—appertain only to individuals.

It is possible, too, to lend some greater specificity to the definition of "income" as given by J. R. Hicks[4]—a definition which has been widely adopted, both implicitly and explicitly, and often without question, in accounting and economic writing, even though Hicks himself pointed out its impracticability.[5] In this definition, "income" is what a man can spend and be as well off at the end of a week as he was at the beginning. One point about this definition is that it applies strictly to individuals and should not be carried over to business as the same concept. Secondly, there is some little ambiguity in the words "can spend." If the expression means "has available for spending," that is, what a man can *in fact* spend without depleting his commencing resources, then it is what we have called "reddito." If, on the other hand, it means "could spend if available in cash resources," then the concept is what has been termed "income" in our terminology,

[4] J. R. Hicks, *Value and Capital* (Oxford: The Clarendon Press, 1939), p. 172.
[5] *Ibid.,* at pp. 176-77.

that is, it is a measure of potential spendability but not a fact of spending.

When we come to apply these concepts to a particular case, we get something like this. The commanders of resources (net assets) deploy or manipulate them in a way that results in a measurable change in them. This measurable result for a venture is a profit, if the change is an increase, a loss if it is a decrease; over a period, the result of all the ventures is a net gain or net wane. Some resources are distributed from time to time to certain persons with proprietorship rights; these take the name of dividends (for a company) or drawings (for a sole trader or partnership). If such distributions involve a greater quantum of resources than the increase represented by the gain, the commander's resources are depleted; in orthodox terminology, dividends or drawings have been made out of "capital." We can now see what this and the similar expression that dividends (or drawings) should only be paid out of profits mean. They are significant not only in the legal recognition they have gained but also in the support they command as precepts of sound financial policy. What is meant is not really that dividends are to be paid out of "profits," but that the measure of profit or, in the present terminology, gain for a given period or series of activities is a limiting measure for dividends or drawings. Profit represents an increase in net assets; dividends and drawings decrease them. It is considered desirable and important that net assets should not be decreased; hence the amount of dividends or drawings should not exceed the amount of gain for the same period.

Profit or gain, then, is not directly a source of income or reddito. From the point of view of the commander, a distribution of resources as a dividend has the same kind of incidence as a payment of resources as wages or settlement of a trade creditor's account—all equally deplete the resources at his disposal.

This also raises the point that the profitable activities may result in an increase in assets that are not readily distributable; this is partly a question of acceptable (or accepted) methods and techniques of measurement of profit and partly a matter of interpretation of the question: When does profit arise? Whatever the reason, it is a frequent fact of practice that the payment of a cash

dividend may strain the financial resources of a company even though the dividend is more than adequately covered by the amount of gain. Obviously, the simple reason is that the gain, although measured in monetary terms, is often the result of an increase (net) in non-monetary assets, whereas the dividend, equally measured in monetary terms, is at the same time normally payable in monetary assets. One of the great virtues of the so-called funds statement—an accounting report developed in the twentieth century—is that it does attempt to explain something of this situation. The identification of profit with monetary resources is a sad but widespread misconception held not only by beginning students in accounting but also, to judge from their writing and talking, by many sophisticated economists, some experienced businessmen, probably most lawyers and almost all laymen. And while accountants continue to talk about "paying dividends out of profits," even though amongst themselves they may recognise that they are using a kind of shorthand, they too must be held suspect—of imprecision if not of misconception. Accountants have not made it sufficiently clear just what they mean by such expressions as "distributable profits," although the term is seen frequently enough. The real meaning needs to be expounded again and again if it is to overcome current misconceptions, and if the point appears to be laboured here, we can only hope that eventually the labour will not have been in vain.

V Profit as a Result

Let us now consider some of the matters involved in regarding profit as a result—the primary attitude towards profit adopted in accounting.

In general, the accounting view of profit, and especially of gain, is that it is a residual element, that is, what remains from the proceeds of providing goods or services after meeting all relevant charges against those proceeds. The amount of profit arising from specific activities in a venture or gain derived from the activities during a given period is determined in accordance with the matching procedure. The specific activity may range from production of a unit of output in a manufacturing concern to the conduct of a department or branch of an organisation. Thus we

have a profit on a washing machine or a ton of steel—a specific unit of output or sale—or the gain of a firm for a year or a quarter, or, as something of a mixture between these two notions, the gain of the Adelaide branch or the hardware department for a given period.

In any of these cases, the profit or gain we are talking about is thought of and arrived at as a result of comparing two sets of data. The first set comprises the revenue or proceeds derived from certain activities—that is, from the sale of one washing machine or one ton of steel or all the commodities sold or services provided during the year or the quarter, or all those for the Adelaide branch or the hardware department for the period. There are some difficulties attaching to the application of the term "derived from" in this context which are considered later,[6] but they can be deferred for the present.

The second set comprises the charges which are deemed to be relevant to these revenues—outgoings of various kinds which bear a measurable relation to the revenues. There are many difficulties attaching to this set of data and the problems are by no means settled. What is meant by "relevant"? What is the nature of the outgoings? Who is responsible for the "deeming"? How is the relation to revenues measured? These are all difficult problems about which much has been written with little resulting agreement or finality. But they have to be faced day by day by accountants and some sort of answer given and result indicated.

By comparing the two sets of data, a figure is arrived at and this is regarded, with more or less confidence, as the result of the activities under consideration. At this point some writers consider that the accountant's task is completed; others think that this represents but one stage in the accountant's work. Whichever view is adopted, the determination of result in this way represents a fruition of accounting endeavour.

As has already been suggested, another way of determining the gain for a period is by comparison of net assets at the end of the period with those at the beginning. The financial position of a person or an institution is assessed at each point of time by marshalling the assets and setting the liabilities off against them;

[6] See below, Sec. IX.

the difference between the net position at the two points of time, allowing for specific proprietary contributions and withdrawals, represents a measure of the results, profitable or unprofitable, for the intervening period.

It is, perhaps, the crowning accomplishment of the double-entry system that it enables the two methods of assessing periodic result to be connected in a coherent system of recording, and it is probably for this reason that the theory of double-entry recording has been for so long considered to be the substance of the theory of accounting. But the double-entry method, while it long ago solved the problem of *recording* profit (and gain), has done little to solve the problem of *measuring* profit, and the last two or three decades, which have seen a great deal of attention to problems of measurement, have also seen a shaking of accountants' assurance in the supreme power of double-entry to solve all accounting problems.

It is clear that, whichever method of measurement has been used, the accountant has been concerned with assessing a *result* of activities. Indeed, even when an accountant estimates a future profit or gain, as in the preparation of a budget, he is projecting this "ex post" attitude into the future; in other words, the accountant projects himself into a future point of time from which he looks back at the likely results of activities of what *now* is a future period but would then be a *past* period.

Whether this attitude can ever be escaped is open to some doubt, but it is often averred that economists, by contrast with the attitude adopted by accountants, are concerned with "ex ante" gain or, as they more often term it, income.[7] They argue that businessmen are or should be "maximising their profits," and the pursuit of "profit" is an ever-present incentive in commercial, industrial and financial activities. From this point of view, the important thing, at any given moment of decision, is the prospective profit from the activity to be undertaken; it is the *expectation* of profits that provides the impulse to economic activity. Thus, in economic analysis, an individual is continually being faced with alternative activities, of which he has to choose one, the basis of

[7] See, for example, J. R. Hicks, *Value and Capital* (Oxford: The Clarendon Press, 1939).

his choice being his assessment of the likely resulting profit. In his function of recording, the accountant, on the other hand, has no alternative to consider; his task is to measure the result of activities previously chosen and already undertaken; and even in his estimates of future activities, each one is considered from this point of view, even though the respective results may serve as a basis for choice between alternatives. Each course of action actually undertaken is unique, and the accounting process is directed towards measuring a unique set of activities. This is a fundamentally different attitude from that of the economist. Because of this uniqueness of activity, a businessman cannot "maximise profit," he can only aim at maximising profits. For we can never know, with certainty, whether a profit gained from particular activities would ever have been different in other circumstances, since those circumstances did not, in fact, apply. Nevertheless, the aiming at a maximum profit is (no doubt rightly) taken to be a powerful influence in economic activities. What people do depends on what they think; the economist is concerned with what they think; the accountant is concerned with measuring the results of what they have done.

The man who is most directly concerned with profit and gain —the businessman, entrepreneur or, in the terminology of the previous part of this work, the commander—uses both of these concepts. He is actuated by the incentive of probable profit, but at the same time he requires to know what measure of success his past activities have met with. The assessment of what he has done affects what he will do; he does not consider each present or future situation divorced from all past situations. In other words, in order to act with judgment he needs to have an experience which necessarily involves a knowledge of what is past. In the present context, this knowledge is incomplete without a measure of the result of activities. For this reason the method used by accountants in measuring profit and gain is highly significant.

In modern commercial, industrial and financial life, the measurement of profit and gain is a complex matter; it is a process that is not easily understood and it is a process that is not infallibly and unequivocally precise. Nor is the view convincing that there is,

somehow, a result which, if we could but arrive at it, would be *the* true result and to which all our measurements are but approximations; what we might regard as the "idealist" view. For fundamentally the measurements vary not only because of the shortcomings of the measurers or of the units of measurement—though both of these may be potent factors in particular cases—but because the central result of the activities that are being measured is a change in resources, and different expressions of this change may have equal or equivalent validity according to the purposes for which and the point of view from which they are made.

The commander who is faced with a decision to make or not to make a batch of a particular commodity or with the task of fixing a price for an article needs to know what the result of making and/or selling previous batches of similar things has been. The figure provided to him is arrived at after a complex procedure of recording, estimating, allocating and calculating, in which individual personal judgments and interpretations, however rational and agreeable they may be, are inescapably applied. In some cases, the decision arrived at may even affect the figures on which it is based; for example, if the two sets of activity come within an accounting period and the spread of overhead expenses is greatly affected. In such instances, direct or marginal costing may reduce the extent of these judgments and interpretations for some purposes, but will not eliminate them even in the most direct circumstances. The point at issue, however, is that the commander does make a decision on the basis of information derived from the accounting process, making allowance for known or expected changes in conditions. The problem of designing adequate management reports is directed towards providing the commander with data relevant to his decision-making, so that he can increase the degree of rationality in his decisions.

Two matters are involved here. In the first place, many commanders are not necessarily conversant with the details of the accounting procedures used in assessing the results of activities, and, to the extent that this is so, their business judgments may be impaired unless the accountant can anticipate the use to be made of his data and can assist the commander accordingly. On the one

hand there is need for the commander to take the accountant into his confidence in explaining the use he wishes to make of accounting data; on the other, the accountant should do what he can to explain the complexities of his procedures or at least warn against any misinterpretation or misuse of his data. In brief, this is a case of mutual education.

In the second place, the accountant should be ever alert to any possibilities of simplifying and refining his procedures and the presentation of his reports. This may well proceed concomitantly with the mutual education, but should never be overlooked whether the commander is co-operative or not. There is scope for considerable accounting initiative here and it should always be exercised.

A prerequisite to either of these matters is, of course, that the accountant should himself understand and appreciate the nature of the accounting process and, in particular, in the present context, the complexities of profit measurement. Much has been written in recent years about the "conventions" and "doctrines" underlying accounting practices, but it is still questionable whether much attention has been directed towards a proper understanding of them. These propositions have been propounded and eagerly accepted as "explanations" of the accounting process. This readiness of acceptance in itself suggests to a sceptical mind that they may be rationalisations or bases of justification of accounting results rather than true explanations of anything. At the least, since they are often now treated virtually as axiomatic tenets of dogma, there is a need for a rigorous analysis of each one to determine just what it does explain and to what extent. Progress has always come by a critical examination of what most people regard as self-evident truth, and this happens in accounting as in other areas of study and (even more important) of activity.

Two accountants, using the same set of figures, came up with opposite conclusions before a Senate subcommittee investigating the Reconstruction Finance Corporation, it was reported last month in *The New York Times.*

J. W. Considine, CPA, controller of the RFC, said his agency made a profit of $5,226,000 in the fiscal year ending June 30, 1949, while Theodore Herz, CPA, of Price, Waterhouse & Co., Washington, D.C., an accountant hired by the sub-committee, maintained that the agency lost $6,448,000 on its loans. The conclusions reached on profit or loss hinged on the question of whether

the Treasury Department was entitled to interest on funds used by the Reconstruction Finance Corporation.[8]

Perhaps it is one of the characteristics of a profession that its practising members should differ in their opinions as experts on matters which appear to be basic to their profession, but cases such as the one cited above raise the question whether the concept of profit and gain is merely a subjective one or whether in a given instance the profit or gain can be arrived at with any positive degree of objective examination. In the above cited case, the difference of opinion, while in one sense it involved only a variation in degree, related nevertheless to an item the inclusion of which meant a difference in result between a substantial gain and a somewhat greater wane.

This ambiguity is also illustrated in the following extract from an English source:

> The surplus before taxation is £995,486—just a few thousands under a million pounds, said Sir Graham Cunningham, chairman of Triplex (Holdings) Ltd. (the safety glass group) at the company's annual meeting recently. Without any difficulty at all, he added, the board could have brought that surplus up to seven figures. It did not, however, fall to the temptation to do so, although a million pounds sounded a "nice round sum of profit." Instead, he went on, "we made all the proper and appropriate provisions without regard to what the ultimate results would be and we saw that they were just short of the seven-figure result. We said 'let it be so' and with your approval it is so."[9]

The chairman here is telling the shareholders that he and the other members of the board could easily have given instructions which would have varied the figure for periodic gain, but that with great probity of mind (or was it condescension?) they refrained from doing so. Perhaps there is a trace of irony in the remarks which followed the above:

> No doubt the Triplex board will continue to exercise such self-control in the matter of profit computation. As we all know, profit figures are not reached by a formula. "Proper and appropriate" provisions may be necessary and in thus providing, prudent judgment is needed. It is when judgment is involved with a desire to reach a particular figure that "profit" becomes meaningless, and we are reminded of a company chairman who, in the days when accounts were not as clear as they are now, advised shareholders not to

[8] *The Journal of Accountancy,* June, 1950, p. 467.

[9] *The Accountant,* November 8, 1956, p. 571.

rely too much on the figures before them. Other figures, he said, could have been produced which could equally well have earned a clear certificate![10]

There are two propositions to be distinguished and clarified. The first is that there is, in any given instance, a figure for profit or gain which would, if only the means of calculating it could be devised, represent the true, proper, absolute result in the circumstances. Any figure arrived at by means of our known methods of computation is but an approximation to this "ideal" result. The second, by contrast, is that not only is there not any such absolute figure for profit, but that the computation of profit may legitimately vary according to the concept adopted and that the operations by which the result is calculated virtually dictate the nature of the result itself. In other words, on this argument, the concept of profit is or will be fixed when the operations by which profit is measured are fixed. On this basis, different people may arrive at different results for the same set of circumstances according to the respective methods of measurement adopted by each, and the number of possible results is potentially infinite or at least potentially very large. Out of this possible population of results, one is selected for one purpose, while another may be selected for a different purpose, each being a legitimate interpretation so long as the operations of computation are related to the purpose legitimately.

The contrast between the two views may be demonstrated by a simple example. Suppose the activities in a given period comprise three ventures as under:

Venture A, goods bought for £2000, and sold for £3000;
Venture B, goods bought for £1500, and sold for £1800;
Venture C, goods bought for £1600, and sold for £1450.

Expenses connected with the acquisition and selling of the goods totalled £600. These expenses were not specifically allocable to particular ventures, although they related to them. For example, goods for all ventures were advertised at the same time as being for sale; deliveries of all three types of goods were often made together; acquisition costs frequently covered the three types of goods; and so on. The purchase price of all goods totalled £5,100

[10] *Ibid.*

and their sale price £6,250; out of the difference of £1,150 between these two, the charge of £600 for expenses has to be met; the net gain overall is £550. So much is clear and unequivocal. To arrive at a figure for profit on each venture, however, some mode of allocation of the expenses must be adopted. Those who advocate the first view would say that there is, somehow, an ideal basis of allocation which, if it could be arrived at, would give an absolute figure for such profit on each venture, and that any other basis is but an approximation to such ideal. The others would say that any one of several bases could legitimately be used and that more than one of them would give a valid result. Thus, possible bases of allocation of the expenses in this case might be (i) in equal proportions, that is, £200 to each venture, (ii) in proportion to the cost price of the goods in each venture, (iii) in proportion to the selling price of the goods in each venture, (iv) in proportion to the gross margin of each venture. These several bases would all give different venture profits. And it may be noted that "contribution accounting," whereby the expenses are not allocated at all, begs the question here of venture profits; it may be sufficiently acceptable for the assessment of periodic gain, but it leaves the matter of net profit on each venture untouched; in effect, the advocates of contribution accounting in a case like this virtually adopt the position that there is no such thing as net venture profit at all. However, the expenses envisaged here are venture expenses, that is, they are related to the ventures and not simply to the period as a primary factor; they are envisaged as being identifiable in total with the three ventures though not, in any unequivocal proportions, with each specific venture. Rent, for example, which would be a period cost and applicable whether three or thirty such ventures were undertaken, is *not* included as one of the items making up these expenses. The "idealists" would say that, despite the impracticability of arriving at a definitive profit for each venture, any profit result arrived at is an approximation to the ideal result which is possible conceptually; the others would say that because of such impracticability, all the results arrived at on rational bases are conceptually valid and no one result necessarily has preeminence of reason over the

others unless it is supported by compelling logical grounds, and that different circumstances may well justify the selection of different results.

Whichever of these alternative views is adopted, whether a given result is an approximation or one of a number of legitimate possibilities, it is clear that a specific profit or gain figure is not absolute but relative; it is, in either case, a function (in the mathematical sense) of the operations used in its computation. And to talk about profit in a general sense—at any rate in its character of result—is to introduce a generalisation which is at best nebulous and, in most cases, largely meaningless. This may not be quite true when speaking of profit as an incentive, in which case, while the generalisation may indeed be nebulous, it is not necessarily meaningless—but only because people can in fact attach some sort of meaning, even though vague, to the concept. Perhaps it is a matter of emotion, that is, a hope of improved circumstances, which operates as the incentive and that this hope (an emotion) is the mainspring of economic activity. If this is so, it is not rational behaviour so much as optimistic behaviour which is the basis of analysis in this area of economics. Even pessimistic expectations—that is, expectations of unprofitable activity—will rationally produce actions undertaken with an optimistic anticipation; that is, an expectation of loss will cause rational men to take steps that they *hope* will minimise the loss.

Thus, when we consider profit as an incentive, we are undertaking an analysis of an emotional and therefore subjective matter rather than a purely objective and verifiable aspect of human activity. The rationality of economic activity is only relative to an emotional motive—change the emotion and it may well be that the whole pattern of activity alters.

VI Profit as a Reward

The notion of profit as an incentive is closely related to that of profit as a reward—an incentive is, indeed, only a prospective reward. Profit has for a considerable period been viewed by many economic writers as a reward for "entrepreneurship," for carrying risks, that is, for providing risk-capital.

The broad question arises whether the accountant, in measur-

ing profit or gain, does or should do anything approximating to measuring any such concept.

A reward is, of course, a result, but it is not a necessary result of *any* activities or of activities as such. It is a prize or compensation for something done or something foregone; it implies some sort of effort. But effort of itself does not always or necessarily imply reward—at least in the generally accepted sense of the word.

Professor Frank H. Knight[11] has shown that the notion of risk is not a completely simple one, and has drawn a distinction between risks that are to a greater or less degree foreseeable and what he calls "uncertainty," which is in no way foreseeable. Foreseeable risks can be anticipated, that is, they can be contracted out of or the incidence of them can be shifted. For example, insurance can be effected whereby the payment of an annual or specific premium shifts the incidence of loss through fire, flood or other causes of damage from the individual firm or person to professional takers of this kind of risk who calculate the probabilities involved and fix their charges (premiums) accordingly. Again, accountants have devised a means of internal shifting of incidence of loss through, for instance, the non-collection of debts which are legally due, by raising, in a given period, a provision for doubtful debts which represents an estimate of debts which will ultimately (that is, in some subsequent period) prove to be uncollectible. The shifting involved here is from one period to an earlier period—it is an anticipation of a form of loss in the true meaning of "anticipation."

When all such foreseeable risks have been anticipated in some way or other, there still remain, however, those unforeseeable uncertainties—unforeseeable at least in our present state of knowledge and social organisation—which have to be borne by the individual person or firm. These cannot be contracted out of, the incidence of them lies where it falls and cannot be shifted.

The pertinent question here is whether the result arrived at through the accounting process is a measure related to such risks or such uncertainty and, if so, to what extent.

There is this much in common between uncertainty (in this

[11] Frank H. Knight, *Risk, Uncertainty and Profit* (Boston and New York: The Houghton Mifflin Co., 1921), pp. 19-20, 197 ff.

present sense) and profit or gain as determined by the accounting process—they are both residuals. But they are not necessarily the same residual. That they should be has been argued—up to a point—by Professor George J. Staubus. He makes the point that the residual equity (that is, the "risk-capital") is becoming more and more the focal point in general purpose accounting reports.[12] However, the question whether the risk-capital is used to carry only the unforeseeable uncertainties can be determined only by a consideration and knowledge of management policy in each particular case. For if, in one case, commander *A*, although able to foresee some risks, nevertheless does not try to off-load them, while, in another case, commander *B*, foreseeing similar risks, does take steps to shift their incidence, the difference between the resulting profits in the two cases will depend—to this extent at least—upon the different uses to which the risk-capital has been put. In case *A*, the risk-capital is used for the purpose of itself carrying some risks which could have been off-loaded—at a cost, without doubt—as in case *B*. Thus an organisation which carries its own insurance instead of making use of the facilities provided by existing insurance companies is making use of some of its risk-capital for this purpose; it may be cheaper in the long run for it to do so, but this does not affect the situation that it is itself carrying risks which *could* be off-loaded to other organisations and this may, in the short period, reduce the amount or proportion of risk-capital available to meet the uncertainties of economic activity.

One of the significant features of economic and social development of the mid-twentieth century has been the attempt to move factors from the realm of uncertainty, in this sense, to that of calculable risk, and the application of mathematical and statistical techniques in such areas as market analysis, operations research, quality control and the like is, in effect, an expression of this tendency to narrow the region of the unknown and unknowable and broaden that of the calculable probabilities. There is such a multitude of elements which affect economic and social activity,

[12] George J. Staubus, *A Theory of Accounting to Investors* (Berkeley: The University of California Press, 1961), Ch. II. See also his article, "The Residual Equity Point of View in Accounting," *Accounting Review*, June, 1959, pp. 3 ff.

however, that there is still plenty of scope for many further developments of this kind before the significance of uncertainty in economic and social affairs is likely to be seriously undermined.

One such potential development which may be suggested as having particular interest for accountants lies in the area of so-called price level changes. The traditional approach in business activity has been that changes in prices of commodities and services is an element of uncertainty rather than of risk, and that part of the "entrepreneurial" function has been to shoulder the effects of such changes. It is conceivable, however, that part at least of such changes may be susceptible to interpretation by means of the techniques of statistical probability. If this proves to be the case, and to the extent that it does, then the problem of meeting these changes may be shifted from the area of uncertainty to that of risk, and suitable techniques, even possibly including that of insurance, could be developed whereby the incidence of price change upon individual persons or organisations would be considerably diminished.

One concept which has become familiar to accountants in relatively recent years and which is related to the notion of uncertainty is that of return on capital in respect of specific projects. Although in practice this concept is somewhat obscured by varying interpretations of capital—capital initially invested, average capital employed, and so on—and the appropriate arithmetical methods of calculation—pay-back period, discounted cash flows, etc.—are still under debate, the discussion is directed towards the attempt to shift from the area of unpredicatable uncertainty to that of calculable risk the likely results from contemplated alternative courses of action in respect of incurring outlays of a capital (that is, long-term) nature.

Another direction in which the notion of profit as a reward for undertaking risks has been explored by accountants is in connection with the valuation of goodwill and of shares in companies. P. D. Leake's concept of "super-profit" was a concept of risk-reward[13]; in measuring it, a return on capital, consonant with the risk characteristically involved in a given type of enterprise, is one of the elements of the "economic expenditure" to be

[13] P. D. Leake, *Commercial Goodwill* (London: Pitman, 1921), pp. 19-21.

deducted from revenue in order to arrive at the super-profit. The degree of risk may vary from case to case and depends upon the nature of the industry, the state of the money market, the judgment of the calculator and (perhaps unconsciously rather than consciously) the purpose of the calculation. The resulting measure is not to be regarded as being of absolute validity, and in practice is but a starting point for negotiation, which is the purpose of the calculation. However, the point here is that the notion of risk-reward is not altogether unknown to accountants, but the normal measure of profit or gain cannot be taken to be an attempt to represent it.

