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THE DEFINITION
AND
QUANTIFICATION OF ASSETS

by

Sarah J. Williams BCom

Degree of Master of Commerce

This thesis is submitted in partial fulfilment of the requirements of
the Degree of Master of Commerce

Faculty of Management
Deakin University

June 1995
I certify that the thesis entitled

'THE DEFINITION AND QUANTIFICATION OF ASSETS'

submitted for the degree of Master of Commerce

is the result of my own research, except where otherwise acknowledged, and that this thesis in whole or in part has not been submitted for an award including a higher degree to any other university or institution.

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Name ............................................................... SARAH JENNIFER WILLIAMS

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Date ................................................................. 2 NOVEMBER 1975
Synopsis

The word 'asset' was originally taken into the English language, from the Latin 'ad satis' and French 'assez', as a term used at law meaning sufficient estate or effects to discharge debts. It later came to be used in the sense of property available for the payment of debts. Assets were understood to be property (objects owned and rights of ownership) that could be exchanged for cash. The importance of factual knowledge of the money equivalents of property and debts, in managing mercantile affairs, was emphasised in accounting manuals during the eighteenth and nineteenth centuries. The rights of investors and creditors to factual up-to-date information about the financial state of affairs of companies, given the advent of limited liability, underscored the early company legislation that required the preparation and auditing of statements of property and debts. During the latter part of the nineteenth century the emphasis in accounting moved away from assets as exchangeable property to assets as deferred costs. Expectations took the place of observables. The abstract (expectational) notion of assets as 'future economic benefits' was embraced by accountants in the absence of rigorous definitions of the elements and functions of dated statements of financial position and performance. Assets are quantified financially by a heterogeneous mass of potentially inconsistent rules that, by and large, have no regard for the empirical nature of measurement. Consequently, accountants have failed to provide the community with up-to-date factual information about the financial state of affairs and performance of business entities - and, hence, with an informative basis for financial action.
Acknowledgements

My sincere thanks:

To Professor P