The analysis of the reward concept lies properly within the domain of the economic theorist rather than that of the accountant. Consideration of it gets back to the personal aspect of economic and social activity. The incentive behind any given activity is a prospective benefit to be derived from it; insofar as this benefit is a recurring one measurable in monetary terms it may be regarded as income, but it is as well to recognize that the benefit may take other forms. An increase in wealth, or an increase in power, or a feeling of greater security, or even, perhaps, the personal satisfaction of being able to point to a record of gainful results may be the operative incentive behind a commander's decision to engage in what he hopes will be a profitable venture; and this depends ultimately on the subjective scale of values of the particular commander. The commander pursues profits on ventures because each profit earned increases resources; the resulting greater quantum of resources is but the source of the benefit which the commander is really seeking; and the benefit is a personal thing. Hence it is the expectation, or rather hope, of benefit which motivates commanders in their activities; and here once again we find an emotional basis for so-called rational action. Thus economic activity is only "rational" if a certain emotional outlook is assumed, or, perhaps more accurately, it might be put thus: Given emotional outlook *X*, certain "rational" activity *x* follows logically; given emotional outlook *Y*, certain other "rational" activity *y* follows logically.

Professor G. L. S. Shackle has expressed a somewhat similar thought as follows:

> It is not the recorded profit itself of an interval already past that directly induces a businessman to invest his capital in buying the equipment to start a new firm or to extend or modernise an existing one. If he decides thus to invest his capital rather than keep it in the bank, if he decides upon one project rather than another, he does so because of the future profit that he can visualize with more or less vividness and sense of realism, as a possible consequence of such investment. These imagined consequences or expectations may indeed spring from his contemplation of past profits gained by others or by himself, in enterprises which had some features in common with the one he now proposes. But that is not to treat the expected and the past profit as the same thing, which conceptually they cannot be.[14]

It would appear that there is at least an implicit recognition by accountants of the distinction between the two concepts of profit as result and profit as incentive; while it is universally agreed and accepted that the measurement of result is one of the central tasks of the accountant—indeed, it is argued by many writers and practitioners that it is *the* central task—there is a strict professional institutional embargo on his lending his name to any estimate of future profits or gains which might be used publicly as an inducement to others to invest resources in an enterprise.[15] Members of the profession of accounting apparently do not wish to take up the role of public prophets or forecasters of future results, although private estimating, as in the preparation of budgets or the calculation of goodwill, is recognised as one of the normal day-to-day tasks of an accountant, whether in public practice or not. The job of prognosticating is regarded as being one for the commander rather than for the accountant.

VII The Destination of Profit

The notion of "profit" can be used as an incentive to economic activity when it is thought of as a goal to be aimed at. It can be viewed as a reward for the "right" sort of activity. In this section, we have to consider what happens to profit, in the sense that if it is to be an incentive and a reward it must be capable of being

[14] G. L. S. Shackle, *Economics for Pleasure* (Cambridge: The Cambridge University Press, 1959), p. 110.

[15] Cf., for example, American Institute of Certified Public Accountants: *Code of Professional Ethics* (New York: The American Institute of Certified Public Accountants, 1962), Article 2.04: "A member or associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast." (pp. 31-32).

used in some way by those to whom it is such an incentive and reward.

It is common usage in business, economic and accounting literature to say that profits can be used for payment of dividends or providing for replacements of equipment or that they can be ploughed back into a business, and so on. Can we be precise in importing meaning into expressions such as these and does this throw any light upon the problem of profit? In a legal context, the question of divisible profit has attracted considerable attention from both accountants and lawyers because the courts and the legislature have paid some attention to criteria for determining—in specific cases—the amount of profit or gain than can legally be paid out as dividends to shareholders. The legal and business policy implications of making inroads upon the "capital" of an enterprise through excessive dividend payments have had an influence in the thinking upon this subject.

We have already drawn a distinction between enterprise gain and proprietary withdrawals (for example, in the form of dividends) and it is necessary to reiterate this distinction when we come to consider the relation between them. While proprietary withdrawal is not the only way in which profit or gain, when once ascertained, may be used, it may well be considered first, in recognition of its significance as the analytically, if not also the historically, original destination, so to speak, of profits.

The position may be approached by considering a simple example. Suppose the following are the assets, liabilities and proprietorship of an enterprise at two points of time and its profit and loss statement for the intervening period:

	Point 1	*Point 2*
Cash	£1,000	£ 200
Debtors	2,000	3,000
Merchandise Stock	4,000	5,000
Motor Vehicles	2,000	6,000
Land	4,000	4,000
	13,000	18,200

	Point 1		*Point 2*
Creditors	3.000		5,000
X Capital	10,000		10,000
X Current Account—Gain		4,000	
Less Drawings		800	
			3,200
	13,000		18,200

Profit and Loss Statement

Sales		£20,000
Less Cost of Goods Sold—		
Stock at Point 1	£ 4,000	
Purchases	14,000	
	18,000	
Less Stock at Point 2	5,000	
		13,000
Gross Margin		7,000
Less Expenses		3,000
Net Gain		4,000

A gain has been "made," that is to say, the activities of *X*, in his capacity of commander of the resources listed as at Point 1, have increased those resources to the state as listed at Point 2. The resources at the latter date, however, represent a result not only of these activities of *X* but also of another type of activity by *X*, namely, as a proprietor exercising the right of withdrawing some resources from the "enterprise" to dispose of in a manner not related to this particular enterprise. As commander of the "business," *X* is commander of these resources as a manager; when he withdraws resources for his private use, he exercises his alternative capacity of proprietor. Admittedly, he is still commander of the £800 he withdraws, but his command is in terms of personal consumption or investment and not in terms of activity related to the other "business" resources. Because of this

withdrawal, the activities of *X*, although resulting in a business gain of £4,000, have provided a net increase in business resources of £3,200.

The position could be set out in a statement such as the following:

Gain for period per Profit and Loss Statement		£4,000
This gain is reflected in:		
Assets increased—Debtors	£1,000	
Merchandise Stock	1,000	
Motor Vehicles	4,000	
	6,000	
Assets decreased—Cash	800	
	5,200	
Liabilities increased—Creditors	2,000	
Net increase in business resources reflected in balance sheet items	3,200	
Withdrawals by *X* for private purposes	800	
		£4,000

This statement of the "disposition" of gain says, in effect, that of the £4,000 gain, £800 has been "used" for the proprietor's private purposes, the remaining £3,200 being "ploughed back" or "reinvested" in the business. These latter expressions are open to some possible misinterpretation, or at least often appear to give rise to a misplaced emphasis. The use of verbs such as "ploughing back" suggests a deliberateness which is not always or necessarily a valid inference. A more precise way of expressing the position would be to say that the business activities of *X* during the period resulted in a net increase in business resources of £4,000; this is what we call business gain and it may also be expressed as an excess of business revenue over all appropriate charges against such revenue; business resources of £800 were withdrawn by *X* for his own private purposes; the remainder of the net increase in resources (that is, £3,200) was left for future deployment. In other words, the positive and deliberate activity is that of withdrawal of resources for non-business commander-

ship; the non-withdrawal of business resources (or "ploughing back") is not an activity, it is a refraining from activity.

Thus every venture which is profitable results in an increase in resources; indeed, the profit on a venture is simply the measure of such increase. When the ventures in a given period are taken together, the net gain is also a measure of an increase in resources. This is not an uncommon view of the concept of profit; for example, it is well established in law, as is evident from the much-quoted opinion of Fletcher Moulton, L.J., when he said:

> "Profits" implies comparison between the state of a business at two specific dates, usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates . . . we start, therefore, with this fundamental definition of "profits," viz., if the total assets of the business at the two dates be compared the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.[16]

Two points of interest in the present context are included in this exposition of profits. First, as has already been suggested, the comparison of assets at two dates is not, contrary to the learned judge's specifications, the *only* means available of arriving at a figure of gain for a period, but, whatever other method is used, there is an implication that the result will be the same as that ascertainable by the use of this method. However, it seems likely that the learned judge, in setting forth his proposition, was expounding the same basic notion as the one now being put forward, namely, that a figure for periodic gain (or wane) is a measure of an increase (or decrease) in net resources between two given points of time. "Profits" as such do not exist in themselves, but only in resources, that is, in things and rights. It does not seem to matter greatly whether the profit figure is regarded as a convenient expression and measure of a change in resources, or whether the change in resources is regarded as expressing and measuring a "profitable result"; the significant point is that "profit" and "profitable result" are notional and that reality lies in the things and rights that constitute the resources. Thus an expression such as "divisible profits" is only a shorthand way of speaking; what

[16] *In re* The Spanish Prospecting Co. Ltd. (1910) 103 L.T. 609.

is meant is to suggest a measure of the resources which may be distributed or withdrawn from an enterprise. When we say that the divisible profit of a concern is legally (or safely or prudently) so much for a given period, we mean that during that period its resources have increased by the amount of such gain and that this increase represents an upper limit to the quantum of resources which may be legally (or safely or prudently) distributed or withdrawn. We cannot distribute or withdraw "profit" but we can and do distribute or withdraw resources, whether in the form of cash or kind or rights (such as shares). The function of profit or, more specifically in our suggested terminology, of gain is that of a measure; it is nothing more. As Professor Sewell Bray put it,

> the first legal principle asserts that dividends may be paid only out of profit and not out of capital. To the accounting mind this is more accurately expressed in terms that dividends may be paid only to an amount not exceeding profit.[17]

The second point is that, while it may well be that, as suggested by Professor Bray,[18] the judge had in mind the introduction or withdrawal of monetary resources when he referred to "capital," the formulation of his proposition is sufficiently wide to permit an interpretation of it in terms of non-monetary resources as well. It is true that legal judgments have interpreted the integrity of capital and the contributions or withdrawals of capital in terms of money, but this does not preclude irrevocably or for ever the interpretation of such a proposition as the above in non-monetary terms if a suitable and socially (including legally) acceptable measure could be devised as an alternative to money. In those circumstances, the Fletcher Moulton definition would be an expression of "real" profit or, rather, of "real" gain, but dividends, withdrawals and any other items of disposition or outlay would also need to be expressed in the same terms.

Another aspect about which there appears to be some misconception is related to the "use" of "retained" earnings. When an

[17] F. Sewell Bray, *Precision and Design in Accountancy* (London: Gee & Co., 1947), p. 60.

[18] F. Sewell Bray, *The Measurement of Profit* (Oxford: The Oxford University Press, 1949), p. 48.

amount is transferred to a reserve,[19] it is thought by many people that by some magical process this serves to strengthen the financial position of an enterprise. What actually happens, of course, as every accountant knows (but as some occasionally appear to forget), is merely that an entry is made whereby one account, Appropriation account or Earned Surplus account or one with an equivalent title, is debited and another account, Reserve account, is credited. The making of such an entry cannot possibly have, in itself, any effect whatever on financial position: the assets and the liabilities are precisely the same after the entry as before. All that happens is a shifting of an amount from one classification within the proprietorship category of accounts to another. What the entry represents, however, is a policy decision by directors to the effect that they propose to make unavailable for distribution to shareholders in the immediate or near future such amount as is transferred to the Reserve account. This does not mean that it will never be so distributed, and dividends, whether in cash or shares, declared out of reserves are not an uncommon occurrence. When such dividend is paid in cash, it involves then a decrease in the resources of the concern and it constitutes, in effect, merely a delayed transfer of resources from company to shareholder. When it is wholly in shares, all that happens is a further shifting from one category of proprietorship to another, namely, from the Reserve account to paid-up capital. In this latter case, the issue of the shares has no effect in itself on resources of either the issuing company or the receiving shareholders; what is significant is the implication that the future dividends of the company will be increased in total amount (even if at the same rate per share as before) and, therefore, the amount that each shareholder will receive as dividend is greater, if he holds the new shares, than before. If, on the other hand, he sells the new shares, the amount he receives in dividends will be the same as before, and he will

[19] The term "reserve" is used here in accordance with English and Australian, rather than American, usage, the former being somewhat more precise than the latter. Hence it does *not* refer to such items as "Reserve for Depreciation" or "Reserve for Income Tax" and the like, which sometimes arise in American usage; that is, neither so-called valuation reserves nor liability reserves are meant to be suggested here.

have benefited to the extent of the proceeds from the sale of the shares, but another shareholder will also receive dividends. Each of these alternatives again represents a delayed dividend and transfer of resources from company to shareholders.

If the reserve is not "used" in any of these ways, it means that the positive act of distributing resources is not undertaken. Only in this way and through this negation of action can the "creation" of reserves be regarded as having any effect on financial position. The same result could be achieved without any such transfer entry, that is, by simply allowing the balance in the "undistributed gains" account to accumulate. It can only be presumed that the effect of transfers to reserve accounts is psychological; it is certainly not economic or financial.

Giving labels to particular reserve accounts does not alter the situation in any way; a reserve for contingencies or for dividend equalisation or for plant replacement or for any other stipulated "purpose" is no different in character or origin from any other reserve; the difference in label is possibly an indication of the intention of directors at the time when the entry was made, but any such intention has no binding significance and there is nothing to prevent other entries being made subsequently to vary the amounts in the accounts. The legislature, however, has sought to make it compulsory for directors to disclose to shareholders the amounts transferred to and from reserves in any given year because, as a matter of practice and as a matter of prudence—abundantly borne out by experience—it is considered desirable that shareholders should be made aware of any proposal by the directors to recommend and pay a dividend the amount of which is not covered by the current year's gain, that is, by the increase in net resources that has taken place in the current year. It is thus accepted as a general principle that proprietary withdrawals of resources for a given period should be somewhat less than the accretion to those resources from the activities of that period; while there is no prohibition against withdrawing a greater amount than accrues, it is provided—at least for companies—that this should not be done unknowingly or under a misconception.

VIII The Concept of Real Profit

The expression or notion "real profit" has made its appear-

ance in a considerable amount of the accounting and economic literature of recent years. In particular, dissatisfaction with the measurement of profit and of gain in monetary terms and in accordance with orthodox accounting treatments has been widely manifest in periods of rising prices. Much argument has been put forward to convince us that the gains that have been arrived at are in some way fictitious and that some other procedures of measurement ought to be adopted that will provide us with an assessment of the "real" gain or wane which would be a more reliable basis for activity and policy.

However sympathetic one may be with these expressions of the shortcomings of profit measurement, it is necessary to become quite sure of the validity of any proposed substitute before making a change which would have considerable social implications. One question which it is necessary to clarify as a foundation to any further thinking about the matter is whether the notion of a real profit or real gain is in fact a valid one and, if so, in what sense and with what implications or restrictions.

In the kind of context in which the notion is significant, the word "real" appears to have at least two different meanings. In some cases, it appears to be used in the sense of meaning merely "non-monetary"—a generalised meaning much beloved by economists when they speak of such things as "real wages" and "real income." The second sense is that of physically existing; this sense is also much used by economists when they are writing about "real" assets.

In general, the purpose behind the notion of such a concept as that of real wages or real income is to correct an erroneous interpretation of the benefit or drawback accruing from a change in monetary wages or income when there has been some change in the prices of goods and services on which the wage or income is normally spent. Fundamentally, it is of significance in measuring individual, personal consumption or, more specifically, power to consume. The fact that a person has doubled his income over the past ten years does not necessarily mean that he is better off in terms of what he can buy with his money, if the prices of the goods and services in which he is interested as a consumer have more than doubled during the same period. The application to the figure of income of an appropriate index of prices at each point

is necessary to obtain a measure of the real wages or income.

The important thing to note for our present purposes is that, whatever secondary and tertiary applications of the notion may have been made, it is primarily and fundamentally a notion of "well-offness" in relation to individual consumption.

In examining the validity of the notion of real profit, it is necessary to reiterate the proposition that profit is related to and, indeed, springs from some kind of business activity. Admittedly, activity may be undertaken by or on behalf of a social unit whose primary objective may be anything but that of making an overall profit or gain on its activities, but to the extent that it does engage in activities that result in profits (or losses) they are business activities. Thus, an educational institution is not set up with the objective of making profits and accumulating assets; nevertheless, it may buy and sell books primarily as a service to students and to this extent it is engaging in business activities, since one measure of its success in this endeavour is the resulting profit or loss.

The significant procedure in the measurement of profit and of gain in the modern context is the matching of relevant flows of revenue and appropriate charges against the revenue. Profit or gain can only be real in the second of the senses indicated above, that is, in the "physical" sense, if the components from which it is derived—revenue and charges—are themselves real in the same sense. It is not easy to conceive of an instance—even a hypothetical instance—where this would apply. If we take the case of a landowner who raises wheat on his own land, and pays his labourers in wheat, sets aside a certain quantity each season for seed, and pays all his other expenses in wheat, it may be thought at first sight that his "surplus" of wheat in any given season is surely a real profit or gain. But is this the case, or have we here merely an instance in which wheat is the money and the gain is being measured in a currency of wheat rather than a currency of paper or other socially recognised tokens? For the labour he uses is not itself wheat, it is human effort which it is convenient in this instance to measure in wheat. And the other charges, apart from that of the seed for the next season, are also effort in terms of something other than wheat but measured in wheat for purposes of convenience. Hence we have, even in this over-simplified and hypothetical instance, not a real gain as such but a gain measured

for convenience in terms of a commodity rather than a socially acceptable token; in other words, a commodity is taken as the medium of exchange and the measure of effort and of other commodities and services.

Again, consider the case of a man who (a) buys, say, ten refrigerators at £100 each; (b) sells them at £150 each; and (c) buys fifteen others at £100 each with the proceeds. He now has fifteen refrigerators compared with the ten he started with. Can we say that he has made a profit of five refrigerators? The answer is bound up with our interpretation of when profit arises. If we agree that the buying and selling of a commodity (or a batch of articles) constitutes the venture in respect of which profit can and should be determined, this means that the profit arises at event (b), and is necessarily measured in the monetary terms, that is, £500, the difference between the cost, £1,000, and the revenue, £1,500, of the ten refrigerators. If, however, we wish to be able to speak of a profit of five refrigerators, we must accept the proposition that the replacement of the goods is the point of profit determination and that what happens after event (c) has no bearing on the profit up to that point. We can put it this way. Taking the possession of the ten refrigerators as our starting point (that is, immediately after point [a]), we can say that (b) he buys £1,500 with them and then (c) sells the £1,500 for fifteen refrigerators. But, put in this way, are we not merely getting back to the position that, if we are going to measure our profit in terms of refrigerators, we are thinking of refrigerators as our means of monetary exchange, that is, we are simply using a different kind of "money"?

It thus appears to be impossible to conceive of any real profit in a primary, physical sense. Profit must surely be a result in terms of the unit adopted for the measurement of events, whether this unit be money, wheat, refrigerators, cowrie shells or elephant tusks. "Real" profit in a primary, physical sense is meaningless.

We are left, then, with the notion of "real profit" in the sense of what can be bought with it. But this is a concept of spendability, an income concept and not a profit concept at all.

The fact, of course, is that profit as such and gain as such are not expendable at all; they are merely measures of the result of effort. It is resources—cash resources principally—that are expend-

able, and the usefulness of the profit or gain measure is that it indicates the extent of the addition to resources (that is, net assets) that has occurred through given activities and sets a limit beyond which the use of resources for spending may be (but only may be) unwise if the continuance of such activities is envisaged.

The word "spending" and the concept which it represents have a somewhat different meaning in the context of business profit from that in the context of individual income. The "spending" of resources by a business, that is, outlay made in the course of business activities, is not an act of "consumption" as is spending made by an individual in his capacity of consumer. In other words, a business enterprise or activity is undertaken with the objective of increasing resources, not with the objective of providing physical or psychological satisfaction as is the case with individual spending. True, there are some objects of expenditure which are common to business activities and individuals, and it may sometimes be difficult for social and economic purposes to distinguish cases of individual consumption from business outlays. For example, take the case of a motor car. If acquired by an individual for his own private purposes, it is a means of affording him certain satisfactions which can truly be assessed only by him. If it is acquired "by" a business, the acquisition would have the purpose of contributing, directly or indirectly, towards the current or future profit, that is, towards an increase of business resources. There are many borderline cases, however, in which the one vehicle serves both purposes, being used for part of each week as a business asset and for part as a private satisfaction-source. This situation is well recognised for taxation purposes, and the apportionment of costs incurred in connection with a vehicle used for both private and business purposes is a common taxation phenomenon. This is an example of the recognition (whether conscious or not) of the distinct functions of such an asset, and an implied recognition of the point being currently made, that there is a difference in kind between outlays made for business purposes and those incurred for private individual satisfaction.

Thus, for a business enterprise or activity as such, any outlay is made for business purposes only and not for "consumption," that

is, private purposes, at all. It is made with the intention of furthering business interests, and not for personal satisfaction in any non-business sense. As profit is a measure of the extent of improvement in business interests, it is necessarily measured in a unit which is common to business activities of various kinds. A monetary unit is the only generally acceptable unit devised to date for this purpose; indeed, by definition, any unit which does gain general acceptance becomes the monetary unit of a community. Hence to speak of profit (or gain) in "real" terms is largely meaningless.

It remains to consider the situation in a barter economy. Without indulging in fanciful hypotheses of conditions of "trade" among imagined primitive peoples, we can consider the case which Professor W. T. Baxter describes as having existed in the eighteenth century in the British colonies of North America.[20]

> We are in danger of misunderstanding much of the Hancocks' trade if we think of it in terms of disconnected incidents. Because of exchange difficulties, a transaction could seldom be judged on its own merits; it was part of an elaborate cycle. The oil shipments must not be regarded as isolated ventures, but as remittances in exchange for manufactures; and, when these reached Boston, they too might be sold for more goods, and not for money. Thus a transaction cannot be appraised *in vacuo.* Under a barter economy a merchant could hardly speak of losses, unless a long round of dealings left him with fewer assets than he had at the start.[21]

The direct implication of the last sentence is also that under a barter economy neither could a merchant measure his profit or gain unless at the end of his round of dealings he had more assets than he had at the start.

There is, however, a further implication in this passage, namely, that the absence of a measure common to the assets at the beginning and at the end of a round of barter exchanges precludes us from saying that a profit or a loss has been made through the series of barter transactions. Thus John Hancock shipped oil from America to England and received manufactures in return; these were exchanged, on arrival in Boston, for other goods. Professor Baxter's point is that, unless these other goods were then or event-

[20] W. T. Baxter, *The House of Hancock* (Cambridge, Mass.: The Harvard University Press, 1945).

[21] *Op. cit.,* pp. 175-76.

ually exchanged for oil, there is no means of determining whether Hancock had made a profit or loss in his ventures. That is to say, the measure applied in this case would have to be a unit of oil, and, while in such a case it is not a medium of exchange, it is a measure of value. The profit in terms of oil is "real" in the physical sense, but this only leads us to the further question: So what? Is there any particular virtue in having a measure of profit in such terms? It is only useful if we can translate it into some other terms, that is, into what it will buy in some generalised unit. If we eventually arrive at the point where we can say that Hancock made a profit of 100 barrels of oil, we do not know whether this is, in itself, a substantial or a negligible profit. We need something else to which we can relate this result. We need to know, for example, that with 100 barrels of oil he could have acquired a carriage and four horses, or that he could have paid the wages of two servants for a year; alternatively, we need to know whether he started off with 200 barrels of oil or 10,000 barrels.

In its absolute terms, a profit figure can only have meaning if the unit in which it is expressed is a unit of the medium of exchange and can be translated readily into terms of buying power. With a monetary unit, we make such a translation through habit and long usage, because an expression in money *is* an expression in terms of buying power. That it is not a stable unit at all times only means that our society has not yet achieved an ideal monetary unit *in terms of other commodities and services.* The money we use is, nevertheless, an expression of buying power of any and all commodities which are the subject of exchange transactions.

Further, a particular profit figure, even in monetary terms, has significance only by comparison with some correlative and compatible base to which it can be related. A profit or gain of £100 finds its significance when compared with the amount of profit or gain, expressed in the same unitary terms, of the previous year or a previous venture or series of ventures, or with the amount of capital or assets employed in the activity or activities under review, or some such base. It is meaningless to compare a profit of 100 barrels of oil with a capital of £1,000 or with a profit of 500 furs unless we can translate the oil into monetary terms or into furs, respectively.

IX When Does Profit Arise?

When we come to consider the problem of measuring the profit arising from a specific set of activities—the problem that accountants face as an everyday task—a basic, but sometimes difficult, question that soon arises is that of determining the point at which profit is to be taken as emerging.

In the isolated, single unit trading venture, there is generally little difficulty. If *A* buys, say, a book and pays ten shillings for it and shortly afterwards sells it to *B* who pays him fifteen shillings, there are few people who would doubt that *A* has derived a profit of five shillings from these activities and that the point at which the profit arose was that at which he sold it to *B*.

Suppose, however, that *B* delays payment for a long time or, worse, suppose that *B* does not pay at all? Does the point of sale still represent a point at which a profit was made? *B* may have agreed to pay when he took the book; indeed, he is legally obliged to pay; but if he does not pay at all or, as might well happen, if he pays something less than fifteen shillings, what is the amount of profit (or loss) and when does it arise?

Or suppose that *A* buys a dozen books at ten shillings each and sells seven of them at fifteen shillings each, the remaining five having to be sold eventually for, say, three shillings each. Does a profit or loss arise on the sale of each book? Suppose that, if he had bought each book singly as required, the cost would have been, say, twelve shillings per book, the reduction to ten shillings apiece being a condition of ordering the dozen quantity. This introduces the element of risk. By buying each one as required he would make a profit of twenty-one shillings on his sales of the seven, but by taking the dozen he takes a risk of not getting his sale price on some of them or, indeed, on any of them. If profit is regarded as a reward for taking risks, does this help in any way in determining the point at which it arises?

Another aspect presents itself when raw materials are fabricated into finished goods, and costs of production, additional to those of material costs, are necessarily involved. Does the outlay of these costs, by increasing the "value" of materials in process of manufacture or of finished goods on hand, contribute to any kind of profit determinable before the point of sale?

It is desirable to begin analysis with the simplest type of venture, such as that of the purchase and sale of a single article. As we have seen, profit is a measure of an increase of resources arising from trading activities, and there can be no doubt that, in the case first mentioned above, the increase in *A's* resources from a book which had cost him ten shillings to cash of fifteen takes place at the point of the cash sale. It cannot take place either before or after.

Where payment is delayed, what happens is that, in addition to the trading venture of purchase and sale, a financing venture is undertaken. From *A's* point of view, there is an increase of resources, and hence a profit, at the moment of sale; this is a profit on the trading venture. If *B* does not pay, or pays less than the total sale price, there may be a subsequent loss (which may be set off against the trading venture profit in arriving at a periodic gain figure), but it is a loss on a financing venture; *A* has supplied resources to *B* who, instead of repaying them in full measure at a future date, pays something less or defaults altogether.

A difficulty that arises in practice, and one which has contributed to some obscurity in thinking about this point, is that, whereas the trading ventures can normally be determined clearly and are usually (though not always) of relatively short duration, financing ventures may be long drawn out, and the need to arrive at a figure for periodic gain means that many of these financing ventures, the outcome of which cannot be clearly and certainly foreseen, are incomplete at balance date. It is thus in relation to financing ventures that some formula of probability is applied in arriving at an estimate of possible loss through the incidence of so-called bad debts and doubtful debts.

Where a number of articles of the same sort are traded in, the problem is one of deciding what the unit of trade is in a particular venture. In the case of the twelve books bought at a given price and sold at varying prices, the venture of trading in the whole twelve is not completed until they are *all* disposed of, and any assessment of result prior to that point can only be an interim or progress determination of revenue rather than an assessment of profit. That is to say, before it can be said that a profit has been made, it is necessary that the resources laid out in acquisition of the trading unit should have been recovered through

the event or events of sale. In the example cited above, the acquisition outlay of resources amounted to 120 shillings for the twelve books. When seven had been sold, the interim revenue amounted to 105 shillings and it cannot be said that the venture had resulted in a profit or a loss; it was incomplete at that stage. It is true that the resources (in respect of this venture) at that point comprised five books in addition to the 105 shillings, but to put any sort of value on these five books involves an anticipation of profit (or loss) and does not in itself produce increased (or decreased) resources. It may be expedient or prudent or even over-optimistic to make some such anticipation, but this does not affect the position that the profit on the whole venture, and particularly in relation to the five books still unsold, is indeterminate until the venture is completed, that is, until all twelve are sold.

In such cases as this in practice, however, with a multiplicity of similar concomitant ventures, the separateness of each venture is taken cognisance of only for particular purposes, and the unit adopted for the purpose of determination of periodic gain is, in effect, the smallest identifiable unit within a batch rather than the quantity of units comprising the lot in each venture. That is, in the illustration under consideration, it would normally be considered that each book of the twelve bought cost ten shillings each; this is an average cost and is not in accord with what the cost would have been if each book had been bought individually; it is nevertheless taken to be the actual cost of each unit. Thus a unit "profit" is arrived at in terms of an amount per book; but it should be recognised that this is a derived and not a natural result, so to speak. Strictly, in a case like this, we can only impute such a unitary result, because our trading venture deals with the twelve books and not with one. However, the process of matching which nowadays produces a figure for periodic gain rests upon just such imputation of unitary results. It is not suggested that there is anything wrong with this, but it is important that we should be clear about what we are actually doing. And what we are doing is to say that, on the basis of an imputed cost, profit arises on every sales transaction and to regard each profitable sale as involving an increase of resources. No difficulty arises here for ventures which are completed within any given accounting period; but where ventures are not completed, the problem of

valuing inventories on hand at balance-date has given rise to varying interpretations, some of which will be considered in Chapter 15. What we are concerned with at present is the recognition that this problem is bound up with that of saying when profit arises.

Where materials are fabricated into some other form of finished goods, the position is greatly complicated. It is sometimes argued that the profit resulting from the sale of finished articles at a price in excess of the sum of the costs of the raw materials and fabrication and other relevant expenses accrues steadily during the process of manufacture. In those relatively rare cases in which all the materials and all the expenses can be unequivocally identified with the finished article, the position is that the acquisition aspect of the venture is composed of a number of separate buying events; this does not affect the fundamental nature of the venture and the profit arises no less at the point of sale than in the more simple case. In the construction of a bridge or a dam, for instance, the venture comprises (a) the purchase of all the requisite materials, (b) the purchase of the services of employees who work on the construction, (c) the purchase or hire of machinery and equipment used in construction, and (d) the "sale" of the finished product at the contract price. In one sense, the "sale" may take place before any phase of construction begins, which means simply that the selling price of the finished product is known before any of the costs are actually incurred or paid and before the construction is undertaken, but this does not in any way constitute a profit-producing event. Profit can only be determined when both the sale price and the total costs are known and therefore it cannot "arise" until the work is completed. Anything prior to that may be a progress assessment or estimate but it is not unequivocally a profit.

This concept of profit is different from the concept of "value added" which is often used in economic analysis. It is not sought here to deny that the expenditure of effort in fabricating materials does add "value" to them, but it is sought to emphasize that this kind of value is conceptually different from the profit which we are thinking of. There is certainly no causal relationship between them. For it often happens that the "value added"—as measured by the financial cost of the fabricating process—is not

"recovered" in the selling price; in other words, there is a net decrease in resources after a particular venture and therefore a loss. That is, although the "value" of the finished product is greater than that of the raw materials, the price it brings does not necessarily cover *all* the costs incurred.

In some cases, until the fabricating process is completely carried out, the outlay of effort involved in it may make the materials actually less useful than they would have been in their initial, raw state. If "value" is added through the process of fabrication, it is not, in these cases at least, use-value. There are numerous examples where this happens, and as one instance we may consider the homely example of a pair of scissors. As everybody is aware, a pair of scissors consists of two arms, of identical or very similar nature and function, which, when joined in a particular way, form an exceedingly useful cutting instrument. But the process of fabrication is not completed until the joining is carried out, and no matter how many single arms were available they would be virtually useless as such. It is only when they are paired and joined that the instrument has any use-value. Further, having been fashioned so far, the materials in the single arms are virtually useless except for the particular purpose for which they need the final assembling process.

If, then, one wishes to speak of "value added" through processes of manufacture or fabrication or the like, it must be recognised that this "value" is not necessarily either use-value or exchange-value; and the onus of defining the character of the value that is added lies on those who wish to use the expression or the concept. From our present point of view, we do not need to use this notion at all. The process of fabrication involves only a change in the form of resources, and whether this change in form constitutes an increase or decrease in quantum of resources can only be determined at the completion of a venture, that is, when the products of a fabrication process are in fact sold.

One piece of evidence that, in the absence of extraneous influences, accountants do tend to think of profit as arising at the time of sale lies in the treatment of profit on goods sold by one member to another of a holding/subsidiary group of companies and still unsold in the hands of the recipient company at the time of consolidation of the accounting reports. Although the vendor com-

pany has made a profit on *its* sale to the purchasing company, the convention of viewing the whole group as a unit is interpreted as having the consequence that the goods have not in fact been sold by the group as a whole, and, until it is sold, the already recorded profit in the books of the vendor is eliminated for purposes of consolidation. This appears to be a tacit admission that profit does not arise at any point short of completion of a sale to an outsider.

A problem may of course arise in practice where the duration of ventures of this sort is greater than that of the accounting period made necessary by fiscal or legal requirements. However, this does not affect the essential characteristic that the increase or decrease in quantum of resources cannot be determined until a venture is completed, that is, until all the events of acquisition, fabrication and sale have taken place, whatever may be the order in which they take place. Interim or progress payments on the construction of a bridge or a dam or on the erection of a building, for example, may contain a profit element, so to speak, only *by imputation* as they are made, and only *in fact* in retrospect and by allocation. Thus a periodic gain figure in cases such as these constitutes an abstraction rather than an accrual to date.

Another problem in practice arises from the fact that few ventures of this sort are completely self-contained. In the vast majority of cases, some elements of cost are common to several ventures. These are the so-called overheads, and their existence means that the profit on particular ventures can rarely be assessed with anything like an absolute accuracy, and can only be arrived at by some use of imputation or allocation. It is not likely that all the energies of all the people and all the equipment of a concern will be concentrated on one task from its inception to its completion; hence it is practically certain that there will be *some* overheads and that therefore some allocation will be necessary. That is, there is practically always some arbitrariness in a figure of profit even if it is subject to rationalisation by argument. This situation arises not merely because of the so-called continuity of operations of enterprises but also because of the simultaneous undertaking of numerous ventures without a completely separate organisation of resources and personnel for each one.

CHAPTER 14

The Problem of Control

I The Meaning of Control

THE WORD "control" has an interesting origin. According to the standard dictionaries (such as Oxford English and Webster's International) it is derived from French, and ultimately Latin, words meaning "against" or "counter" and "roll." Originally, "to control" appears to have meant to check or verify by comparison with a duplicate register. The Oxford English Dictionary cites the following illustration, dating from 1475, in support: "To controlle the receytes & all the yssues of the Thesaurers office."

This original meaning is not unlike that in which the word is used in the modern narrowly accounting context of "control accounts" which represent in summary the mass of detail recorded in subsidiary ledgers. The use of the term "control" in this context, however, is relatively recent because the procedure to which it applies has become necessary only with the need to minimise the bulk of information recorded in the main accounting record, namely, the general ledger. Harry C. Bentley defined a "controlling account" in 1911 as "one kept in the general ledger for the purpose of controlling (i.e., proving the accuracy of) some subsidiary record."[1] H. R. Hatfield, writing in 1908, said that the term "Adjustment account" is "used somewhat ambiguously, and, especially in England, signifies what is known as a Collective account, or, in recent American nomenclature, a Controlling account."[2] A book published in the United States in 1904, while

[1] Harry C. Bentley, *The Science of Accounts* (New York: Ronald Press, 1911), p. 29.

[2] Henry Rand Hatfield, *Modern Accounting* (New York and London: D. Appleton & Co., 1915 printing of 1909 edition), p. 119.

using the method, does not use the term either in the text or in the illustrative example.[3] It thus appears that the introduction of the expression in the United States in the first decade of the twentieth century was, in fact, a reversion to what was virtually the original meaning of the word in the fifteenth century.

While this is an interesting philological sidelight on the use of a word, it is not the relatively narrow technical sense of the word that we are primarily concerned with in the present context. We are concerned with the relationship between accounting functions and functions of control in a much wider sense, and it is therefore necessary to make some attempt at determining what people mean nowadays when they talk about control. The difficulty is that it is a fairly elemental notion which so often is comprehended at a general conceptual level which, in turn, is, for the most part, adequate enough for day-to-day purposes. Despite the difficulty, however, some analysis must be attempted.

From the original meaning there was derived a second sense of calling to account, reproving (a person), reprehending, objecting to (a thing). This sense appears to have largely disappeared from common usage. But a third meaning given by the Oxford English Dictionary is very much in contemporary use; this is the exercising of restraint or direction upon the free action of something or somebody, and so, domination or commanding. This meaning also goes back a long way in the history of our language, the dictionary citing Shakespeare in support of it (Othello, V, ii, 266): "But (oh vaine boast) who can controll his Fate." The notion of restraint is at least very common in the use of the idea of control. When we speak, for example, of self-control or parental control or price control (or economic controls in general), there is undoubtedly the immanent thought of restraint upon what might otherwise be chaotic activity. There is a pattern of order, conformity to which can be enforced by the person or thing in control. Suppose, however, that the pattern of order is not well-defined or that conformity to it is, for whatever reason, not enforced or not capable of being enforced. We can—and often do—say that control is weak or even absent; for example, a person may be said to lack self-control, or a family's activities exhibit an absence of

[3] I.C.S. Reference Library—*Bookkeeping* (Scranton: International Textbook Co., 1904). See Sec. 30, pp. 17 and 44.

parental control. There is a difference between having the responsibility for directing activities and being in control of them in this sense. A teacher, for example, may be in charge of a class, that is, in a position of responsibility for directing its activities, and at the same time not be able to exert the control required to direct those activities in an orderly way.

This distinction between being "in charge" and "in control" of activities or of a situation is important for our purposes, but the distinction often appears to have been overlooked, and one of the significant features to recognise in the relation between accounting functions and control functions is the gradation of control and controllability from no-control through partial control to complete control. That is, in relation to any given set of phenomena, there may be a state of no adherence to any particular pattern of order, or partial adherence or complete adherence —and this whether the pattern is considered desirable or not. The discovery or formulation of a pattern of order is a first step in the determination of means of control, and this applies in the area of natural phenomena as much as in that of social and individual behaviour.

Hence we have to consider, in relation to each of various categories of commander, the purpose of its control functions and how accounting functions and procedures can be expected to help in attaining or maintaining the kind of control envisaged. The several categories apposite to our study are those of owners, managers, creditors, employees, and the community in general (acting through communal government).

II Ownership Control

Ownership is a legal concept and is an expression of rights which a person can exercise against others in relation to a given thing, such as land or buildings or equipment, or to socially recognised rights, such as copyrights or leaseholds. Although there are serious difficulties in the legal concept,[4] they need not detain us here, as the notion of ownership has been accepted in all civilised (and many primitive) societies. Even private ownership is adhered to in most communities. Just as it is practically certain that

[4] For a brief discussion of some of these difficulties, see G. W. Paton, *A Text-Book of Jurisprudence* (Oxford University Press, 1946), pp. 386-93.

there is no community in which everything is privately owned, so there are very few, if any, communities in which there is no private ownership at all. The degree of private ownership varies considerably, however, even among civilised communities.

Jurists draw a clear distinction between ownership and possession.[5] In our present terminology, and for purposes of our present argument, it is convenient to draw this distinction in terms of ownership and command. The "owner" of a commodity under hire-purchase, for example, does not have command over it; the "hirer" has command over it, that is, he is able to use it for the purposes and intention that he has in mind in acquiring it. This command is unchanged at the end of the hiring period when the legal ownership changes and he becomes the legal owner as well as the commander of it. The owner of a factory who lets it to a manufacturer does not have command over it as a factory; and even though he may sell the property to another, this change of ownership does not affect the manufacturer's command over it so long as he retains the tenancy of the premises.

The distinction between ownership and management has often been noticed in recent accounting and business literature in relation to companies in which different people are involved as owners and managers respectively. However, the distinction in *function* is present even where different people are not involved. We must not allow ourselves to be blinded by the exceptional case of the sole trader. He is both owner and manager simultaneously, but the functions are nevertheless distinct, and we should not get ownership controls mixed up with management controls, even though in this case the one person is managing on his own behalf. A good deal of argument in economics is based on the activities of a sole trader with a subsequent transfer of reasoning to companies, without sufficient recognition of the difference in economic organisation between the two cases. What we need to recognise, however, is that ownership control is functionally different from management control even in the solely owned enterprise.

In a partnership, there is joint ownership and the right to joint management; from this point of view, a partnership is an exten-

[5] *Loc. cit.*

sion of the sole trader. But there are cases in which one of the partners is a silent partner, who acts as joint owner but takes no part in the management of the firm; from this point of view, the partnership is akin to the company.

Further, there are many companies which, although recognised as separate legal entities and complying with minimum legal requirements as to ownership of shares, are in fact sole enterprises for economic and business purposes. Others are family businesses in which there is an intimate connection between the owners of shares and the directors who ostensibly manage the affairs of the enterprise. And in most cases, even among the largest companies, one of the requirements for directors is to hold *some* shares in the company as a prerequisite to accepting the directorship.[6] The directors, admittedly, are not necessarily the whole of the management team; in some cases none of them may be an executive officer; but they constitute the policy-making body for the company and are charged by the shareholders with the responsibility of command over the company's resources, even though they may delegate this command.

The controls of ownership, which are to be distinguished from the controls of management, are largely, therefore, legal controls, but there are cases in which accounting information can serve these legal controls.

Let us consider first the case of a company as one of the forms of organisation to which a great deal of attention has already been paid in the literature of accounting, economics, law and business; it is a significant and familiar phenomenon of our modern society. It is also a case in which ownership can be isolated fairly readily, for purposes of analysis, from other aspects of economic influences. The company, especially the large public company, is the instance par excellence in which the functions of ownership and management are clearly distinguishable.

The shareholders of a company, and especially the holders of

[6] But see Lewis D. Gilbert, *Dividends and Democracy* (Larchmont, N.Y.: American Research Council, 1956), pp. 11-12, where he states: "The managers and executives, the chairmen of the boards, the presidents and directors, do not own American business. They merely act as though they do. . . . In fact one of our fights is to force the managers, the officials, the directors, to buy at least some stock on the open market at prevailing prices, at least one hundred shares, in the corporations which they manage."

ordinary shares or common stock, are generally recognised as the owners. It is they who provide the "equity" funds and it is they who possess residual rights to the assets of the company. (Admittedly, the effect of limited liability is to restrict their residual obligations to creditors of the company.)

What we have to ask, then, is: What is the pattern of activity which ordinary shareholders in a company would consider adequate or apposite to their interests, so that adherence to such pattern would give them the kind and degree of control over their resources appropriate to their function vis-à-vis the company?

We must remember that once an investor makes the decision to hold shares in a company he relinquishes effective command over the resources so invested, transferring it to those who are in charge of the day-to-day affairs of the company. In other words, the owners, in this instance, transfer their command over their invested resources to the managers of the company who, in one sense, are appointed to act on their (the investors') behalf. Such command cannot be resumed by the investors so long as they remain owners, that is, unless and until they sell their shareholdings in the company.

In return for the transfer of his command over the resources invested in the company, the owner gets (in those countries whose statutes have developed from English company law):

(i) command, in common with other owners, over the appointment of the directors of the company, that is, over the management commanders;
(ii) a residual right in the assets of the company;
(iii) a right to the profits of the company, in the form of dividends, subject to the judgment of the directors as to their legal and "prudential" divisibility;
(iv) a right, in common with other owners, to appoint auditors to examine the accounting and other records of the company and to safeguard owners' interests against illegal and imprudent actions of the company's officers.[7]

The constraints upon the effective commanders of a company's

[7] In the United States there appears to be a fairly strong trend in the direction of stockholder appointment of auditors, although there still seem to be many companies whose auditors are appointed by the management.

resources that are possible in respect of ownership comprise those that are conferred legally by statute, by the articles of association and by common law, and those that are conferred by the economic power to sell the shares held. The latter may affect share prices which in turn reflect the degree of confidence in the company and in its direction and prospects.

The pattern of activity that is envisaged in company ownership is expressed and measured in terms of the return on the investment made. As owners, the shareholders will be concerned (a) with the dividends paid and likely to be paid to them, which in turn involves consideration of the profit-earning capacity of the company, (b) with the security for their investment, for which the asset backing is a significant measure, and (c) with the potentialities of growth of their investment.

In order to obtain an assessment of the satisfactoriness of their interest in the company, shareholders may compare measures of these expressions of activity with (a) similar measures from other avenues of investment, such as the rate of return paid by other forms of organisation and the security afforded by them, and (b) the expectation of return when the investment was made. The two are not unconnected, since in formulating his expectations in relation to a given investment, an investor would normally and naturally have in mind the rate of return available through alternative avenues of investment.

The means of assessing their investments are not patently available to owners and it is therefore necessary for them, or for somebody on their behalf, to use instruments of accounting in doing so. Some accounting techniques have been developed which are of value in assisting owners in this assessment. This development has not been deliberately and wholly promoted with the interests of owners clearly in view, but they have been at least a partial inspiration in the development. Three of these techniques may be briefly considered.

In the first place, the technique of preparing periodical summary accounting reports from the accounting records has received particular impetus through the advent and progress of joint-stock companies, both of limited and unlimited liability. Until relatively recently, however, not a great deal of attention had been

specifically given to the question whether the periodical reports published by joint-stock companies were adequate to meet the needs of owners. In the English-speaking world, it apparently needed the shocks of the Kylsant case in England and the New York Stock Exchange crisis of 1929-30 to catalyse into rapid action the otherwise slowly developing awareness that investors were entitled to more adequate information about their company investments than was generally vouchsafed them. Since the 1930's, however, the requirements of investors and potential investors for information which would assist them in making intelligent and knowledgeable decisions in relation to the holding of shares in public companies have been given increasing attention. Thus, there are now statutory provisions under company legislation, recommendations and advisory bulletins emanating from professional acounting bodies, and regulations issued by stock exchanges and such institutions as the U.S. Securities and Exchange Commission, which lay down in considerable detail the form and contents of published financial statements of public companies. Much of this detailed advice and instruction has been initiated by concern for the position of the shareholders, that is, the owners.

At the same time, however, there has been little specific study of the nature of owners' investment decisions and of the adequacy of these reports in relation to these decisions. Owner-investment and creditor-investment have often been grouped together in consideration of the form of accounting reports for publication. Indeed, it is probably true to say that in the development of the form of the balance sheet since the turn of the century, the basis of classification of items has received the greater part of its formulation from consideration of creditor relationships rather than ownership relationships. The grouping of current assets on a time basis, for example, is clearly of importance in credit-granting (using this term in a wide sense) rather than for ownership. Accounting reports can be prepared for the information of different categories of people, and the needs of each category are different from those of the others. Development in this respect, however, has been mostly in the direction of general-purpose statements and not nearly enough attention has been paid to specific needs of each category. Some notable exceptions to this broad state-

ment, however, should be mentioned. The area of reporting for management purposes has been given fairly intensive attention for a number of years, and some of the results of this are considered in the next section. Also, an analysis of the needs of investors has been made by Professor George Staubus who has made a number of suggestions for the preparation and use of reports specifically designed to meet these needs.[8] The provision of half-yearly and quarterly reports to shareholders, which has been a feature of many companies in the U.S.A. for several years and has shown signs of beginning in other countries, is also directed towards meeting the needs of owners for more frequent information about their investments; in general, however, this information is of the same kind as and in somewhat less detail than that provided annually.

Closely allied to the technique of reporting, and subject to many of the same strictures, is the technique of analysis of reports and their interpretation. It is not necessary here to examine the whole area of analysis—as already noted, the relationships to be derived from the balance sheet and profit and loss statement of an enterprise have been worked out in detail over a considerable number of years and are commonplace topics in many textbooks on accounting.

One point we have to notice, however, is that the value of an analysis and, consequently, the validity of an interpetation depend largely on the standard of the reports being analysed. The starting point of analysis is the detail of items and amounts appearing in the accounting reports, and this detail must be sufficient to allow significant relationships to be calculated, and the amounts must be sufficiently dependable to validate the relationships when they are calculated.

Another point is that not all the derivable relationships are of equal significance to owners and other categories of interested parties. Many of them originated in and have primary significance for lenders of resources rather than investors, and even though some of these are of some secondary significance for owners, their development has not taken place with specific ownership requirements in view.

[8] George J. Staubus, *A Theory of Accounting to Investors* (Berkeley: The University of California Press, 1961).

Bearing these points in mind, we can consider some of the relationships, derivable through the technique of analysis from the normal published reports of companies, which have specific significance for owners.

Relationships relevant to the areas of owner interest postulated above are:

(a) Dividends and profits—
- (i) Dividends/paid up capital.
- (ii) Dividends/shareholders' funds.
- (iii) Dividends/stated profit.
- (iv) Profit/paid-up capital.
- (v) Profit/shareholders' funds.
- (vi) Operating profit/operating assets.
- (vii) Imminence of conversion of convertible notes into shares, which may affect prospects of dividends.

(b) Security for investment—
- (i) Total asset backing.
- (ii) Net tangible asset backing.
- (iii) Proprietary ratio.

(c) Growth potential—

No measures derivable from normal accounting reports appear to have been yet developed to give an owner any firm indication of his company's growth potential. The position of the company within the industry and of the industry within the economy are significant influences, as well as the efficacy of the management team to whom the owners have entrusted the custody of their resources.

The third technique which has been developed on behalf of owners has been that of auditing. Auditing has a very long history, throughout which it has been functionally and predominantly related to ownership interests; it is only lately that there has been any significant development, for management purposes, of auditing techniques, such as internal check, which scarcely goes back to the nineteenth century, and internal auditing, which is of even more recent origin; even they are sometimes erroneously regarded as ancillary to ownership auditing rather than as instruments of management control. It is true, of course, that the work of an "external" auditor can be very greatly diminished if effec-

tive systems of internal check and internal control are in operation; but, while he may suggest or even recommend the institution of such systems, the external auditor cannot himself institute them or operate them and their chief purpose is to ensure the custody of assets and the smooth working of procedures which are the direct responsibility of the managers; it is only indirectly that they affect ownership interests.

The principal functions of auditing have themselves changed somewhat over the past century or so, particularly in respect of joint-stock companies. Whereas the chief purpose of an audit of the early companies was generally interpreted as being that of safeguarding the resources of owners in the hands of company officials, this purpose, while still significant, has been overlaid with the more subtle requirement to report to shareholders that the statements of result and financial position presented to them by the company's officers are true and fair representations and, in the United States, prepared "in accordance with generally accepted accounting principles consistently maintained." The assumption behind this requirement is clearly that, given "true and fair" reports or reports prepared in accordance with accepted accounting principles, the owners will be able to make their investment decisions with intelligence and adequate knowledge, and any errors they may make in their decisions will be the result of their own faulty judgment. It is questionable, however, whether the reports presented to them, despite the assurance of the current audit report, are in practice adequate to meet this need. If they were, the phenomenon of take-over bids in the nineteen-fifties would hardly have been as widespread as it has been; nor would the provisions of the Companies Acts or the requirements of the Securities and Exchange Commission have needed to have been prescribed in the detail they have been in relation to the contents of published financial statements of the relevant enterprises.

At the same time, the efforts of auditors have ensured that the owners' interests have been well served by ensuring that the legal provisions prescribed should not fall into desuetude through non-compliance; in many cases, there is little doubt that the auditors, bearing in mind the interests of owners, have exerted their

influence, both as individuals and as a professional body, in improving the level of presentation of such reports to owners—both as to form and contents. Their task in this respect, however, is far from finished.[9]

It will be clear that there is a close relation in practice between the three techniques here considered. Adequate analysis cannot be carried out unless the accounting reports contain the requisite information; a principal object of a company audit is to ensure that these statements comply with appropriate standards of reporting.

III Management Control

It is in the area of management control that accounting techniques and procedures have reached their highest and widest development to date. This is readily understandable when we consider that it is the managers who have direct command of resources —whether, for example, they are owners themselves as in the case of sole traders, or selected as managers by the owners (directly or indirectly), or appointed as managers in a system of community or state ownership of productive property.

In the extensive literature of accounting, a large and growing proportion has been devoted to what is specifically called management accounting; this deals with the application of accounting procedures to problems arising in connection with managerial control. Much of the writing in other areas in accounting—the so-called financial accounting or general accounting—also has reference to problems of control of resources by commanders appointed by others. For example, the principal problem in trust accounting is to control resources with a view to protection of the corpus of the estate; the trustee is appointed by another—the settlor—and his activities are carried out for the benefit of still others—the beneficiaries.

We are here again concerned, however, not so much with managers or commanders as separate persons as with management or commandership as a function. Even in the case of a trust, the settlor and the trustee may, in specific cases, be the same person,

[9] Cf. Howard C. Greer, "How to Succeed in Confusing People Without Really Trying," *Journal of Accountancy*, March, 1963, p. 61, for a brief critical review of some of the difficulties facing the stockholder seeking to elucidate an annual report.

or the trustee may be one of the beneficiaries. Hence it matters little whether our commander is acting for his own immediate (and ultimate) benefit or for that of other persons; his functions as commander are the significant factor for our consideration.

There is scarcely an accounting technique which has not relevance to the problems of management or commandership control. For management command embraces not only the day-to-day problems which have to be faced but also the formulation and carrying out of long-range policies. The accounting task is to provide the commanders with all accounting information relevant to the making of the necessary decisions. In order to do this effectively, it is necessary for accountants to understand and appreciate the kind of decisions that have to be made and then to determine what accounting information is requisite to these decisions, how the information can be collected and the best form of presentation. A good deal of progress has been made in this direction, particularly in the past fifty years or so, and in more recent years the rate of progress has been increasingly rapid; however, there is still much exploration and experimentation to be carried out, especially as conditions of management activity and its environment are almost continuously changing. We can here only consider in outline some of the significant ways in which such progress has been made.

Analysis of accounting reports, even though it may have originated in an attempt to meet problems of creditorship interest or ownership control, has become an important instrument in managerial control. The emphasis here is naturally on analysis of operating reports of various kinds and detail, including the profit and loss statement, but balance sheet analysis can also be used to some extent for management purposes.

Analysis obviously depends upon the preparation of reports, and the reporting function is largely devoted in practice to meeting management needs. The variety of reports required by the several levels of management is legion, and there is much literature on the nature and contents of management reports. For management purposes, reports are needed at more frequent intervals than for ownership purposes, because management decisions have to be made more frequently than ownership decisions. Thus,

where annual, half-yearly or quarterly reports may be adequate for ownership purposes, monthly, weekly and even daily reports, in addition to those of longer periodicity, are required for purpose of management control.

Cost accounting has had a rapid development since the publication of Garcke and Fells' pioneering work on factory accounts in the latter part of the nineteenth century.[10] In the early stages of cost accounting development, emphasis was placed upon cost determination: the call was for knowledge by manufacturers of "the cost in wages and material of any article of their manufacture" so that they may be able

> to determine accurately and scientifically, not merely approximately and by haphazard, the actual profit they make or loss they sustain, not only on the aggregate transactions during a given period, but also upon each individual transaction. In a business, the operations of which vary widely in character, this special knowledge as to the profitableness or otherwise of a particular piece of work is of paramount importance, for it is not only conceivable but very probable that the presence or absence of this information may have the most vital bearing upon the policy to be pursued in accepting or rejecting large contracts.[11]

The primary objective of cost determination has seldom been expressed more clearly than in this early exposition. Whatever the basis on which prices are determined—whether they are tied to a full-cost figure, or set according to what it is thought the market will stand, or fixed by forces of competition—knowledge of costs actually incurred is a necessary prerequisite to intelligent decisions on pricing and production. It should be clearly recognised, however, that costs are important not in themselves or for themselves, but because they symbolise or represent activities which can be controlled or influenced in some degree.

The early writers on cost accounting devoted most of their attention to prime cost, that is, material and labour costs, ignoring or taking for granted the incidence of overheads as an element covered by the margin of price over prime cost. Later writers and practitioners, attempting to arrive at a definitive total cost per unit

[10] Emile Garcke and J. M. Fells: *Factory Accounts. Their Principles and Practice. A Handbook for Accountants and Manufacturers* (London: Crosby Lockwood & Co., 1887).

[11] *Op. cit.*, pp. 5-6.

or type of product, found themselves faced with the problem of allocating overheads over areas of production and distribution. They soon realised that "actual" cost is not factual cost, but inevitably includes elements of estimate based on subjective judgments. Then followed the proposition that the term "cost" takes on different meanings in different contexts, or, as J. M. Clark put it,[12] there are different costs for different purposes. Nevertheless, an assessment of "actual" cost remains a useful instrument for many managerial decisions.

Realisation of the shortcomings of assessments of "actual" cost gave rise to the concept of standard costs. On the basis of given levels of output and/or turnover and the prices to be paid for component elements, the levels of what costs *ought to be* in a certain period were determined in advance. Variations from these standard costs were explained in terms of variances from level of output or turnover, from prices of components or from levels of efficiency in working. Variance reports became a significant tool in the "control" of costs, which means, in realistic terms, that a means became available whereby the activities of people concerned with procurement of materials or services, or fabricating materials or despatching goods became subject to a higher degree of supervision and direction than would otherwise have been the case. The control made possible by the use of standard costs is really a control over people's activities rather than over costs—costs are merely an expression in measurable terms of the results of these activities. Again, however, standard costing constitutes a highly useful and significant instrument of managerial decision-making.

Alongside the development of standard costs, the technique of budgeting was developed, being derived, in essence, from the example of government activity. In a sense, budgeting is the counterpart of standard costs, in that standards can scarcely be set without some sort of forecasting being undertaken, although budgeting does not necessarily involve the setting of standard costs. It does, however, involve estimating, in advance, performance in the various activities of the enterprise, these estimated performances

[12] J. Maurice Clark, *The Economics of Overhead Costs* (Chicago: The University of Chicago Press, 1923). See Ch. IX.

representing targets to be aimed at. To be of material value, the budgeting procedure must include some means of measuring and explaining departures from budgeted performances and, if necessary, pointing to remedies for them; changing circumstances may require the application of flexible or multiple budgets. Considerable advantages may be derived even from partial budgets, and there are numerous instances in which it is not considered necessary or warranted to institute full budgeting procedure over all the activities commanded by the management of particular enterprises. One of the essential and exemplary features of budgeting procedure is that it necessitates giving forethought to future activities and thinking of the likely consequences of future actions; this in itself is a useful factor in intelligent and planned activity, as anybody who has attempted to budget his future income can testify.

Internal control has received considerable attention in recent years as an area in which accountants have a significant part to play in devising means by which resources may be used most economically (using this term in a wide sense). Within this category fall such procedures and techniques as records of continuous inventory[13] as an instrument of inventory control, fixed-asset registers, office and organisation manuals, safeguarding of investments, and the like. Related to internal control and sometimes confused with it but none the less distinct is the activity of internal auditing. Here, the auditing technique, developed over centuries in an external context, is applied by officers within an organisation partly for the purpose of protection of property and partly for that of improving enterprise efficiency through more economical use of resources and effort. The full internal auditing function merges into that of internal control and in many cases nowadays the function of the "controller" of an enterprise includes the maintenance of a system of internal audit side by side with budgeting, maintenance of all accounting records, and the oper-

[13] I have always been at a loss to understand why the term "perpetual inventory" has been adopted so popularly. According to Professor Garner, the term first appeared about 1904. (Cf. S. Paul Garner, *Evolution of Cost Accounting to 1925* [Univ. of Alabama Press, 1954], p. 96). Surely the basic notion is that of continuity or very high frequency in the recording of inventory movements rather than that of perpetuity or endurance for ever. What is perpetual about inventory records?

ation of any appropriate instruments of internal control. Sometimes, however, the internal auditor carries out his functions independently—so far as responsibility is concerned—of the controller and makes his reports and recommendations directly to the senior executive. In any case, however, both internal control and internal audit are developments of techniques of accounting applied to problems of management. This is equally true of internal check, which involves an analysis of non-accounting as well as accounting procedures and their arrangement on a basis of division of labour so that the work of one part of a procedure affords a check upon other parts of the procedure. In this way the reliability of records is greatly enhanced.

In special areas of management decisions, accounting studies are frequently significant. Some of these that have attracted attention in recent years to the extent that accountants may expect to be called upon to assist or initiate are those relating to cost-profit-volume relationships, financing of long-term asset acquisition, differential costs, direct costing. Foreshadowed in the near future are such problems as linear programming and operations research.

Thus the scope of management accounting is continually widening and the raising of the level of mental equipment of accountants is becoming increasingly necessary. The accountant's equipment will have to become co-extensive with the problems of management—and these are becoming both more intensive and more extensive.

IV Creditor Control

The creditor relationship here envisaged covers a wide variety of circumstances in which resources are provided by non-owners to the managers of enterprises. In the case of trade creditors, resources are provided in the form of goods, equipment or services, for which the buying enterprise defers payment for some time—the period of credit. Bankers may provide resources in the form of a money loan or in the form of an undertaking to honour cheques drawn by the subject enterprise upon them up to an agreed limit; in the latter case, the bank overdraft at any time is the measure of actual indebtedness to the bank. Holders of bonds or debentures, whether secured or unsecured, provide monetary resources on

loan for a specified period at a specified rate of interest, as also do lenders under a mortgage over specific assets, such as a building. All these come clearly within the category of creditors.

In addition, there are certain borderline cases which might well be included for present purposes, that is, in relation to control measures. In recent years, unsecured term notes carrying an option of conversion into ordinary shares at the time of maturity have frequently been issued by companies. Although the opportunity of ultimately exercising ownership control is envisaged, the holders of such notes are none the less creditors during the tenure of the notes.

The position of holders of preference shares is a rather peculiar one. Legally, they are owners with a preferential right to dividends and, usually, to return of capital in the event of liquidation of their company—preferential, that is, in relation to the right of the holders of ordinary shares but not in relation to the rights of creditors. From our present point of view, it is convenient to regard them rather as deferred creditors than as preferred owners, since it is only if the company's operating circumstances are exceedingly and, often, hopelessly difficult that their particular ownership rights come into play.

It should also be noted that, in some circumstances of company difficulties, certain other categories of creditors, such as debenture holders, may have the power, under the terms of the legal instrument setting up the creditor relationship, to exert certain ownership rights such as appointing a receiver to carry on the business until their rights as creditors have been satisfied. Further, in cases of extreme financial difficulty, the creditors in general have a right to have a trustee in bankruptcy or a liquidator appointed to take charge of the assets of the enterprise for purposes of realisation and distribution. These circumstances, however, are generally exceptional and do not normally come within the purview of the problem of control which we are presently examining.

As in the case of shareholders, creditors, of whatever category, provide resources to others, and, by doing so, cede the command over those resources so long as they remain creditors, that is, until the indebtedness to them is discharged by the transfer back

of resources over which they can resume command. In return for their yielding of command over resources, they have the right of ultimate resumption of command over equivalent resources. Also, as in the case of owners, the creditor relationship is a legal relationship.

The principal, if, indeed, it is not the only accounting instrument of creditor control that has been developed is that of analysis of accounting reports. Much of the technique of analysis owes its development to the attempt to exercise creditor control, especially by lending bankers, who are usually in a favoured position, through their intimate relationship to borrowers, to require more detailed reports from client enterprises than are normally vouchsafed to other creditors. However, there has been a tendency in latter years for credit officers in non-banking organisations to require reports from credit-seekers on a basis analogous to that previously used almost exclusively by lending bankers.

Naturally enough, creditors are concerned with the prospect of repayment of debts and their chief interest in analysing reports of borrowers is connected with this aspect. Emphasis upon working capital, working capital ratio and quick asset ratio is derived primarily from their significance in the creditor relationship. To some extent, even the bases of valuation of assets derive significance through their effect on the validity of ratios used in assessing creditor interests.

The widely recognised basis of classification of balance sheet items according to relative liquidity of assets and relative urgency of liabilities probably owes its origin and certainly much of its acceptance to its significance for creditors. Its value for owner analysis is secondary to this significance for creditor analysis.

The degree to which creditors may use the technique of analysis will differ partly according to the category of relationship into which they fall and partly according to the extent of information about the borrower which is made available to them. Secured creditors, looking primarily towards the assets secured as a "backstop" in the event of non-payment of their debt, may place much less reliance on or pay much less attention to the signs provided by the analytically derived relationships. Indeed, it is conceivable that some secured creditors might actually welcome the

inability of the borrower to redeem the debt in question, so that they can possess themselves of the assets involved. Published accounting reports of companies may be made available, under the terms of the debenture agreement, to debenture holders, and certainly to preference shareholders in their ownership capacity, but not usually to trade creditors for supplies, while bankers are frequently in a position to require even more detailed or more frequent reports than are published. In the case of enterprises other than public companies, this discrepancy in availability of information is even more marked.

Another significant factor in creditor control is the relative extent of indebtedness. On the one hand, if a creditor provides a substantial proportion of his resources for a given borrower, he would be very likely indeed to watch his client's financial position and progress much more closely than if an insignificant proportion were involved, even though the amount might represent a relatively small proportion of the borrower's total indebtedness. On the other hand, if the amount of resources provided constitutes a large proportion of the borrower's total resources, the creditor would be likely to watch it closely even though it might not form a very material part of his own resources, because, in this instance, the margin between the borrower's total assets and the creditor's contribution is of necessity a relatively narrow one.

V Employee Participation

Some attention has been paid in recent years to the desirability of interesting employees, particularly of profit-earning enterprises, in the financial aspects of their employer organisations. The growth of the trade union movement and the adoption of liberal policies towards labour, even by the most conservative of governments, have promoted a steadily growing awareness on the part of employees of the message that is carried by financial statements, especially those of our larger public companies. The recent attention has been ostensibly directed towards minimising misinterpretation of financial reports by employees, their union officials and their legal and political representatives.

How much of this concern for employees' correct interpretation is dictated by strategy in resisting wage increases and how much

is a genuine desire to take employees into managerial confidence to a greater degree than obtained in earlier years is a matter of subjective opinion and relative cynicism. What is certain, however, is that there is now a discernible tendency to provide reports of enterprise activity for the consumption of employees. Up to date, much of this has been done through the annual report to shareholders which is sometimes distributed to employees as well as to shareholders. The question that arises is: What sort of financial information about an enterprise is likely to be of most concern to its employees and how can it best be reported?

The problem can be regarded as being one of participation rather than control, at least under current economic circumstances. Fundamentally, however, the economic choice available to employees who provide labour is analogous to that of the providers of other kinds of resources. Just as the potential investor has to decide which of a number of possible avenues he will choose for the investment of his resources, so the potential employee has, at a certain stage of his life, a choice of this vocation or that, and, having decided (or having had it decided for him), then a choice of a job with this employer or that. The extent of his choice, however, is frequently far more limited than for an investor. The unskilled labourer has a wider choice of job than the skilled technician, and the higher the degree of specialisation the narrower the area of choice of employment; but monetary resources are much less skilled than the most unskilled labourer and, being utterly unspecialised, can be applied to any sort of financial work.

As an aside, it should be noticed that there is something of a paradox in relation to degrees of labour skill. While the above proposition is true in general, and the greater the degree of specialisation the narrower the area of job-choice, there are many vocations which, ranking their followers as technologists rather than technicians, provide a wider choice of job than is afforded to technicians, because of the organising ability which technologists normally have. That is, the technologist can organise men—skilled and unskilled—and materials and machines, and therefore is able to apply his abilities over a wider area than the skilled technician. Higher still in the hierarchy of employment is the trained scientist who is able to apply his knowledge to any relevant field, such

field being wider than any given technology; his area of employment is thus very wide indeed—perhaps almost as wide as that of the unskilled labourer. Highest of all is the entrepreneurial type of organiser—the member of "top management"—who can adapt his attainments to any type of problem and sphere of activity. His ubiquitous employability is equivalent to that of money. It remains true in most cases, however, that once an individual is vocationally equipped for work, his choice is virtually restricted to that of employment with this firm or that firm.

The fact that accountants and managers of businesses have already begun to think in terms of providing financial information about an organisation for its employees is evidence of a changing social climate. It is not so many years ago that any suggestion that the employees of a firm were interested in or entitled to any information about its financial status or progress would have been dismissed as an impractical, visionary fancy. Those who are still of the old opinion—and there are some, undoubtedly—are to be regarded as probably anachronistic survivors of an age which has passed or is rapidly passing—the age of the concept of employees as wage-slaves, the age of the concept of the class war.

When one gives the matter a little dispassionate consideration, one perceives that, in the conditions of today, employees are in much closer collaboration with management in the economic team than are shareholders. With informative reports and intelligent interpretation of those reports, employees might well contribute more to and gain more from the progress of the organisation than has often been the case in the past. The contribution and the gain should be concomitant, however; neither should be looked for without the other.

What, then, is the nature of employee decisions, and what kind of information is likely to help them in making their decisions rationally? The primary decision is whether to take a job, keep a job or leave a job. Secondary decisions are, being in a given job, whether or not to work hard, intelligently, efficiently, or co-operatively, according to circumstances.

With respect to the first type of decision, the financial information most likely to be of relevance would be that relating to the financial stability and prospects of the organisation. This is the

sort of data which is also relevant to shareholders, and to this extent the annual report contains information useful for employees. Profitability and earning capacity are relevant here, as also would be information showing something of the long-term prospects of security and advancement. It must be remembered, however, that one of the most important assets of a firm from any point of view—and one that concerns employees most intimately —is not measurable in any terms suitable for inclusion in a balance sheet, namely, the morale and organisation of the whole employee body. Also apposite would be data about the accident rate, safety measures instituted and labour turnover, and movements in cost of these factors.

Whether this information is to be embodied in the annual report which would be distributed to employees as well as shareholders or whether it should be made the subject of special reports for employees is a matter on which differences of opinion may well arise and on which the answer may well depend upon considerations to be looked at in each case on its merits. On the one hand, there is probably much in the annual report which would be irrelevant from the point of view of employees—one suspects at times that there is much that is not fully relevant from the point of view of shareholders. On the other hand, separate reports may create an impression that the employees are being talked down to as not being as capable of assimilating information as shareholders. Only empirical study in particular cases can resolve this difficulty. It may be noted that one investigator has stated that the kind of data which trade union officials (in the United States) consider necessary in financial reports of companies would be such as would indicate (i) costs and profits before and after taxes, (ii) what financial benefits the interests of the entrepreneur and the employees receive and what gains are retained by the enterprise itself, (iii) comparison of results with those of other enterprises, and (iv) likely future levels of activity in terms of volume of sales, prices and costs.[14]

Another point, which is important psychologically, is that one of the most significant aspects of employee relationship is that

[14] See Wilbur F. Pillsbury, "Organized Labor's Views of Corporate Financial Information," *Journal of Accountancy*, June 1958, pp. 46 ff.

employees naturally prize, almost above anything else, appreciation for work well done or for initiative exercised. It appears doubtful whether any contribution to this aspect can be made in accounting terms.

VI Community Control

There is probably no community in the modern civilised world in which either of the extremes of control—complete control of all economic activities by individual members of the community and complete control of all economic activities by the whole community—exists. Restrictions exist in all civilised communities—restrictions upon the activities of individuals in the interests of other individuals. No individual has a completely unfettered power to carry out his will, no less in his economic than in his social activities; there is not and probably never has been any completely uncontrolled economy, and, probably, some freedom of economic action must be allowed to individuals in even the most rigidly controlled economies. However, there may be a very great difference in degree of control exercised by communal authorities.

Some of the kinds of community controls which have become familiar to most people in the present century and which have significance for accounting have operated through taxation (of various kinds), price control, action taken against restrictive practices, prohibition of manufacture or sale of certain commodities, import restrictions, tariffs, excise and customs duties, and others. We are not here concerned with all of these, but what we have to ask is what sort of control is required by the community over activities to which accounting procedures are relevant and to what extent do the products of those procedures assist the exercise of that control.

The issues involving accounting procedures and accounting information bearing upon the public interest cover a considerable field. The questions of what is the public and what is the public interest are themselves matters which often need clarification and definition: there is often a danger of some confusion of thought because of the absence of specific referents when such terms as these are used. The solution lies in the realms of political science, sociology and semantics, but for our present purposes we can take it as an acceptable proposition that, in any case in which ques-

tions of public or community interest arise, "the public" is a generalised term to cover some or all of the individuals in a community outside those who are directly connected with or responsible for the activities under review. For instance, in the case of publication of a company's financial reports, the people comprising the management of the company would be responsible for the reports published, the shareholders would be directly concerned in the information published and the form in which it is published, but there may also be aspects in which "the public" is concerned, and this public may comprise shareholders in other companies, people in governmental instrumentalities, financial analysts, economists, educationalists, political, legal and economic representatives of employers and employees, consumers of the company's products, and so on.

Where the public is concerned, it seems reasonable to suppose that publication is a feature that warrants attention, and the function of accounting most clearly and intimately related to publication is that of reporting. We have to ask then: What accounting reports of what units of activity are of general community interest? This can be broken up into a number of component questions, such as: What economic and social organisations are of social significance? What aspects of the accounting of these units have social significance? What kinds of reports are available from these organisations? To what extent and in what ways, if any, are these reports deficient? How can these deficiencies be remedied? What side effects, if any, would such remedies be likely to have?

In one sense, the activities of practically every individual in a community have economic and social significance. Everybody is a consumer and his needs have economic significance; the productive effort of every producer likewise has economic significance. But the influence of myriads of consumers and producers are, in a sense, random influences; unless some organising force is applied, the randomness cannot be escaped.

It is only when people and the instruments of society are combined in some sort of organisation that their social and, in particular, their economic influence becomes significant for many other people in the community, and thus the greater the number of people or the greater the proportion of the instruments involved in an organisation, the greater its social influence and significance.

This applies whether the organisation is one of consumers or producers, whether it operates as a financial or distributive agency. Thus, co-operative societies, manufacturing concerns, banking, insurance and transport agencies are all economically significant, and they are significant broadly in proportion to their size, but also in so far as they have economic influence on other organisations in the economy, possibly through political directions. Departments and instrumentalities of governments, whether local or national, are also obviously of great economic and social importance.

It is largely because the formation of these organisations involves a transfer of resources or power from some people to others that they are significant. In a community in which every member had complete command over his resources and did not delegate any of this command, there could be little by way of economic organisation, and no member would have much greater economic significance than any other, even if there were some inequality in the possession of resources. By contrast, even if each member of a community has an equal "possession" of resources, any differentiation in the effective command over those resources will give rise to differences—and often serious differences—in their relative economic importance. Thus the factors upon which economic and social significance of organisations depends are precisely those with which accounting processes are intimately connected, namely, the effective command over resources.

To consider the kinds of reports that are available from these organisations in relation to the command over resources which the commanders exercise is a matter which cannot be extensively investigated here. They are, in a sense, all around us, and it is a feature of modern life that *some* report is made public by the vast majority of the significant organisations in our communities. There is, however, enormous variety amongst these reports and one of the features of recent accounting literature is the attention that has been paid to the problem of devising suitable standards of presentation of these reports. If the members of a community —whether acting individually or in groups—are to exercise any sort of social control, that is, to register approval or disapproval of the way in which the commanders of resources exercise their command, they must be supplied with reports which are adequate

to the purpose: they must be understandable, accurate and honest. These requirements apply to governmental agencies as well as to private enterprises. Herein, incidentally, a social responsibility and a social function are available for auditors which they would be wise to accept and carry out. This responsibility is in fact carried out by most of our government auditors who have frequently pointed out in their reports cases of governmental shortcomings.

It is a reflection upon the accounting profession that these audit reports have evoked so little comment in professional literature and virtually no action by practitioners. Thus an important means by which accountants as a body could exert a significant social control over certain commanders in our community is not availed of because the critical reports which could form the basis of appropriate action continue to fall on sterile ground. To some extent, the reverse is also true in relation to private enterprise. The reports of all public companies are audited, and the auditors report to the shareholders; but in doing so they have—at least up to the present—interpreted their reporting responsibility somewhat narrowly and have not directly (even though they may have done so indirectly in a vague way) accepted a duty towards third parties or the community generally. In this they are not to be blamed unduly; the job of auditing is an onerous one under any circumstances, and auditors carry heavy legal responsibilities for even inadvertent oversights, some of which may only be viewed as oversights in the light of subsequent events and knowledge; and the remuneration for auditing is relatively inadequate. It is therefore quite understandable that auditors should not have sought to undertake—at least directly—more onerous social responsibilities than presently press upon them. At the same time, the necessity for social control in the public interest exists, and if the accounting profession, as a body of people who are probably best qualified to exercise the kind of supervisory attention required, does nothing to shoulder these responsibilities, then it is not unlikely that others will be found, whether invested by governmental agencies or not, who will be charged with these responsibilities. The net result of this would almost certainly be a relative relegation of professional accountants to a minor position in the hierarchy of social influence—the effect of a missed opportunity.

CHAPTER 15

The Problem of Valuation

I A Dilemma

ACCOUNTANTS are concerned with problems of value and valuation which are pitched, so to speak, at two distinguishable levels.

In the first place, there are questions such as those involved in determining or verifying the amounts at which specific items are recorded and reported. At what figure and on what basis should inventories be recorded? On what basis should goodwill be calculated? What allowances, if any, should be taken into account in respect of doubtful debts and the like? To what extent should contingent liabilities be recognised in accounting procedures? What is a proper treatment for prospective commitments for long service leave or pensions for employees? Questions of this sort, arising in the ordinary course of an accountant's work, comprise a series to which the notion of economic value is apposite, that is, in each case the problem is one of arriving at a figure which can be viewed objectively.

Secondly, however, and perhaps underlying the first group, there are questions of much wider application and deeper significance. Where an accountant or auditor is required to give an opinion as to whether a set of accounting reports truly or fairly portrays the financial position or the "state of affairs" of a social or economic unit, the means by which he forms such an opinion constitute a series of value judgments in which the criteria are as yet rather nebulous and their translation into quantitative measures is subject to personal and individual interpretations. In this area, the concept of value in a philosophical or ethical sense

is the significant notion. What is truth? What is fairness? What are generally accepted accounting principles? Questions of this kind have to be asked, and, whether there is a precise answer or not, every accountant has to set up, consciously or unconsciously, his own standards of interpetation as answers.

The question of value is intimately bound up with the very basis of economic activity—indeed, with practically all activity. Activity—and, if you please, inactivity or inertia also—can be viewed as the exercise of a choice between alternatives. Economics deals chiefly with deliberate choice, but it should be observed that choice may be deliberate or involuntary. When we ask: Why do I choose to do this instead of that?, we are involved in a problem of value. To say that I do this because I choose to or because it suits me, only begs the question; such a reply is circular or unmeaning except that it introduces a personal element. An approach to a more useful answer, with more meaning, is indicated if I say that I do "this" because I value "this" more than "that," provided we go on to explain that this means that "this" accords more closely than "that" with my personal standards of economic, aesthetic, moral, religious, biological, political or physical comfort or well-being. These standards, of course, are complex things; they are a compound of all my previous experience. Even if "this" involves some hardship or sacrifice, I do it because it accords with my experience; I make a judgment—a value judgment—on the basis of my experience. My experience, too, may well include many things that I have imported or accepted from others; such acceptance is part of my experience.

In accounting, valuations are being made continually. A valuation is made to assist people in making choices, and these are made or to be made in relation to their experience. There is thus a practically inescapable subjective element in accounting valuations.

A graphic example, taken from a non-accounting area, of one *kind* of valuation problem that might arise is given by one writer[1] who instances the exhibit in a natural history museum of a pile of cubes, each purporting to represent the amount of a chemical element occurring in an average adult human being—so much

[1] Wolfgang Köhler, *The Place of Value in a World of Facts* (New York: Liveright Publishing Corporation, 1938), p. 17.

hydrogen, oxygen, carbon, nitrogen, etc. The current market price of the element was marked on each cube, the total amounting to some $63. "Can anything be wrong with correct statements?", he asks, and the answer, as in his own words, is obviously, "Yes, this is perfectly possible and nothing occurs more frequently. It is also a correct statement," he goes on, "that approximately 70% of a human being is common water. And yet, if this happened to be the only information about man which would reach the inhabitants of another planet, these creatures would almost certainly be led to an entirely erroneous conception of ourselves."[2] And he points out the further fact that the same elements are present in exactly the same proportions in a corpse, at least immediately after death. Thus "the market prices of these substances are entirely irrelevant to an appreciation of man. . . . Thus the data of the exhibit, given singly as they were, conveyed untruth to the public. . . ."[3]

It may well be, of course, that an exhibit of this kind does no harm because everybody knows that a man is obviously something more than the sum total of the physical and chemical composition in his body; an enumeration of all the objective facts about him would still not present a picture of a man as a living organism, and it may be only a sardonic joke to place such a monetary evaluation upon him. But there are areas in which this kind of enumeration of parts or elements may be misinterpreted as an adequate representation of a whole, and an evaluation of the whole may be erroneously based upon the parts alone.

This kind of error or misinterpretation appears to have occurred in accounting. The accounting reports of a concern—balance sheet, profit and loss statement, and so on—may be factually correct in their elements and yet fall far short of telling the whole truth about the concern; the concern is the sum of its measurable parts plus something else. It is not an organism, as a human being or an insect or a plant is, but there is an interacting relationship between people and things which gives to the concern as a whole a value greater or less than that of the sum of the things (and rights) which the financial statements normally enumerate. At-

[2] *Ibid.*, p. 18.
[3] *Ibid.*, pp. 19-20.

titudes and expectations—not only of those at the head of the organisation but also of those who operate the equipment and interview the customers and so on—contribute to this value; these are not measurable, or at least have not been up to the present, yet it may not be impossible to make some sort of assessment of them in terms, for example, of change over time—more or less, better or worse. But "more or less" introduces measurement, while "better or worse" expresses value judgment and indicates and expresses subjectivity.

At both levels of consideration of the problem of valuation there is always a contrast, and often a conflict, between objectivity and subjectivity. In the accounting literature of the past twenty years or so there has been discernible a tendency towards attempting to make accounting more "scientific" by emphasising the desirability of using "objective" and "verifiable" data as the phenomena of accounting. Professors Paton and Littleton, for example, make much of this in their "Introduction to Corporate Accounting Standards," as when they say:

> The most desirable evidence is that which is completely objective and wholly without any taint of the uncorroborated personal opinions of an interested party. . . . If accounting is to become increasingly scientific, it must continue to develop new ways and means of obtaining facts that are convincingly objective and at the same time appropriate to the long run.[4]

At the same time, however, the inescapability of personal judgments is recognised:

> Accounting, however, can never become completely scientific, because its factual materials can never be determined with complete and conclusive objectivity. . . . The evidence supporting a given [accounting] treatment may be completely objective, convincingly objective, doubtfully objective, or clearly unobjective.[5]

These writers avoid the use of the word "value" by substituting "measured consideration" and "price-aggregate" in appropriate contexts, but, while this gives a little added precision in expression it does not solve any basic problems, since the determination of particular "price-aggregates" still has to be made in specific situations and this constitutes the very essence of the problem of

[4] *Op. cit.*, pp. 20-21.
[5] *Ibid.*, pp. 19-20.

valuation, whatever term we may use to describe the result.

Accountants are thus faced with a dilemma. On the one hand, they appear to be striving for a level of objectivity in the phenomena with which they are dealing which will enable them to indicate unique measurements for particular events. On the other, they are faced with two problems. In the first place, it is unlikely that any such degree of objectivity can be obtained, even ultimately because the phenomena they are dealing with are fundamentally human and social phenomena; and, secondly, even if such unique objective measurements were obtainable, there would still be circumstances and occasions in which the sum of a grouping of such items, while "factual" in itself, would not convey the "truth" about the social or economic unit to which the items relate.

II The Subjectiveness of Valuation

It is clear, on a little reflection, that large areas of accounting endeavour are subject to value judgments or personal interpretations of events based on an implicit or explicit attitude adopted by individual persons.

In a sense, perhaps, it may be argued that the recording function as such is not affected by value judgments, in that the recording procedures are merely concerned with putting into due form certain events which are determined as being appropriate for this purpose. The determination takes place, it may be held, before the recording begins; once the determination is made, it constitutes certain events as "facts" and, so far as the function of recording is concerned, these facts may be regarded as objective. All this may be admitted, but there still remains a normative idea behind the recording. It is generally agreed that the double-entry method is the most satisfactory one yet devised to record these data. When we seek the reason for this, we find it surely in the proposition that it provides something that no other known means of recording appropriate data provides, namely, a coherent, integrated system with a combination of methods of arriving at a periodical result. But is there not behind this proposition an assumptive or axiomatic proposition that such a coherent system is considered to be a good thing? That is, double-entry in itself is neither good nor bad, but the results it produces *are judged* to

be good. The facts recorded may be neither good nor bad; even the results themselves may be neither good nor bad. It is our attitude towards them that is the important thing in evaluating them; and this is derived from a system of standards which has been developed within ourselves, whatever its initial sources may have been. It is important to examine this inner attitude, but this is something that each person can best do for himself; *A* can only assess *B's* attitude by *his* (*A's*) interpretation of evidence produced by *B* in terms of what attitude on the part of *A* would produce similar evidence.

A system of accounting thought based solely upon "objective, verifiable" data cannot lead to *precepts,* that is, to rules for good or desirable procedures. If such precepts are required, then somewhere there must be an axiom or axioms of a normative nature. Perhaps, instead of chasing the rainbow of objective verifiability, accountants ought to spend more time and effort in establishing these axioms. This proposition, it will be readily recognised, is itself a value judgment, based on the axiom that it is desirable that accountants (or perhaps somebody else) should understand the nature of their procedures. It is difficult to see how normative axioms can be escaped in any serious examination of the province of accounting.

We can consider one or two illustrations from varied fields of accounting. We can observe, for example, that a company has a working capital ratio of, say, 75 per cent. This, in itself, does not lead to the proposition that it should remedy the position by, say, raising a long-term loan or fresh capital without the interposition of the value proposition that the working capital position ought to be improved, and this implies some sort of measurement or assessment of what a desirable working capital ratio is. Again, an auditor cannot reasonably insist on having objective, verifiable evidence produced to him without implying the value judgment that objectivity and verifiability are desirable; to put it paradoxically, the virtue of objectivity is a subjective judgment. Or again, a variance from standard cost or standard performance can scarcely be queried without the implicit acceptance of the standard as a norm, and this *acceptance* is the operative, but clearly subjective, judgment.

In what, then, do the standards or ideals of accounting lie? Or, to put it in other words, what is the underlying ethic of accounting? Is it truth? Is it fairness? Is it the preservation of a given form of society? Is it efficacy—and, if so, efficacy for what? Is it the golden rule—of the Bible ethic, not of inventory valuation—that we should do unto others as we would have them do unto us? Here is something for accountants to ponder on, and it is significant for them, for in the answer lies the soul of accounting.

What do we mean by valuation and value? It is suggested that valuation is a process of putting a tag on an economic resource, whether tangible or intangible. In most cases, the tag is a monetary figure, but it may be expressed in some other measurable units, such as "real" terms. The process of valuation itself occurs continuously. For example, pricing is a case of putting a tag on goods or services for the purpose of selling them. The transaction of exchange, that is, actual buying and selling, involves a dual application of the process of valuation by both buyer and seller such that the price represents a bargaining point which, by comparison with their respective valuations, appears to be advantageous or satisfactory to each of them.

Apparent exceptions occur, for example, in monopoly conditions where the buyer has to pay the monopolist's price even though he (the buyer) may consider that the goods or services are not worth it; with non-necessaries he has the choice of not buying, but with necessaries he may not have even this alternative. Even in these situations, however, there is a valuation process, vague though it may appear to be, for the purchaser or prospective purchaser to be able to say (or think) that something is or is not worth the price put on it; if it became necessary he probably could, with some thought, say how much he would be prepared to pay willingly for the resource in question. Similar considerations may apply on the seller's side; under some circumstances he may be forced to sell things at a price below what he thinks is a fair valuation, but the valuation process is none the less present in that he can formulate in some terms his notion of a fair valuation.

Clearly, the process of valuation itself is often a complicated one, perhaps in some cases almost an unconscious one, and may frequently be affected by subjective considerations which could not

be appreciated by anybody other than the person directly involved. In our present state of knowledge, it appears doubtful whether any calculus of satisfactions could ever be determined for consumption goods, at least for other than subsistence necessaries.

What we have to recognise, however, is that values are created by human beings, they exist for human beings and are not inherent in goods or services apart from human interest in them. This is not to deny the possibility of the existence of absolute values, in the sense of values existing outside the experience of men. We cannot affirm that there are *no* absolute values; but, as men, only that there are no absolute values for men. In other words, all of the values that men may hold are relative in some way or other, and primarily and chiefly, of course, to the experience of men.

The next question is whether there can be any values universal among men. The answer here appears to be that if the experiences of all men have something in common then it is possible for all men to have *some* values in common, which would mean values universal among men. However, not only is this common experience necessary, but also a common attitude towards that experience. All men experience life, but this in itself does not give universally held values of life because not all men have the same attitude towards life. Some men hold the lives of others cheap and their own dear; others, and sometimes even the same ones in times of crisis (such as war), have the reverse attitude. The attitudes of men are determined by their experience, that is, by their activities within the context of the environment in which they find themselves; but this in turn is determined in part by the mental and physical characteristics with which they have been endowed by their ancestors and their environment. This all adds up to the determination—or acceptance—of values being a thoroughly and inescapably subjective process.

III *Value, Equality and Equivalence*

When we try to analyse the concept of value, we have to ask: what do we do when we place a value upon something? Difficulties arise not because the process of valuing is unfamiliar but because we have, all of us, been so used to valuing things, in one way or another, since early childhood that the thought-processes

involved are an automatic, if not entirely subconscious, part of our mental activity.

It is submitted that the process of valuing is, fundamentally and primarily, an attempt to equate two unlike things and to bring one of them, which is not within one's experience *in a particular context,* into that experience by equating it with the other which is within one's experience.

If something is unique, or regarded as unique, in *all* its characteristics, it can scarcely have a value placed upon it, simply because there is no basis for any common relationship between it and anything else that lies within one's experience. That is, for something to have a value, it must have some characteristics which make it comparable with something else. The thing we compare it with becomes a kind of norm or standard with which we are familiar, and we attempt to equate the compared thing with the norm. If somebody tells me that the value of a particular thing is *£x,* there is an assumption—or presumption—that I know both what *"£"* means and what *"x"* means, that is, that these are within my experience. If somebody tells me that its value is, say, umpty-two pecus, then, unless and until I can assess, that is, bring within my experience, what this expression means, it is nonsensical to me, if not to the person using it.

The notion of value is related to that of equality and it is therefore appropriate to examine the latter briefly. When we say that "this equals that," we say, in effect, firstly, that "this" has some characteristics which "that" also has, and, secondly, that "this" has other characteristics which "that" does not have, and, thirdly, that "that" has some characteristics that "this" does not have. If this and that were the same in all their characteristics, then that would be this or this would be that and they would be indistinguishable from each other. In other words, if two things exist at all separately, there must be some differences between them in characteristics, even though these differences may be exceedingly small. Hence, inherent in the notion of equality are two other notions, namely, that of sameness in certain characteristics, and that of difference in other characteristics. Thus, when we say that twelve pence equal one shilling, we mean that for the purpose of paying accounts or for other monetary transactions, twelve pen-

nies will serve the same purpose as—or will be "as good as"—one shilling, and *vice versa.* But if we were interested in, say, the weight of the coins, the equation would not be true, since twelve pennies weigh very much more than one shilling does. The essential point is that there must be some difference between twelve pence and one shilling before anybody would be concerned in equating them for any purpose or, indeed, would be able to equate them.

To take another illustration, the proposition, $2 + 3 = 5$ indicates that there is a difference between $2 + 3$ on the one hand and 5 on the other. What is this difference? What we are really saying in this equation is that if we take a group of two objects and another group of three of the same objects, we shall get, *for the purposes of counting the objects,* the same result as if we took a group of five of these objects. That is, the equation becomes:

$$(1 + 1) + (1 + 1 + 1) = (1 + 1 + 1 + 1 + 1)$$

But there is a difference between the two sides of the equation, namely, that the left-hand side consists of two groups while the right-hand side comprises only one group. Hence, for the purpose of counting the *groups,* the proposition is not useful, since two groups do not equal one group.

In a somewhat similar way, even the notion of identity involves a notion of difference. Identity means the possibility of substitution for certain purposes. For example, if I go into a book shop and look at two books of the same title, author and edition, I might say that they are identical. But what I mean is that it would be a matter of indifference to me which of the two I bought, for either would serve my purposes as well as the other. However, the very fact that there are two books involves some differences between them. One may have had its dust cover put on it at 10.26 a.m. on a certain day, the other at 10.27 a.m.; one may have been at the end of a row when packed, the other next to the one at the end, and so on. The history—and the future—of the two books is different. Yet, at a given moment or series of moments, they may be substituted for each other for any practical purposes. Even when we "identify" a person, we say, in effect, "This is the same man as one who was at a certain place at a certain time in the past"; but in saying this we are indicating quite clearly that there is a dif-

ference in the temporal, spatial or other circumstances relating to him. And even when we say, "This is John Jones," we are merely applying a label to a person which will enable us to recognise him through certain characteristics which will remain the same in different circumstances.

While the notion of equality is an essential constituent of the concept of value, the latter appears to contain something further. There appears to be an "ought"—an ethical quality, so to speak—about value and valuation, at least in the common usage of the term in accounting, economic and business literature as meaning something different from "cost." We often say, for example, that something has cost so much, but that this does not necessarily represent its value. What we mean here is that there has been a specific event in which an equality has been attained—the purchaser and the seller have exchanged, say, money for goods and there has been an effective substitution of the one for the other. This cost is a "fact"—a matter of history, in a sense. But when we think of the value of the thing in so far as this is different from its cost, we are thinking of a hypothetical substitution, such as what somebody—and this somebody is not necessarily stipulated or even consciously identified—ought to be prepared to pay for it. The determination of such a value involves an assessment, appreciation or evaluation of circumstances which lie outside the fact of the exchange itself which expresses the cost; we could almost put it that the assessment of value involves an interpretation of cost. In an analogous sense, we might say that the "truth" relating to a situation involves an interpretation of the "facts" of the situation. It is the ethical aspect of the process of interpretation or appreciation which allows differences in value to be thought of or suggested for any given thing, the cost of which is not in question, just as it permits given and undisputed facts to be differently presented so as to give different "truths." In this sense, facts cannot lie, but neither can they tell the truth in this wider meaning of this word; so too, determinate costs cannot be disputed, but neither do they give values, in this distinct sense of the word. "Costs" are "facts," but that is all they are. Truth, like value, is very much a matter of interpretation of facts.

IV Valuation and Measurement

In accounting, that is, for accounting purposes or in relation to accounting procedures, valuation is an aspect of the problem of measurement. Measurement of some kind is inherent in valuation. Even in the case of general values some sort of ranking is implicit. If I say that I value *X's* friendship, the implication is that I value it highly, and the implication in this is, in turn, that I value it more highly than I do the acquaintance of some other people. In the same way, if I value a particular thing as a possession, there is an implicit comparison with other things or possessions. In other words, the attachment of the notion of value involves some kind of ranking or ordering of preferences, not necessarily explicit or precise but nevertheless positive in the mind of the person "valuing." Thus values are doubly relative. They are relative to the person concerned, and the value of each thing is relative to that of other things.

The problem of valuation in accounting involves applying some specific measure to this ranking, that is, making it explicit and precise. Where pricing takes place, that is, putting a tag on a commodity or service in terms of the unit of exchange, there is behind it the purpose, whether achieved or not, of effecting a sale. However, not all valuation takes place for this purpose and therefore not every valuation in accounting or business is necessarily an instance of pricing. For example, when Matheson,[6] in the first book on depreciation, suggested that the best method of approximating real value of nominal capital was to have regular revaluation of everything in a business and that charging depreciation was only a second-best approximation to such revaluation, he was really begging the question because some basis for valuation is always necessary and the basis is always affected by the purpose in view and the attitude of the person for whom the valuation is to be effective. In the valuation of the goodwill of a business, the different circumstances of the interested persons may result in widely differing valuations, which nevertheless serve the purpose of starting points for a bargaining process as a result of which a compromise valuation somewhere between the initial

[6] Ewing Matheson, *The Depreciation of Factories* (London: E. & F. N. Spon, 2nd ed., 1893), p. 14.

valuations is arrived at as a basis for action. This sort of interplay also applies in ordinary trading, but it may be masked to a greater or less extent by the apparent fixity of prices of commodities or service at a given time, and it may be complicated in some cases by a buyer's surplus or seller's surplus in that the individual prices may not represent the extreme extent of the buyer's or the seller's preparedness to trade.

The value of something is, then, an expression of the result of a process of valuation or, perhaps better, of evaluation. This is, of course, a circular proposition and does not advance our thinking until we analyse the process involved. To this end, "evaluation" appears to be the better word in the present context, because, in its ordinary usage, it seems to carry a little more of the "ethical" flavour of the essential notion of value than does "valuation"; it appears to carry more of the essential lack of certainty and more of the dependence upon relative and subjective elements than the other.

For the process of evaluation, it is necessary to have three ingredients, namely, (a) something to be valued, (b) somebody who evaluates, either on his own or on somebody else's behalf and (c) some basis or criterion which can be used as a measure and an expression and which is recognised by and acceptable to the people concerned in the value.

As to the object (a), certain facts can be stated about it, for example, how old it is, how much it cost, to what extent and for what purpose it has been used and so on. The sum total of all these facts, however, does not give a value nor does the collection of these facts amount to a process of evaluation. In practice, of course, some of the facts themselves, in relation to a particular object, may emanate from previous evaluating processes. All the relevant or available facts have to be brought into relationship with elements which depend ultimately upon the evaluator's experience and judgment. Often, in practice, all the relevant facts are not available; sometimes differences in experience or attitude (which usually develops from experience) of the evaluators will give different results from the same facts; often differences in objectives or purposes of the evaluation will colour the treatment of a given set of facts.

Despite all these sources of differences in particular instances, however, the evaluating process does involve the common element of translating known facts into a normative expression according to some recognisable and admissible criteria. That is, the value arrived at is an expression of something which "ought" to be paid or to be recognised as payable, or to be done or not done, etc. When we say, for example, that the value of So-and-so's writing lies in its critical analysis of such and such, we mean that the people who read it ought to do so from a particular point of view or within a particular frame of reference, namely, that of such and such to be analytically considered. So, again, when we value a painting for, say, its bold use of colour we have a particular point of view or frame of reference in mind. We are not necessarily looking for accuracy of dimensional representation or a logical arrangement; these may also be present, and this may enhance or detract from the value, again depending on point of view; the primary criterion, however, is the use of colour. In another case or for another evaluator, one of the other elements might be the primary criterion for evaluation. Thus value certainly has a large subjective element, but it also has an objective one in that it must surely always be in relation to something outside the valuer's thought-processes of evaluating.

We can consider an illustration which will further help to bring out some of the features of the concept of value. Suppose that X has something which he values but is prepared to dispose of, and suppose that Y is prepared to pay something in order to acquire it. X translates the value of the thing for him into £x, and puts an initial price of £$(x + a)$ upon it. Y translates its value *for him* into £y, and puts an initial price of £$(y - b)$ upon it. As quite often occurs, $(x + a)$ is greater that $(y - b)$. A process of bargaining then takes place, whereby X reaches the point £$(x + a - p)$ as a *price* which he is prepared to take, and Y reaches £$(y - b + q)$ as a price which he is prepared to pay. If $(x + a - p) = (y - b + q)$, then a sale can take place; if there is a gap between them then no agreement can be reached. In the former case, the *values* of £x and £y for X and Y respectively are not necessarily altered; in other words, X does not value the thing any less because he cannot get the original price he put on

it, but other values have entered into the process of his thinking and bargaining, for example, the "value" of having ready cash, the "value" of something else that he can acquire with the proceeds, and so on. Similarly, Y does not *necessarily* value the thing at more than £y, but other values enter into his calculations also, such as the "value" of immediate use or enjoyment of the thing. At the same time, if $(x + a - p)$ is greater than $(y - b + q)$ and there is no exchange, the original valuations of X and Y are not thereby impaired.

Thus, the *price* at which something is sold does not necessarily represent any objective or inherent value of the thing, nor, indeed, does it necessarily represent its subjective value for either the buyer or the seller. All that it represents is, in fact, a price, that is, a figure at which buyer and seller enter into agreement. For the buyer who gets a bargain—in his eyes—the value is much more than the price represents; that is, there is a buyer's surplus. For one who pays something more than he thinks it is really worth—and this sometimes happens—the value, if it can be expressed monetarily, is something less than the price, but the difference lies within a range of tolerance beyond which he would not buy; other considerations, that is, other values, impinge upon his acquisitory attitude to affect the amount he is prepared to pay. Hence, such propositions as "when property is new, cost and value are normally the same" and "when property is acquired for cash the amount paid normally measures its value"[7] assume an absence of buyer's or seller's surplus which is probably contrary to fact in most cases.

This is not merely a purely academic or ethereal argument; it is, on the contrary, starkly realistic for a high proportion of commercial activity. The very essence of most of the advertising and sales presentations that take place nowadays is a proposition which can be put in this form: "Commodity X will cost you £y, but it is worth much more to you than that; you should, therefore, buy it now." The value differential, that is, the excess of "value" over "price" may not always be expressed precisely or in monetary terms; it may be couched in an appeal to social aspirations, to personal comfort or taste, to future economic security, and so on;

[7] G. O. May, *Financial Accounting* (New York: Macmillan, 1943), pp. 87, 108.

it is, none the less, almost always present in the salesman's and advertister's endeavours to sell.

One effect of this line of thought may be noted in passing. The value of a long-term asset, such as plant or equipment, may be arrived at by discounting expectations of future benefits derivable from its ownership and/or use, and this value need not coincide in amount with the price paid for it. To talk about depreciation as being a loss in value or a method of measuring benefits from use is inconsistent with viewing it as an allocation of cost. If it is desired to calculate depreciation on a basis of benefits or expected benefits "used up" period by period, these expected benefits over the life of the asset, capitalised at the time of its acquisition, ought to be brought to account, and depreciation, based upon an appropriate formula of calculating benefits "used up," should be determinable in relation to the value of the asset rather than the price paid for it. That is, the price of an asset should not be allowed to *govern* the assessment of its value; they are quite different things.

It is recognised, of course, that it may not be thought desirable to relate depreciation to value or benefits at all. The purport of the foregoing paragraph is not to advocate any particular basis for calculation of depreciation but merely to emphasise the difference between value and price or cost, and to suggest that, *if some measure of consumption of expected benefits or services is required,* it should be related to value rather than to price. No question of variations in price levels arises here, the proposition being submitted as valid whether prices remain constant or not. It is, indeed, a more fundamental, although hitherto neglected consideration in relation to assets than that of variations in price levels, important though these are in themselves.

V Valuation and Published Reports

Whatever accountants may say about the function and purport of a balance sheet, it is, in practice, used very widely as a valuation statement. Notwithstanding all the outpourings that have taken place in accounting literature with a view to convincing people that this document is merely a historical by-product of the matching procedure and that it does not purport to convey any

sort of picture of current values of assets, the social fact remains patently before us that balance sheets are used, almost universally, as instruments for the purposes of placing valuations upon businesses, shares or parts of a business. Even if accountants themselves are convinced of the arguments they put forward (and there appear to be some grounds for questioning this), the utmost result is that readers who are interested in the question of valuation should not take the figures in a balance sheet at their face value. In other words, what is meant by the proposition that a balance sheet is not a valuation statement is merely that the figures it contains do not necessarily or automatically represent the amounts at which assets could be realised or at which the proprietorship should be assessed.[8] In essence, this means, for practical purposes, that the proponents are warning balance sheet readers that some adjustments are necessary in using the balance sheet for purposes of valuation rather than telling them that they should not use it at all for such purposes. For, indeed, no other document has been devised which will serve as an instrument of valuation, and people, including accountants, will go on valuing so long as it is necessary to do so. Nor is it easy to envisage any other instrument so convenient as a balance sheet as a basis for valuation of a business. A list of the assets and liabilities as at a particular date—and this is what a balance sheet essentially is—is the prime requirement for such valuation. That it should be a complete list is of paramount importance; but that the figures placed against the several items be "accurate" is a matter of interpretation of "accuracy." It is here that objectivity and verifiability have been generally set up in opposition to subjective assessment.

The essence of the problem of valuation—so far as it relates to the interpretation of accounting reports—lies in the relativity of the valuation process. The person who carries out the valuation process in the course of preparing an accounting report can only guess at the purpose or objective of the person who will read

[8] It is recognized that the so-called statement of affairs, prepared in view of imminent bankruptcy or liquidation, shows estimated realisable values for particular assets and the ranking amounts of liabilities and is thus a fairly precise instrument of valuation of proprietorship in its legal, residual capacity; in the present context, however, it is to be considered as a particular form of the balance sheet, since it is, in effect, a balance sheet with additional, specifically orientated data attached for each item.

the report which embodies his valuations. In some cases, the guess may be an informed one, as for internal reports for management, or a shrewd one, but in others it may be almost a random one. At the same time, the person reading the report can only guess at the criteria used in the valuation process by the person preparing the report. It is small wonder that differing interpretations of the values of such things as shares in particular companies should arise in respect of the information contained in published (or even unpublished) reports, nor is it surprising that accounting writers with a sense of social responsibility should have been advocating over a lengthy period that the bases of valuation of particular items in balance sheets should be more specifically and precisely indicated than has generally been the case up to the present.

It is necessary to clarify the basic function of the periodical published accounting reports which are made available to those entitled to them. The problems of valuation involved in published reports of enterprises cannot be even remotely approached until we can be clear as to their purpose. The most widely discussed examples in accounting literature of such published reports are those of companies or corporations in a private enterprise economy, and we can first consider these as being typical, but with some modifications in certain cases, of all published reports.

Public companies or corporations—those whose shares are held more or less widely by investors—are required by statute[9] or legal regulation[10] to make public certain information relating to their assets and liabilities, expenses and periodic results. While these are reports of stewardship, the purpose is often taken to be that of enabling shareholders (or their advisers), investors and creditors to make an assessment of the financial position of the concern from time to time so as to be able to make investment decisions on a basis of knowledge rather than ignorance.

What must be recognised is that, as reports of stewardship, statements showing financial results and financial position are not of great value in themselves. Their real value lies in the fact that they provide a means whereby certain *people* can formulate

[9] E.g., United Kingdom Companies Act, 1948, 11 & 12 Geo. 6, c.38; Victoria, Companies Act 1961, No. 6839; etc.

[10] United States Securities and Exchange Commission Regulation S-X under the Securities Act of 1933, the Securities Exchange Act of 1934, etc.

judgments about certain other *people*. That is to say, the commanders of resources of the company or corporation are required to report regularly and publicly to the shareholders, that is, to those commanders who provided the resources, on the way in which they have handled the resources entrusted to them, and the financial statements—the balance sheet, profit and loss statement, funds statement, statistical summaries, and the rest—are a part of this report. The truly significant aspect, however, is that the report is in effect a request by the directors or managers of the concern for continued confidence in them for the future. In effect, they are saying to their audience, "We have done well in this last year and we should like you to entrust us with the command over these resources in the future," or "Although we have not done so well this year, this is because of such and such factors, and nobody could have done much better in the circumstances; we have done our best and shall continue to do our best if you will give us your confidence again in the future," and so on. The periodical published reports are in fact reports upon the management of concerns.

When viewed in this light, the financial statements take on a somewhat different significance. Their contents are significant according to their adequacy for assessing the validity of the managers' claims for continued confidence. From this point of view, certain criteria for the presentation of financial information suggest themselves. These criteria have long been recognised and accepted among accountants, but their significance lies in their being, fundamentally, criteria of behaviour rather than of merely intellectual attainment. In other words, the question that we should ask ourselves is this: If we were shareholders in a company, having entrusted part at least of our resources to its managers, what standards of behaviour in relation to reporting to us as ordinary people should we expect of these managers?

In the first place, we should be entitled to expect them to deal honestly with the resources entrusted to them. This is both a legal and a moral obligation on them. And, closely linked with this, we should expect them, secondly, to report truthfully to us about their stewardship. It is in this sense that the accounting reports presented to shareholders should be, as is frequently required by statute or regulation, true and fair. They should be

truthful in the sense that they should not, in themselves, contain or suggest any propositions which would lead to misleading conclusions about the integrity of the managers of the enterprise. And it is just here that the possible distinction between facts in a narrow sense and truth in this broad sense might well arise. For it is possible for statements to contain factual propositions, each one of them correct in itself, and yet to convey a message of untruth or of something less than the whole truth. Further, it is just here that questions of terminology in published reports become significant. If the reader of a report interprets an expression to mean something different from the meaning in the mind of the preparer, there is a failure of communication, and something less than the truth is likely to be conveyed, possibly inadvertently, but none the less positively and effectively. The practice, which has developed in relatively recent years, of appending explanatory notes in relation to items in the published statements is a commendable instance of the attempt to improve the communication process.

The criterion of consistency may also be considered to be a desirable one in this connection. In the United States of America, this criterion has been incorporated in the recognised wording of the independent accountant's report upon the financial statements presented by management to the shareholders and to the public generally. Consistency is relevant and significant only because a given report is in fact only one of a series of reports. Behind the requirement for consistency is the presumption of a norm of performance. Thus the argument for consistency really amounts to these propositions:— I (a) Performance (in relation to accounting principles) last year was satisfactory; (b) performance this year is consistent with that of last year; therefore (c) performance this year is satisfactory. Or II (a) Performance (in relation to accounting principles) last year was thought to be satisfactory last year; but (b) some defects since discovered have made change desirable; therefore (c) performance this year, although not consistent with that of last year, is better than that of last year.

As has already been pointed out,[11] consistency is not *necessarily* a virtue for its own sake. Its usefulness lies in the basis it gives for

[11] Above, Part I, Ch. 4, Sec. III.

enabling people to arrive at sound conclusions about the activities of other people. This is not possible if these others, reporting regularly as they do, are able to use inconsistent means of reporting to import confusion into the minds of their audience. Inconsistency, in fact, may in some circumstances amount to untruth, but it is equally true to say that adherence to consistency for its own sake and in the face of a palpable need for change can also amount to untruth.

The question as to how much detail should be contained in published accounting reports is one about which there has evidently been considerable difference of opinion over a fairly lengthy period. Practice varies greatly in each country, whether the publication of reports is governed by statute, regulation or custom. There are always some managements who believe that the least information to be revealed is the ideal situation, while there are equally some who believe in publishing a great deal of information beyond what is legally or even customarily required; most managements appear to operate between the two extremes, offering something more than the legal minimum but not so much as the daring innovators in this area.

Something of a paradox might be noted here. If, as shareholders in a company, we have a great deal of confidence in the integrity and competence of the directors and managers, we might well be content with less detailed reports than if we had less confidence in them. The basis upon which confidence may be built up, however, is the provision of evidence of such integrity and competence, and often an important part—although not by any means the only part—of such evidence is the provision of a reasonable amount of detail in the periodical reports. "Reasonable" is to be interpreted in this context in relation to the generally recognised norms of performance in a given period and may vary from time to time. For example, the directorate of a company of long standing may have established its standards of reporting under statutory and general requirements which were not nearly so demanding as those in operation today. Having built up a degree of confidence in their activities by a long successful financial policy accompanied by relative paucity of detail in their reports, the directors are not likely to be required, in the absence of an influ-

ence undermining this confidence, to provide so much detail as those of a company more recently formed to operate from the beginning within the more demanding context of today. Critical eyes are turned on the reports of new companies nowadays to a slightly greater extent than on those of older companies, and both the form and contents are subject to scrutiny and comment in the press, by professional organisations, and, often, in the class room, as evidence of intention of the management to conform to recognised standards of reporting. This is not to say that criticism is not directed against old-established concerns at all nor that the reports of their managements are not scrutinised closely—the incidence of take-over bids,[12] which do not appear to discriminate on any basis of venerability, is sufficient evidence of this—but merely to make the point that the managements of the newer establishments make their bow, so to speak, so far as their published reports are concerned, before a more sophisticated and demanding audience than their more elderly counterparts did years before.

In the United Kingdom and the countries of the British Commonwealth, there has been, in general, a trend in company legislation in the direction of requiring more information to be included in the published accounting reports of public companies. In the United States of America, the regulations of the Securities and Exchange Commission have provided, since the 1930's, for the publication of more information in the reports of corporations coming within the ambit of its operations than any of the company statutes in the British Commonwealth do even now in the early 1960's. The two great events in commercial history which contributed directly towards these statutory and regulatory requirements were the *Royal Mail* case[13] in England and the stock-market crash of 1929 in the United States. Details of these events can be readily obtained elsewhere; what is to be pointed out here is that both represented the result of undiscriminating but misplaced confidence in the managements of companies which did not provide sufficient details of their operations to enable reliable assessments of performance to be made.

[12] That is, offers or proposed offers for acquisition of controlling share interests in companies.

[13] Rex v. Lord Kylsant and another. See Collin Brooks (Ed.), *The Royal Mail Case* (London: Butterworth & Co., 1933) for a full account of the trial.

The legal obligation to provide more and more information in the periodical reports made by directors to their shareholders or to prospective investors and, through them, to the public generally, has been designed as a protection to investors against the swindler, the shyster and the confidence trickster. The majority of directors have in fact been honest; they have justified the confidence placed in them and have taken and do take their responsibilities to shareholders and the investing public seriously. It has been found impossible to legislate against the credulity or greed of unwordly-wise speculators and every now and then an instance occurs of people having been duped by some clever schemer operating either just inside or not very far outside the law. It must be recognised—and gratefully—that cases of this sort involving company reports are happily rare nowadays; the loopholes in the law relating to accounting reports are steadily being closed up and the auditor acts as the shareholders' watchdog, to use the expression of Lord Justice Lopes.[14] The point at issue, however, is not affected by this consideration: the basic feature of the investor/management relationship remains that of confidence of the former in the latter.

The demand for more and more information which has developed in the past several decades should not, however, be viewed as a vote of lack of confidence in management. It is, to some extent, a safeguard against possible mismanagement, but it is much more the expression of a desire, by people who are competent to interpret the reports of directors, for a more precise and more delicate instrument of measurement of the relative success of the commanders of the resources of companies and kindred institutions, an instrument of information to replace that of guesswork and rumour. From this point of view the demand is justified, but one suspects that in some instances insufficient thought has been given, by some who make demands, to the use to be made of detailed information by those to whom the reports are directed. For example, those who require data, which would assist in the compilation of industry or national statistics of factor payments or of imputed costs, to be included in the annual reports of companies,

[14] *In re* The Kingston Cotton Mill Co. Ltd. (1896), 65 L.J. Ch. 673.

appear to have overlooked the probability that much of the information they require would be of little, if any, use to shareholders or investment analysts, and have failed to realise that a better and more convenient means of getting the information they require would be through the submission of such data to a statistical bureau.

The amount of detail which may reasonably be required in directors' reports is such as would be sufficient to allow informed people to formulate a judgment on the prospects of the concern, that is, to enable them to make an assessment of the degree of success with which the present management has carried on the affairs of the concern in the past and, if there is no change proposed, the degree of confidence that might reasonably be reposed in it. The degree of such confidence takes on a positive expression in the prices of shares. Just how much detail this amounts to is something on which it would be unsafe to generalise, since the circumstances of each community differ from those of others. However, it is probably safe to say that up to date, at least, no obvious or visible harm has come from the statutory and regulatory requirements for more information than had been provided before, and that the limits of information presentation have not yet been reached.

We come back to the point that the reader of a report and its preparer are pretty much in the dark about each other's point of view. Yet they do meet on this common ground, namely, that the preparer is concerned with preparing a report on management while the reader is concerned with an interpretation of the report to enable him to assess the relative success and merits of management. The question asked by the readers of a directors' report and a set of annual accounting statements is whether management has been satisfactory during the past period and shows evidence of continuing to be satisfactory. This is a value judgment to which the data contained in the accounting documents contribute, but only in part. Many readers would answer the question affirmatively so long as the amount of dividend is not reduced from year to year, irrespective of the relation between dividends and annual result or between dividends and transfers to reserves. The value judgment is none the less there, and the function of the

published accounting report is to provide information to assist informed readers in making their judgment on a basis of reason rather than non-reason.

VI Tagging

Accountants are much concerned in their everyday activities with the determination of costs and prices of goods, services and rights. That is to say, what we might call tagging or putting value-tags on things takes up a significant amount of an accountant's attention. An exhaustive treatment of his procedures is not practicable but it is desirable to consider a few of the conceptual problems involved in some of the areas in which he carries out or attempts or purports to carry out this function.

Tagging may take place for various purposes. It may be carried out for the purpose of arriving at a selling price for products; this is the most obvious form of tagging. It may be carried out for the purpose of determining a periodic result of activities. It may be carried out with the objective of adjusting, whether upwards or downwards, proprietary rights in an enterprise on specific occasions; for example, in a more or less general revaluation of assets or a valuation of goodwill. At first sight these purposes do not appear to have very much in common and there is consequently considerable divergence in methods of tagging involved in each category; there is nevertheless a common element between them.

Those economists who have directed their attention to the theory of value have been largely concerned with the influences which determine the prices of things. There does not appear to be very great agreement amongst them, and studies in the field of actual price setting do not seem to support greatly the principal arguments of the theorists. We are not concerned here with examining any particular theory of price setting or with selecting between a full-cost, direct cost, normal cost, standard cost or any other costing basis as a means of determining prices. Nor are we concerned with the haggling process which directly or indirectly, explicitly or implicitly, takes place in the exchange process by which prices in the long-term and sometimes in the short-term are arrived at. What we have to notice, however, is that the

setting of a price for a commodity or service involves a process of evaluation.

It is first necessary to point out that a price is only significant and, indeed, only has meaning if an exchange transaction is contemplated. If I wish to acquire something, its price may induce me to buy it or it may discourage me from buying it; it is thus a positive influence on my actions in this respect. Having once acquired it, however, the price in itself is no longer significant. Of course, the fact that I paid so much for it may appear to be at the back of a suggestion that I should take very good care of it, but this is a superficial view; the true reasoning is that if I do not take care of it I may have to replace it or do without it; and in this respect it is not the price of the thing acquired but that of its replacement that is the significant consideration. In the absence of a contemplated exchange transaction, a price has neither meaning nor significance.

Normally, in arriving at a price for selling something, its cost is only one of a number of factors which the person setting the price takes into consideration. Some at least of these factors involve value judgments in which subjective interpretation cannot be escaped. Alternatively, in those cases in which a formula for price is adopted as a mathematical function of cost (such as "cost-plus" contracts), the determination of cost usually involves subjective interpretations.

In the very simple case in which I buy an article at, say, £10, and put a selling price of, say, £14 on it, various kinds of consideration might be operative in determining the margin, and several at least of these cannot be reduced to positive factual assessment. For example, I might consider that I want an income of £20 per week, in which case I have to envisage selling five articles per week on a £4 margin. But behind this proposition is the assumption that no costs other than that of acquisition are involved in each venture. If there are other costs involved, it is necessary for me to make some kind of estimate of their incidence and relate this to the margin and the turnover. This introduces the whole question of fixed (or indirect) and variable (or direct) costs. Thus, if, in addition to the acquisition cost, there are further unit (direct or variable) costs, such as carriage, of £1 per unit, and fixed or in-

direct costs, such as rent, of, say, £4 per week, then the turnover required to allow me my income of £20 per week will have to be eight articles per week, calculated in accordance with the formula:

$$n = \frac{Y + F.C.}{S.P. - A.C. - V.C.}$$

where n is the number of articles;
Y is the amount of income required per week;
F.C. is the amount of the fixed charges per week;
S.P. is the selling price per article;
A.C. is the acquisition cost per article; and
V.C. is the variable or direct charges per article.

The result can be "proved" by a profit and loss statement:

Sales 8 articles @ £14 per article		£112
Less Costs:		
Acquisition Cost 8 @ £10	£80	
Variable Charges 8 @ £1	8	
Total Direct Charges	88	
Fixed Charges per week	4	
Total Cost and Charges		92
Gain (=Income Available)		£20

Notice, however, some of the matters that are implicitly involved here. Is £20 an adequate or a more or less than adequate weekly income for me to contemplate? Can I sell eight of these articles each week; is this within or beyond my selling capacity? Is there a sufficient market for this quantum of sales? Can I be assured of the same levels of acquisition costs, variable charges and fixed charges?

Some at least of these questions are not by any means matters of fact and cannot be determined by reference to purely objective measures. Admittedly, it is possible to make market surveys and to examine my past selling performances and so on; these may give more or less trustworthy facts as a guide to the answers, but they constitute no more than a guide, and probability, not certainty, is the basis for extrapolation of the past into the future. However

such questions may be answered, each answer is based on certain usually unexpressed assumptions. Thus, £20 per week may be an adequate income on the assumption that there is no material change in the prices of those consumption goods and services on which I habitually spend my income. Or I may be able to sell eight articles per week on the assumption that my health is not impaired in any way. And so on. Assumptions of this sort may be valid for short-run decisions but may have to be examined expressly and carefully for the longer run; and, it must be remembered, the point at which the short run becomes the longer run can rarely be more than arbitrarily and often imprecisely drawn.

In practice, of course, the situation is often much more complicated than this. There appear to be few empirical studies of the way in which prices are determined in practice. However, in one notable example,[15] it has been shown that the evidence for one firm, provided respectively by the price-fixing executives themselves, the cost estimates and the annual accounts, was not consistent and that

> not even from the cold, impersonal mechanics of the accounting system of the firm can the investigator always unearth the whole truth—that this seemingly objective evidence is often in fact a network of snares and delusions in the shape of arbitrary conventions, an odd mixture of plan and performance.[16]

One writer has put the position in these words:

> The setting of selling prices is one of the more complex problems that the sales manager has to face. Many of the factors involved are difficult to evaluate, and as a result decisions are often made on an intuitive basis or even through a process of trial and error. How should the sales manager go about establishing prices? . . . No true scientific method exists for resolving the many-sided question which is posed, but some factors can be evaluated and the area for discretion reduced accordingly.[17]

Complex or simple, the process of arriving at a price is a valuation process. Even if a basis as simple as, say, twenty per cent above cost is adopted, there are implied questions: Why twenty per cent? Why not eighteen or twenty-two?—questions which boil down to adherence to a standard or norm, the selection of which depends upon personal experience and personal predilections.

[15] I. F. Pearce and Lloyd R. Amey, "Price Policy with a Branded Product," *The Review of Economic Studies*, XXIV, 1, 49-60.

[16] *Op. cit.*, p. 60.

[17] V. W. T. Scully, "'Translating' Financial Data for Nonfinancial Executives," *The Controller*, September, 1961, p. 443.

Professors Paton and Littleton have recognised the significance of non-accounting influences in decision making and administration. They point out, for instance, that

managements, investors, and governmental agencies make final decisions and carry on the process of administration; their judgments and policies, although based in substantial measure on accounting reports, in part reflect the influence of non-accounting data and are tinctured by such imponderables as "broad objectives," "specific short-term aims," and "personal desires."[18]

When they go on to argue that the basic subject matter of accounting is the "measured consideration" in the exchanges which form a large part of the activities of specific businesses,[19] the implication that accounting is restricted to expressing and processing these "measured considerations" gives a rather too narrow interpretation of accounting functions, even for the business corporation with which they were professedly primarily concerned. For there are many instances in which the imponderables of broad objectives and personal desires are fairly directly expressed quantitatively and in such a way as to become part of the accounting procedures. Cost specifications, standard costs and the like are not in themselves wholly expressions of exchange activities, neither is the addition to direct cost of a percentage to cover overhead and/or profit, nor the allocation of cost of a long-term asset by way of a periodic depreciation charge. Hence, while it is true that accounting "undertakes" to express exchanges quantitatively, it also "undertakes" to do considerably more.

Their preference for the expression "measured consideration" appears to be based on their proposition that "it is confusing to say that accounting records 'values.' " They point out that the consideration of an exchange, that is, the price at which a thing is sold,

may express the mutual valuation of the buyer and seller as of the moment of exchange, and, in this limited sense and as of that moment, a record of such price-aggregate may be viewed as a record of value. After the moment of exchange, the value may change but the recorded price-aggregate does not.[20]

The terms "measured consideration" and "price-aggregate" are apparently not intended to be strictly synonymous, the latter be-

[18] Paton and Littleton, *op. cit.*, p. 11.
[19] *Ibid.*, pp. 11-12.
[20] *Ibid.*, p. 12.

ing wider in meaning than the former; the authors instance gifts as having to be priced for recording purposes although no measurable consideration passes.

It has already been suggested that the price of a thing does not necessarily indicate its value to either the buyer or the seller; indeed, rather than the consideration in an exchange expressing a "mutual valuation," it is more likely that it represents something less than the value of the subject thing for the buyer and something more for the seller. Much, however, depends on what we mean by our terms. There is a mutual agreement to trade; the thing is the subject of the agreement; and in this sense the consideration may be regarded as a mutual "valuation." It is, of course, true that the value of something may alter after the moment of exchange, but it does not follow that accountants should be or in fact are exempt from accounting for these changes. Such changes take place because the thing itself changes or the circumstances attaching to it change, and while all such changes are not and, indeed, very often cannot be accounted for as they take place, their effects do have to be accounted for from time to time. Raw material, for example, is worked upon and fabricated into finished products; some of the costs involved are clearly traceable, others are not, but a price has to be determined for each finished article and there is necessarily something of guesswork and estimate—intelligent and informed or not—in which value judgments made by somebody or other play some part at some time. In this sense, one of the functions of accounting is to deal with values, and it is one that cannot be escaped merely by changing terminology or defining expressions.

In not a few cases the price of a thing for the seller is settled before the thing itself is ready or available for sale and in some cases before it or its component parts have been acquired. This does not alter in any way the fact that the price is determined by an act or acts of valuation in which subjective elements come into play. On the contrary, the elements of judgment and anticipation are directed towards the costs of the thing or its components as "facts" of the future to an even greater extent than the case in which all those costs are facts of the past.

In some cases, the price may be dictated to the seller by the purchaser. When this occurs, the seller has no freedom of choice

in assessing the tag itself; he can only exercise his judgment in determining whether the price is satisfactory for him or not. He may or may not have the option of refusing to accept the price so dictated; if he has, then he has an opportunity of haggling even though it may be a deferred opportunity, that is, he may hold on to his produce in the hope that a more satisfactory price will be forthcoming from someone; if he has not, his value judgments will be turned away from the direction of price towards costs and efforts—he will probably still ask himself whether it is worth his while to accept the conditions applying in his circumstances.

The process of tagging is also often applied as an element directed towards the assessment of periodical result. Inventory valuation is the most obvious and best-known instance, but other assets are often regarded and treated in a similar way.

The need for periodical tagging arises from the fact that, at any given point of time, numbers of ventures, of various kinds, are uncompleted, and, if periodic summaries of result and position are to convey meaning, these uncompleted ventures must be reported as well as the completed ones. We can consider some typical examples to indicate the problems involved.

Suppose that, in a trading venture, one hundred units have been bought at £1 each; at the end of the accounting period, seventy have been sold at varying selling prices as follows:

10	@	£1.6	£16
10	@	1.5	15
30	@	1.3	39
10	@	1.1	11
10	@	.8	8
70			89

What has been the result of the venture, so far as it should be reported in this period? At first sight, it would appear that, as seven-tenths of the units, which cost £70, have been sold for £89, a gain of £19 has been made and should be reported. This is mathematically valid and appropriate, but it is based on an interpretation of the venture as comprising in fact one hundred ventures. This interpretation would not necessarily be valid if the acquisition price of £1 was a function of the purchase of the quantity of

one hundred units. If the cost per unit bought singly would have been greater than £1, is it then quite proper to report the result of the incomplete venture without making some allowance for this position? However, we cannot escape the facts that the seventy units sold represent $\frac{7}{10}$ of a lot that cost £100 and that they have been sold for £89.

We still have thirty units on hand. In order to arrive at a statement of position, we have to report this fact and attach a tag to the units. If we report them at cost, this would give a valuation of £30. It may, however, be considered justifiable to vary this. If the selling prices listed above represent a movement through time such that the highest selling price was obtained first and the lowest near the end of the period, there is presumptive evidence that the remaining thirty units very likely will not realise as much as they cost. Should this be taken into account? If there is strong evidence that the units on hand can only be sold if the price is reduced to, say, £.3 each, then the result of the whole venture will result in a loss of £2 (total cost £100, total revenue £98); is it proper that part of the venture should have been reported as having been profitable? On the other hand, it may be that the lowest price was realised first and the later sales made at the more profitable rate; should this affect the tag to be placed on the units on hand at balance date? It may be noted that questions of LIFO and FIFO and the like do not enter here since all the units were acquired at the one time and at a total cost for them all, that is, at the same (average) cost. Thus the "value" of the stock of articles on hand is an open question.

Some would argue that, irrespective of what the likely realisation price may be, the proper valuation of stock is at cost. On this basis, the situation in the above example would be:

In Period 1.

Sales					£89
Cost of Sales:					
Acquired	100	@	£1	£100	
Less on hand	30	@	£1	30	
					70
Gain					£19

In Period 2.

(a) If 30 sold at, say, £.3

Sales	30	@	£.3		£9
Cost of Sales:					
On hand	30	@	£1		30
Wane					£21
Net result over venture—Loss					£2

(b) If 30 sold at, say, £1.3

Sales	30	@	£1.3		£39
Cost of Sales:					
On hand	30	@	£1		30
Gain					£9
Net result over venture—Profit					£28

However, many argue that if it is known or suspected that the realisation price of stock on hand will be lower than cost, then this should be taken into consideration, and the lower realisation price should be the tag for the stock. On this basis, the position would be:

In Period 1. Selling price of £.3 envisaged

Sales					£89
Cost of Sales:					
Acquired	100	@	£1	£100	
Less on hand	30	@	£.3	9	
					91
Wane					2

In Period 2. If 30 sold at £.3

Sales	30	@	£.3	9
Cost of Sales:				
On hand	30	@	£.3	9
Result				Nil

Thus the loss on the venture is thrown wholly into the first period.

If a selling price above cost is envisaged, then the situation would

be as in (b) above, with the profit on the venture falling partly into each period.

The "lower of cost or market" basis for inventory valuation has had very widespread acceptance over a long period. It has generally been justified on the ground that it is prudent to take account of known or expected losses as soon as practicable, but not to bring profits to account until actually realised. One writer at least, however, has sought to justify it on theoretical grounds,[21] making a similar point to that propounded as a possibility above, namely, that "costs do not attach to individual items of purchases."[22] He instances the retailer of ladies' gowns who knows when he buys his season's stock that, while some will almost certainly prove quite profitable, others will have to be sacrificed at less than cost; but he does not know which gowns will fall into each category. Part of the cost of the less successful gowns, he argues, should be regarded as an addition to the cost of the more successful ones.[23] The same idea, as he points out, is expressed by Professors Paton and Littleton.[24] He argues, rather ingeniously, that the "lower of cost or market" basis "fits in with, and is indeed an essential of, a cost-allocation notion of profits and assets," and that "the process is not to be thought of as *providing for* losses."[25] That is, he appears to treat the purchase-cum-sale of all the season's goods as one venture.

The situation can be considered from a slightly different angle, namely, that of cash resources involved. For the sake of simplicity, let us suppose that cash is received immediately for all sales. Then in the first period £89 would be received. Now, if suppliers are paid for each unit *as it is sold,* then at the end of the first period they would have been paid for seventy units at £1 each, and there would be £19 on hand. In the second period, on a selling price of £.3, only £9 would be received, but the suppliers would have to be paid £30. At the end of the venture private cash would have to be found to meet the claims of the suppliers. If the £19 surplus at the end of the first period is held until the end of the venture or at

[21] Harry Norris: *Accounting Theory* (London: Pitman, 1946), pp. 69 ff.
[22] *Ibid.,* p. 72.
[23] *Ibid.,* p. 72.
[24] *Ibid.,* p. 72n. Paton and Littleton, *op. cit.,* p. 80.
[25] *Ibid.,* p. 73.

least is not spent in the first period, the venturer can use this towards meeting the supplier's bill; this, together with the £9 received in the second period, would mean that £2 of private cash would have to be found at the end. If the venturer spends some of the £19 before the end of the venture, then he has to make it good or else the supplier will not be paid in full. The consideration that is germane to the argument is whether or not the declared gain is likely to be used for purposes other than the payment of creditors. In a case like this, the "lower of cost or market" rule is a safeguard against proprietary withdrawals which might endanger the claims of creditors.

If, however, the supplier is paid for the goods when they are bought, the venturer himself is the only one to be affected by any variation in the basis of valuing inventories at the end of a period, and the relevant consideration is whether he should regard resources available at the end of one period as spendable for other purposes so long as the venture itself has not been brought to a measurable finality. So long as we are dealing with one venture and one venturer, it matters little how the incidence of the venture result is allocated between periods, so long as the venturer is aware that, if he withdraws resources on the basis of a gain in one period, he may have to contribute from his private resources to meet a wane in a subsequent period if the completed venture finally results in a loss. It may be imprudent of him to withdraw the resources before completion of the venture, but, if he is prepared to meet the consequences of so doing, there can surely be nothing inherently wrong in it provided the rights of others—in this case, the suppliers—are not impaired.

In practice, of course, the position is much more complicated because of the large number of ventures being undertaken simultaneously and because at any given point of time it is almost certain that many of them will remain uncompleted. However, this does not affect the essential validity of extending the above considerations to the practical case. If the profit and loss statement is regarded as setting out the results of completed ventures, then the gain which it shows will be a total of venture profits which is represented by an increase in resources which may justifiably be withdrawn or otherwise dealt with as the commanders deem fit;

but if, on the other hand, it is regarded as including interim results of incomplete ventures as well as final results of completed ones, then there may be some danger in representing the apparent increase in resources as being free, for withdrawal purposes, of any restrictive claims.

Some writers—and practitioners also—appear to regard the situation as one in which there are virtually no completed ventures until the final winding up of the enterprise; if goods are bought and sold, the selling does not represent the end of a venture, but merely an incident enabling the continuance of the venture by providing means for the acquisition of another lot of goods. On this view, the profit and loss statement can never be a statement relating to completed ventures, but always represents an interim assessment purporting only to show a result which cannot be taken even as an approximation in itself but only as one in conjunction with all the results of previous and subsequent periods. On this view, too, proprietary withdrawals (for example, in the form of dividends) should be taken as tentative and subject to possible future re-contributions if required; taxation payments based on periodic profitable results should be taken as being adjustable through refundable set-offs if subsequent periodic results are unprofitable. In short, if we are to be consistent, no finality in relation to results or to allocations of resources based on results should be envisaged until the enterprise is to be finally terminated —until, in other words, the enterprise as a venture is completed.

We know, of course, that such a procedure is impracticable: the people with proprietary rights in an enterprise change from time to time and recovery of resources withdrawn is impossible, and taxation authorities do not arrange their affairs with regard to the accounting theory applicable to their client taxpayers. It seems to follow, therefore, that, if we are to be practical and consistent, we must regard the unitary ventures undertaken within the lifetime of a given enterprise as being capable of completion even though they may overlap with each other and may extend beyond the limits of any given accounting period.

The relevance of this discussion is that, if periodic results are to be assessed, it is necessary, because some trading ventures are virtually certain to be incomplete at any given point of time, for a

valuation tag to be put on the goods on hand at that point of time. There is no ready-made solution for the basis on which valuation should be made and the process of valuation is not necessarily a simple one; it inevitably involves the exercise of judgment related to the known and expected circumstances prevailing. It is an exercise in presentation of truth, in the wider sense, and the really significant objective is to provide a truth-conveying statement. For reporting purposes, the solution is to indicate the basis or bases used in the process of valuation and the reasons for its or their adoption; no basis should be adopted without adequate reasons, no rule applied simply because it has or appears to have legal or customary acceptance.

In usage ventures, we are again faced with the situation that many, perhaps most, of these extend beyond any given accounting period. Somewhat analogous considerations apply as in trading ventures, especially in relation to usage of materials in manufacturing processes. A tag has to be put on either the material as it is used or the material on hand at the end of the period; the former procedure throws up the balance on hand as a residual, the latter throws up the usage as a derivative. Both procedures are familiar and are treated in numerous text-books. What we are concerned with here is that a valuation process is applied with the scope for interpetation that is inevitably involved in the valuing procedure. It is here that cost is significant, but the interpretation of cost as identifiable, FIFO, LIFO, HIFO, average, etc., allows for variations in the actual amounts arrived at, while lower market-price—either replacement or realisation—has also been adopted in many instances. Arguments at some length have been propounded in favour of and against each basis and, to a great extent at least, the significant elements in these arguments have been extraneous influences. Taxation requirements have had a great effect in practice on the basis adopted in particular cases, and the effect of rising prices has also affected accountants' thinking on the matter. The question of what the venture is also arises here. There appears to be no reason to expect that any one interpretation of the venture or any one basis for valuation should be universally applicable; it is more important to recognise the essential subjectivity of the valuing process, to admit it in appropriate cir-

cumstances, and to indicate and explain the basis adopted in relation to the circumstances.

Tagging also arises in respect of the business generally on those occasions when it becomes necessary to value goodwill or shares in a company or groups of assets. To put a figure upon such an intangible quality of a business as its goodwill is an exercise in estimating potential for future activity and development. Formulae have been devised for some particular types of activity, such as a proportion of gross fees over a specified past period in the case of medical or dental practitioners, or the quantity of milk deliveries for dairies, and so on. Capitalisation of adjusted past profits with suitable modifications for known or expected changes in circumtances covers another group of formulae. But the essence of all methods is an attempt to evaluate the effects of personal attributes in the past and to assess a projection of these effects into the future. There is little means of knowing whether any given valuation of goodwill will ever prove to be right or wrong; the assumption behind any such valuation is that the future human relationships involved will be effectively the same as the past ones have been. This assumption is untestable, and it is questionable whether even the furthest development of mechanical and electronic devices will enable the variables in human relationships in the complex circumstances of a social context such as a business or professional practice to be specifically evaluated with such precision as to make universally applicable any formula for the valuation of goodwill (or its derivatives, the valuation of a business or shares in a company).

CHAPTER 16

The Problem of Communication

I *Accounting as Communication*

ALTHOUGH the question of communication has been touched upon at various points in our discussion to date, the significance of communication as a distinct phase of accounting endeavour warrants its consideration as a separate operational problem. So much of accounting activity is orientated, directly or indirectly, towards the communication of information that it is scarcely an exaggeration to say that the problem of communication is the axial problem in accounting.

The reporting function is obviously and directly one of communicating information by or on behalf of one party or body to another.

The interpretative function is equally an obvious instance of conveying to people information contained in reports and records and imparting conclusions derived from a study of them for the benefit of people; such information and conclusions may or may not be within the cognisance of those who prepare the reports or records, and the analysis of the information and the exercise of judgment in its interpretation constitute a skill which the more experienced accountant needs to master.

The maintenance of records is also an expression of the requirement to communicate. Apart from the fact that the accounting records are the embodiment of the detail from which the reports are prepared, they are in themselves a vehicle of communication. Even if they are prepared simply and solely as an *aide-memoire,* as the equivalent of a diary of events, and even if they are used only by the person who prepares them, they are just

as much an example of communication as the most elaborate and widely disseminated report. As one writer has pointed out, "If I make notes for my own subsequent use, then I am practically two different persons, in different places or at different times, one here and now, the other somewhere else in the future."[1] At its lowest level, so to speak, an accounting record is not less than notes for the writer's subsequent use.

The verifying or checking function is carried out in order to validate the records and the reports prepared from them, and the objective of the checker or verifier is to communicate to somebody else, in the form of a report (usually but not necessarily written), the results or findings of the fulfilment of this task.

Even the designing function is directed mainly towards the provision of means by which more efficacious reports may be made available and is thus concerned, indirectly at the very least, with providing better means of communication.

Since communication pervades the practice of accounting to such a large extent, it is somewhat surprising that the basic theory of communication has hitherto attracted so little of the attention of accountants outside those relatively few who have had to study some of its technical aspects in relation to modern computing devices. The wider implications and the deeper significance of communication theory appear to be almost completely unexplored territory for accountants.[2]

II The Nature of Communication

Communication takes place for various purposes and through various means.

It is not intended here to attempt an exhaustive classification of either purposes or means, but certain primary and broad varieties can be fairly readily distinguished. As will be clear, communication is used here in a wide rather than a narrow sense to cover the

[1] Joshua Whatmough, *Language, A Modern Synthesis* (New York: St. Martin's Press, 1956), p. 12.

[2] A few recent attempts show the beginning of interest in this area; see, for example, H. R. Anton, *Activity Analysis of the Firm: A Theoretical Approach to Accounting (Systems) Development* (Univ. of California Center for Research in Management Science, 1963); Norton M. Bedford and Vahe Baladouni, "A Communication Theory Approach to Accountancy," *Accounting Review*, October, 1962, pp. 650 ff.

activity by which the state of mind of one creature is conveyed to the mind of another, that other actually or only potentially existing, and including the same creature at a future time.

The means of communication are also widely interpreted, comprising verbal and non-verbal means. Verbal means of communication may be oral or written, and non-verbal communication comprises written symbols and non-verbal sounds, gestures and other bodily activity.

One purpose of communication is clearly to express emotion. *Emotional* communication is perhaps the earliest and most primitive form of communication; many of the non-verbal means of communication appear to be associated with emotion. For example, the crying of a baby is generally taken to be evidence of pain or discomfort, when it coos it is assumed to be contented; when a dog wags its tail it is regarded as expressing joy or friendliness, when it growls it is taken to be angry and unfriendly, when it yelps, it is assumed to be in pain. As humans we may not always be able to interpret animal emotions correctly, but it is at least very likely that there is some emotional content involved in most of the non-verbal sounds and gestures of humans as well as of animals. There are, in fact, many non-verbal means of communication; some of them are bowing, smiling, scowling, laughing, hissing, cheering, booing, handclapping, grunts, growls and groans, miming, ballet, music, art; and in our modern civilisation the tooting of a motor-car horn, the hand signals of the motorist and the red, amber and green of traffic lights are familiar non-verbal methods of communication. Not all of these are necessarily or wholly charged with emotional content; the tooting of a car horn may be an expression of fact, for example, when I toot outside my friend's house to inform him that I have called for him, or it may be an expression of annoyance when I toot at another driver who has usurped my right of way; the "meaning" of the expression must be interpreted in the light of associated circumstances. Again, much of our music is emotionally charged, but there is also much which has an intellectual content. The playing of a foreign national anthem may have virtually no emotional charge for us, whereas the playing of our own has depths of emotional content for us but not for foreigners.

Another purpose of communication is to influence the actions of others; this might be called *activating* communication. All kinds of propaganda, most advertising, political speeches, and religious sermons are intended to affect the opinion and attitudes and hence, sooner or later, directly or indirectly, the activities of others. One interesting distinction can be noticed in this connection. Much obviously persuasive communication is embodied in emotional language; this should be distinguished from the more subtle communication which, while not purporting to be openly persuasive, nevertheless makes use of emotive words and phrases, whether deliberately or not, which do in fact carry an emotional connotation within the context in which they are used. Many people who, in a sophisticated society, profess to be repelled by violently emotional language obviously directed towards affecting them in a certain direction are influenced in that direction by more subtle means and even under the impression that they are freely making the choice of direction without any influence of emotion whatever and on a basis of "pure logic." Indeed, it is difficult to avoid the use of emotive language altogether, and the reader will no doubt find examples in this work and perhaps even within this section.

Another type of communication which may be regarded as falling within this activating category is the mandatory communication which embodies a command or instruction. Within this class come not only the sergeant-major's commands to his trainees and the instructions to candidates on an examination paper, but also the manual of office procedure, the architect's working plans, statutes and ordinances carrying legislative authority and the Ten Commandments; each of these is designed to bring about certain action by those who hear or read it.

A third category is composed of *informative* communication, which is concerned with setting forth the facts of a situation. Informative communication, *in itself,* does not produce action. "It is raining" is a purely factual statement, conveying a piece of information based, let us say, on direct observation. If, as a result of receiving that information, I put on an overcoat and put up my umbrella, my action is due not simply because I received the communication but because I related its meaning or import to

the proposition "I do not want to get unduly wet" or "It is bad for me to be unprotected from the rain." On the surface, these latter may *appear* to be factual statements also, but there is an emotive or activating connotation about "want," "unduly," "bad" and "unprotected" in this context. To put it another way, "It is raining, therefore I put up my umbrella" is incomplete as a statement of "events"; implied between the statement of fact and the description of action is a value assessment, that is, a relating of the fact to circumstances of my existence. "How does rain affect me?" is something which I must know before I can determine what action I should take. In other circumstances, the same fact may lead to very different action. "It is raining, therefore I laugh and dance" might well be valid if I were a tribesman in New Guinea at the breaking of a drought. Again, a given kind of action might be taken as a result of receiving very different information, for example, "The sun is shining brightly, therefore I put up my umbrella." "It is raining," "I put up my umbrella," "I laugh and dance," "The sun is shining brightly," are all informative statements in themselves; but the relationship between any two or more of them can only be established through a knowledge or assumption of additional circumstances.

Much of the language of science and technology is informative communication in this sense. The report of an experiment or the description of a process or a table of statistics is informative in character. We must notice, however, that an informative statement is not necessarily a true statement, at least in one sense of the word "true." As the extent of our knowledge increases, the informative communication of one age of science may be shown to be inadequate for another age; an obvious example would be to compare a medical textbook of one hundred years ago, before, say, Pasteur's work had shown the existence and significance of bacteria, with one of today. Both would contain a great deal of informative communication, but they would be contradictory at many points, and one or other must be untrue in the sense of being not in accordance with all relevant facts as we know them now. In another sense of the word "true," however, both may be equally true, in the sense that each is in accord with the known evidence at the time of writing; each author could say with a clear conscience that what

he wrote was true to the best of his knowledge and belief at the time.

There is, however, another set of instances in which informative statements are not true, in the sense that they are not in accord with facts. If a person asks the direction to a particular place and is told to turn right, whereas the correct road is to the left, the statement he receives is none the less an informative one, that is, one which conveys information, although the information is incorrect. The incorrectness may be due to a deliberate intention to mislead or to a genuine but mistaken belief in its veracity by the giver of the information; this does not affect the nature of the communication as being informative.

Another category which has been distinguished[3] is *aesthetic* communication. We are not greatly concerned with this category here, but we may note that the poet, for instance, achieves an expression through his use of language which can only be described as conveying an aesthetic experience. This is possibly closely related to emotional communication; it might be regarded as a particular class within that category, but, if so, it is certainly distintinguishable from the more blatant emotional communication that most of us use from time to time. If the difference is one of degree and not of kind, there is a very wide stretch of measurement to be recognised between a sonnet of Shakespeare and the vehement "Damn!" that expresses our feelings when we step unexpectedly into a puddle of water.

These different types of communication may and often do overlap and they are not always clearly distinguishable in practice. This makes it very difficult at times to analyse and evaluate particular pieces of communication.

Further, communication is not always or necessarily purposive. A given set of activities or signs may not be intended to convey any message, but a message may be conveyed nevertheless through the interpretative skill of the recipient or observer. Medical diagnoses, scientific observation, much archaeological and historical discovery, and the art of the aboriginal blacktracker are examples of interpretative skill applied to signs not intended, or certainly not primarily intended, to convey messages.

[3] E.g., by Professor Joshua Whatmough; *op. cit.*, see p. 90.

One form of communication which also needs to be distinguished might be termed *explanatory* communication. A good deal of accountants' writing comes within this category. It might be thought at first sight that explanatory communication is scarcely distinguishable from informative communication, but in the sense in which the words are used here there is a clear distinction to be drawn. The conveying of information, whether correct or incorrect, does not of itself afford an explanation of anything—an explanation being intended to enable someone to "understand," that is, to be able to accept into his universe of ideas, something to which the information relates. This notion of explanation is discussed in some detail in the Appendix to this chapter.[4] What we have to notice here is that an explanation is directed towards answering the question "Why?", while informative communication answers the questions "What?" or "When?" or "Where?" Some answers to the question "How?" may well appear to have more than a flavour of explanation about them; and a thoroughgoing description of the way in which something is done or occurs may seem to amount to an explanation, but only if it implies an element of "why-ness" in the question, or, in other words, it contains reasoning or a revelation of relationships in the answer. Such a description is, in effect, an answer to an implicit "Why?" which the "How?" contains or which the person who answers has injected into his interpretation of the question; an answer of this sort might be labelled, if so desired, as an explanatory description.

The present discussion is not intended as an exhaustive or comprehensive study of communication; a great deal of work needs to be done before a satisfactory theory of communication, applicable to the wide range of activities—human and non-human—to which the term "communication" can be applied, is likely to be developed. A glimpse of the breadth of enquiry necessary can be obtained from a perusal of "Studies in Communication,"[5] in which essays on communication in relation to biology, art, medicine and economics are presented alongside each other.

[4] See below.

[5] *Studies in Communication* (London: Martin Secker & Warburg, 1955).

III The Communicative Process in Accounting

Against this very brief background, we can now consider some criteria for assessing the communicative aspects of accounting. This consideration is necessarily inadequate in the present state of our knowledge and can do little more than point the direction in which much research and investigation need to be carried out.

It is probably true that most of the communication that takes place in the accounting procedures is informative in the sense in which this word has been used in the previous section. That is, accounting data and reports are intended to convey or to have the form of conveying information.

When an accounting record of events is made, the entries in the books of record (or their equivalent) are made as of factual occurrences, as, indeed, in a sense they are. The "facts" of acquisition and disposal of assets, payments of various kinds, receipts of cash, issues of shares, making of loans, and the like are clearly recorded in words and figures which act as the symbols for the activities themselves. The recording of depreciation or of a providing against a loss of some kind or of a transfer to a reserve puts into appropriate symbols the "fact" that a decision of a certain kind has been made. Whether the depreciation charge or the provision is adequate or not or related to the "facts" of the case (in the broad sense) or whether the transfer is justified by the financial circumstances of the concern, is irrelevant to the procedure of recording. The books of account are constructed on the basis of records of activities, decisions, judgments, even prognostications; each one is a fact which is recorded in a relatively uniform manner. One advantage of a double-entry system over an unsystematised set of records is that the former ensures that a greater proportion of such facts is recorded than the latter. An advantage which the accrual basis has over the cash basis of accounting is also that it ensures that a greater proportion of such facts be recorded. But no system has yet been devised which will record all the facts which affect any given unit of activity, and at the very best the operation of an accounting system involves selection of certain facts for the purpose of recording.

In the traditional text-book treatment of the books of account, the narration appearing underneath a general journal entry is frequently called an explanation of the entry. In the sense in which "explanation" is meant in this chapter, such a treatment is not strictly correct. Admittedly, the narration answers, in a sense, the question: "Why was this entry made?" But the answer is strictly a referential one, that is, it is a piece of informative communication; the explanation lies really in the theory of double-entry which explains not only this particular entry but all the entries in the books. What amounts pretty much to the same thing is that for the vast majority of entries—those in the journal subdivisions —the narration is suppressed in practice because it is readily and traditionally recognised as an unexpressed part of the context of each entry. It is only for exceptional events that a narration is required; and a reference to the nature of such events is the substance of the narration, the nature of the event dictating the entry to be made. The entry is made not because the event takes place, but because the theory of double-entry makes it the obvious record to be made to interpret the event, and the narration simply sets forth the circumstances by reference to which the theory can be specifically put into practice.

The accounting reports—profit and loss statement, balance sheet, funds statement, reports of variances from budgeted or standard costs or performances, and "internal" reports of various kinds— to the extent that they are extracts, summaries or presentations of data contained in the accounting records, are also instances of informative communication. Commentary on the data they contain may be truly explanatory in nature, but this is relatively rare, and more usually such commentary represents additional information rather than explanation in the sense in which these words are presently being used.

A balance sheet, for instance, does not explain anything; no matter how well set out, it can only provide data. A series of balance sheets can only multiply the amount of data available. Of course, inferences can be and are drawn from balance sheet data —this is the function of the analyst and interpreter of accounting reports—but even these inferences do not amount to explanation. It is always difficult to say how far explanation should go. To

take a hypothetical case (but not necessarily inapplicable to a real situation because it is hypothetical), suppose that the reader of a balance sheet notices what seems to him an unsatisfactory working capital ratio of a concern. The working capital ratio itself is a relationship between balance sheet items, and the assessment of the ratio as "unsatisfactory" is a judgment based on the relationship between this working capital ratio and some other ("ideal" or "standard" or previous) working capital ratio that the reader has in mind as a criterion. The provision of previous balance sheets may enable him to infer that a deterioration in the ratio has taken place during a period and the "explanation" may be, say, that the bank overdraft has increased while other items have remained stationary. But such an "explanation" does not really explain much. The further question, "Why has the bank overdraft increased?", must be asked; and the answer to this may lead on to many further questions. A satisfactory answer—that is, one which satisfies the enquirer that he has found, for his purposes, the primary reason or reasons for the position initially noticed—must lie in human activity or the influence of natural forces. In most cases, someone has done something or neglected to do something, and this has had the result observed.

But even this may not satisfy some enquirers. Why, let us say, did the purchasing manager commit the firm to buying (and paying for) such large equipment? The answer may be that he was, for a short time, a gullible victim of a very good salesman, or that he misjudged the future trend of events. Ask for the reason behind this and we might arrive at a psychological explanation which might bring us to a study of the education and family environment of particular individuals. This might seem fanciful and outside the realm of accountancy; no doubt it is, but it is none the less a logical development if we are to follow our question "Why?" back far enough. The point that is being made here, as elsewhere in this work, is that accounting is very largely a matter which rests upon and results from the actions of human beings, and the symbols that are used in its reports and records are representations of situations that have resulted from human action. As such they are information, but not explanation.

Auditors' reports—at least those published and made available

to shareholders—are informative in character though rarely informative (using the word in a somewhat different sense) in content. The short-form, published report to shareholders says, in effect, that the auditors have done what they consider a satisfactory job in validating the informatory accounting reports—usually restricted to the balance sheet and profit and loss statement—and that the shareholders can rely on these reports as reasonably accurate or "true and fair" for the purpose of making their decisions as shareholders. There is seldom, if ever, any attempt at analysis; sometimes a little analysis is provided by the company's officials as additional information in the report, but the auditor takes no responsibility and passes no comment on this. For the most part, however, analysis is left to the shareholder himself or his adviser, who may, of course, be a professional analyst.

If explanatory communication takes place anywhere in accounting, it is in the region of analysis and interpretation or, more properly, of the latter, the tools of analysis being applied only as a means to enable interpretation to be validly made. It is doubtful, however, whether much real explanation is made by accountants even in this area. The task of the accountant is traditionally taken to be to inform, to provide data, to state what has happened, rather than to attempt to explain why it happened or why it happened in the way it did; this is the point of view adopted by most accounting writers and by the vast majority of accountants themselves. Whether this attitude can be successfully maintained by a profession in the face of a substantially changing environment which may well require explanations to be forthcoming is something that can only be guessed at; the question is at least worth the serious attention of both accountants and those who think about accounting.

IV The Accountant's Problem in Communication

In carrying out his day-to-day functions, the accountant is obviously faced at almost every stage with communication problems.

One of the most fundamental of these is the selection of the events which are to be included in the accounting records for processing purposes. It might be thought that the solution to this problem is simple and straightforward: any event which affects

assets, liabilities and/or proprietorship and which can be expressed in monetary terms should be selected, and no others. This is the traditional and accepted basis that, broadly speaking, is currently used and has been used for a long time, and it has served its purpose tolerably well. There are signs, however, that this basis of selection is not serving the needs of society fully as those needs become subject to change. For example, new concepts of corporate goals in business, to say nothing of non-business undertakings, are gradually being evolved to replace or supplement the "maximisation of profit" that has for long been accepted as the overriding, if not the sole, criterion of managerial effectiveness;[6] the maintenance of the economic system, the development of "a desirable image of the business," provision for the education of youth, have been expressed as among the objectives of the large corporation.[7] There would be little profit for accountants—or any other members of society—in assuming that our social institutions will endure forever without change: they are in process of change right now.

If the professed objectives of business enterprises change or expand towards a more sensitive social responsibility, there is no saying at this stage what effects this will have on accounting practice and procedures; what can be said with certainty, however, is that such effects will be profound; they will almost certainly dictate some change in the basis of selection of events for recording, with all the implications of measurement and reporting that this will entail. It is also possible that the objectives of non-business undertakings will be examined afresh, and a reassessment made of the accounting procedures appropriate to them, freeing them perhaps from the restraints that the dominance of "business" accounting appears to have had on them hitherto.

A more obvious problem in communication which faces the accountant today, as it will always face him, is to devise the form and determine the contents of the reports he prepares from his records. This problem is present whether the records are kept manually or are subject to electronic computation, whatever the

[6] See Norton M. Bedford and Nicholas Dopuch, "The Emerging Theoretical Structure of Accountancy," *Business Topics* (Michigan State University), IX, 4 (Autumn 1961), 60 ff.

[7] *Ibid.*, p. 63.

type or size of the enterprise in relation to which the records are kept, and whether the reports are designed for use within an organisation or for public consumption. Some attention has been given in the literature of accounting to the form and contents of accounting reports, but the fundamental issues appear to be still somewhat vague and unsettled. Strictly speaking, the preparation of every such report is a distinct piece of the accountant's work and should be regarded separately in relation to the circumstances prevailing when it is prepared. True, a weekly sales report, for instance, may adhere to the same form and composition week by week so long as the relevant surrounding circumstances do not alter materially, but a substantial change in the sales-mix or of the area of distribution of the report or of the personnel of the recipients may occur at any time, and this may well warrant a reconsideration of both the form and content of the report.

To make his reports a vehicle of satisfactory communication, the accountant needs to bear in mind continuously who the recipients of the reports are or are likely to be and what their interest in the reports is or is likely to be. This is often a difficult thing to determine, and in one area at least the courts have come to the rescue of the accountant who unwittingly, albeit somewhat carelessly, has prepared reports which have been acted upon by third parties to their detriment.[8] Statutory and regulatory provisions lay down minimum requirements for published reports of various types of enterprises, adherence to which fulfils an accountant's legal obligations. This modicum of legal protection to the accountant, however, does nothing to modify the basic criteria which ought to be considered by any accountant in preparing any report.

What makes the accountant's task in this respect especially difficult is that in many cases he simply does not know and often has no means of finding out sufficient about the recipients of his reports. Not nearly enough research has been carried out to enable accountants to develop an informed judgment on the needs of the readers of their reports for information, or on the knowledge and appreciation of accounting data that they may reasonably be expected to have or on their receptivity towards accounting information. Without some reliable information of this kind, the accoun-

[8] See, for example, Candler v. Crane, Christmas & Co., (1951) 2 KB. 164.

tant's reports are an expression of what he thinks the recipients ought to want and be able to use, rather than one of what they do in fact want and are able to use. The accountant is not altogether to blame here; although it may be possible, especially in some cases of internal reports, for him to determine with relative ease what the requirements of the recipients are, it often happens, even in cases of internal reports, that the recipients themselves do not know or realise what information they want and, indeed, do not realise the nature of the decisions they ought to be making, let alone the data requisite for intelligent decision-making.

The accountant of the future, therefore, may have to face up to the task of understanding the decision-making process, if only to be able to guide and educate the recipients of his reports to make an intelligent use of the information they contain. This may be done in part through the reports themselves—by means of experiment with various kinds of form of report and presentation of different arrangements of data. It appears to be fairly safe to prognosticate that no single type of report is likely to be universally applicable to any given area over a lengthy period or to any variety of circumstances at any given time. Each report needs to be specifically designed to meet the circumstances of the case at the time, and any text-book illustration can only be taken, at best, as a suggestion of how a particular set of circumstances at a particular time produced a particular kind of report.

Perhaps the only appropriate general criterion that can be laid down is that the accountant should set out to convey relevant information in his reports and either explain the significance of such information or so arrange it that explanation should not be impossible or unduly difficult.

APPENDIX TO CHAPTER 16

The Nature of Explanation

In considering the nature of explanation, two basic questions which arise are (i) Why do men explain things? and (ii) How do men explain things?

A person may explain something either to himself or to others. When he explains it to himself it is because he wishes to understand it, when he explains it to others it is because he wishes that

they should understand it. This process of understanding something seems to be nothing else than the interpretation of it in terms of past experience which the person striving to understand already comprehends. Thus the same phenomenon may be explained by different persons to themselves (or by the same person to himself at different times) in different ways according to their experience. For example, a young child often personalises inanimate objects and natural events and "explains" them in terms of its own experience: the day goes to bed when the dark comes, thunder occurs when the sky is hungry and cries for its food, and so on. Within the limits of its experience, the child supplies an explanation of phenomena, and *is satisfied with it.* The object of explanation is to supply an answer to a question which fits in with the experience of the questioner. The child accepts the authority of its own experience, which in turn has been built up by a developing awareness of its environment.

An older child, or an adult, having had wider experience, and having (possibly) a capacity for more acute observation of phenomena, would supply a very different explanation. Having observed, say, the sun "rising" and "setting," and having noticed an invariable relationship between the appearance of the sun in the sky and the presence of daylight, he might well come to some variant of the explanation that the sun revolves around a stationary earth. And such an explanation would no doubt satisfy him, as it satisfied many thousands of our ancestors for many hundreds of years, fitting in, as it does, not only with everyday experience, but also with religious authority. Under the more sophisticated, present conditions of our experience, however, this would not do; we are taught in our childhood that it is not the earth, but the sun that is (relatively) fixed, and we find no difficulty in either explaining relevant phenomena to ourselves or accepting explanations from others against this background. Indeed, we should not be satisfied nowadays with an explanation which was based on the fixity of the earth, because we have absorbed into our experience the notion of its rotation and revolution.

A person strives to understand things because he desires to fit them into his previous experience, and often because, by understanding them, he is enabled to use them to enlarge his experi-

ence. (The word "experience" is being used here in the widest personal sense.) The explanation he makes to himself will satisfy him, even though it overlooks or misinterprets relevant data, so long as his experience can be reconciled with or does not include such data. A series of explanations of, say, natural phenomena built up by a Tarzan, who had been cut off almost from birth from his fellow men, would be very different from the series of explanations of the same phenomena to which any society of men would adhere. And the explanations of the same or similar phenomena often vary widely between different types of society. Communication between people leads to modification of ideas. Such modification, of course, does not necessarily mean correction, for a person's ideas may be influenced by others in the direction of faulty interpretation as much as in that of correct interpretation.

In all explanation there are two "parties"—one who explains or expounds and one to whom the explanation is made; when one indulges in explanation to oneself, the two "parties" are embodied in one person. This latter case, however, seems to be a special instance of the more general procedure in which different persons take the roles of explainer and explainee. The question then arises, "Why do persons explain things to others?"

It does not seem necessary to adduce evidence for the proposition that man is a social and, for the most part, a sociable animal, and as such each man (and woman, too) seeks to communicate with his fellow-members in the family, tribe, state or nation. As Locke observed long ago, "God, having designed man for a sociable creature, made him not only with an inclination, and under a necessity to have fellowship with those of his own kind, but furnished him also with the language, which was to be the great instrument and common tie of society."[9]

At first sight, there appears to be a variety of reasons for a person explaining things to others. For instance, he may desire to directly control their activities, and his "explanations" may be coloured by the direction in which he wishes their activities to be made. This was probably the case in the explanations supplied by priesthood in primitive societies: the priests and medicine men

[9] John Locke, *An Essay Concerning Human Understanding*, Book III, Chap. I, 1.

were able to maintain their power over men largely by their greater comprehension of natural phenomena, and it can be readily appreciated that the person in a primitive community who could predict an eclipse of the sun would have a powerful influence in the affairs of the tribe. In more recent times, the "explanations" of events made by leaders in totalitarian states and their representatives have frequently been of a similar intellectual standard with much the same objectives.

Another reason may be that men may wish to persuade others to agree with them; this is, perhaps, only a more refined way of expressing the former objective. For the purpose behind persuasion is some form of the desire to control another's thoughts and actions, and although there may be a very full series of gradations from the most virulent and prejudiced propaganda to the most innocuous-looking and balanced expression of opinion, there is, in all, an element of persuasion. Thus, for example, the purpose behind the reasoned judgments of courts of law is to compel people to act in accordance with the decisions arrived at.

There is always, however, the attitude of the explainee as well as that of the explainer to be taken into consideration. In the process of explaining things to others, there seems to be a presumption that these others wish to understand. This is not necessarily or always the case. The explainee may really wish to understand; but on the other hand he may not. Much of the effort involved in school-teaching, for instance, is lost, in effect, because the explanations are not (and perhaps in some cases cannot be) related to the experience of the school children; most children are not really interested in and do not wish to understand, say, the difference between the gerund and the past participle of a Latin verb; yet the teacher carries on his teaching on the presumption that the explainee desires to understand. That is, the explainer acts upon the convention that his explanation, if it fits in with the experience of the explainee, will be acceptable and accepted. He can only ensure that it will be accepted if he has considerable control over the experience of the explainee—and it is a realisation of this which lies behind the successful techniques of propaganda, advertising and, indeed, of all effective teaching.

Another apparent reason why people explain things to others

is to impart their experiences to them. This, it is suggested, is always done in answer to an expressed or implied question; that is, either the explainee in fact asks a question or the explainer proceeds to explain as if the question had been asked. Much of this can be accounted for in terms of the ego—an ego which for practical purposes is inescapable. A man discovers something new and desires to impart his discovery to others. Why? Surely in order to lead the others to recognise the value of *his* discovery. He may profess purely altruistic or disinterested motives, which it would be ungracious to dispute; he may sincerely wish to benefit his fellow-men; but the fact is inescapable that he offers his views to them in the belief that those views are true and in order to persuade them to agree with him. Again the desire to control the thoughts and through this the actions of others appears to be, consciously or unconsciously, present.

Something may be said of what we may call creative explanation—the communication of the artist—in whatever medium. Where the scientist, for example, experiences an intellectual insight into relationships of phenomena and desires to communicate it to others by explanation, the artist experiences an aesthetic or emotional insight into relationships. He equally desires to communicate it to others, and the means he adopts depends upon the medium of expression with which he has developed technical familiarity—words, pigments, stone or bronze, musical tones, and so on. The poet, for example, uses a metaphor to express a relationship: he "explains" the relationship in terms of an experience which the reader has to appreciate to understand the full sense and significance of the metaphor. There is some advantage in considering this because it brings out the point that, before explaining anything successfully to others, a person must explain it to himself—often, indeed, an artist's only conscious motive in a work of art is self-expression, the desire to communicate his experience to others being ostensibly secondary. But it is questionable whether this conscious attitude is ultimately the governing and driving motive.

So far we have been considering explanation in a very general sense. The object of explanation in a more restricted, scientific sense is taken to be the interpretation of man's actions and en-

vironment in such a way as to render events intelligible to him without recourse to the concept of an omnipotent but inexplicable agency. It is, in other words, a search for orderliness in events. The reason why orderliness—in nature or in society—should be such a strong attraction for man is, it is suggested, that, where orderliness is found or can be imposed, prediction can be made, and, where prediction can be made, control of some sort can in some measure be attained. And man is greedy for control—of his environment, of his fellow creatures, of his fellow men, of himself.

Some means of communication is essential as a prerequisite for any explanation by one being to another. The most widely recognised means of communication between human beings is language—verbal or written—and as Susan Stebbing points out,

> Language is a social phenomenon. Men speak in order that they may be *heard;* they desire to be heard in order that they may express themselves to others and thereby influence them. Hence, men use language in order to be *understood.*[10]

But the "language" need not necessarily be one of words: the painter communicates his ideas by means of combinations of colours, the musician by means of musical sounds, the clown by means of dumbshow. And we can take this point still further. For example, in experimental psychology, the obstruction method for measuring, say, animal drives consists in making a rat take a certain amount of punishment (such as an electric shock) in order to reach something which it desires (food, drink, a female in heat).[11] This appears tantamount to "explaining" to the rats that they must endure pain or discomfort in order to get food, etc. According to the period they take to "understand" this, the relative strengths of the drives can be "measured." Now this sort of teaching seems to be not very different in essence from some of the normative teaching with which we are brought into contact from time to time. What, for instance, is the essential difference between teaching a rat that it must endure pain in order to get food, and teaching men that they must endure a "vale of tears"

[10] Susan Stebbing, *A Modern Introduction to Logic* (London: Methuen & Co., 5th ed., 1946), p. 10.

[11] Cf. J. P. Guilford, *Fields of Psychology* (New York: Van Nostrand, 2nd ed., 1950), pp. 46 ff.

in order to get life everlasting, or impressing upon shareholders the necessity to forego present dividends in order to conserve the likelihood of future dividends?

If an explanation is to be effective, that is, if the intention of the explainer is to be understood by the explainee, precision in the use of the means of communication is necessary. The objective is to provide an identity of experience between the explainer and explainee in respect of the thing being explained; herein lies an essential difficulty in communication: one experiences perceptions, sensations, emotions, which are necessarily peculiar to one individually, yet, in attempting to communicate them one has to make the large assumption that another can perceive, sense and be moved by the same things in the same way and, perhaps, to the same extent as oneself. We can never be certain that this assumption is true in any given case, but we must act as if it were. It is therefore most important that we take the utmost pains to express ourselves as clearly as we can, in terms of referents as clearly identifiable as practicable, so as to reduce the chances of misinterpretation as much as possible. And the higher the degree of abstraction in the ideas being considered, the greater is this need.

This often involves definition of the expressions used in an explanation as a means of identification of the things or ideas being expounded. Russell and Whitehead have pointed out that "a definition is a declaration that a certain newly-introduced symbol or combination of symbols is to mean the same as a certain other combination of symbols of which the meaning is already known."[12] And Stebbing emphasises that "there must be terms which either are *indefinable* or are taken as *undefined*"[13] and that "the undefined symbols are less *familiar* than those which they help to define."[14] Thus, here again we meet the notion of a common experience between explainer and explainee as a basis of explanation. It follows, too, that either the explainee must learn the "language" of the explainer or the explainer must express his thoughts in a medium familiar to (that is, that fits in with

[12] Bertrand Russell and Alfred North Whitehead, *Principia Mathematica* (Cambridge: Cambridge University Press, 2nd ed., 1960 reprint), I, 11.
[13] Stebbing, *op. cit.*, p. 441.
[14] *Ibid.*, p. 442.

the experience of) the explainee. Thus we get the position that in many fields of study nowadays there is a specialised vocabulary of precision which has to be learned before an aspirant to knowledge can hope to understand the subject-matter.

This is especially true in science, and today science for the scientist and science for the citizen are at distinct levels of communication. The former has developed a "language" or medium of communication of precision (in large part, mathematical), the acquisition of which may take years of application and study, but which can be handled, by a skilled technician in the medium, towards increasing the area of scientific achievement. The latter —the work of the popularisers of science—attempts, with varying degrees of success, to translate the achievements of the former into language which fits in with the experience of a much wider audience; in this attempt it inevitably loses much of the precision of the former, but may well be justified if it leads some members of the audience to undertake the ncessary study in order to understand the more highly developed medium used, and it is, of course, always necessary in the introductory stages of scientific study. Thus, some of the concepts of modern science cannot be translated in terms of verbal language at all, and therefore many of its developments must, under present conditions, remain hidden from most people, no matter with what publicity they may be expounded. Popular exposition of scientific subjects necessarily proceeds largely by the use of analogy, which in fact can comprise only partial and possibly misleading expositions of unfamiliar concepts.

In accounting, as in other fields of study concerned with human relationships, there is felt considerable pressure to retain familiar, non-specialised language, while at the same time criticism is levelled at expounders because many of the terms used lack precision. It is unfortunately true that in the literature of accounting very few expressions of general application can be used unequivocally or without some risk of their being misinterpreted. This alone is sufficient to account for a considerable amount of misunderstanding of the content and purport of accounting records, reports, analyses and interpretations.

Nevertheless, this difficulty can be overcome or at the least greatly diminished if the concepts behind the terminology can be clarified. It is this clarification of concepts which is the true challenge in attempting explanation; its successful attainment will make manifest the nature of the activity we call accounting, and this calls for and is worthy of the best efforts that accountants, whether practising or academic, can put into it.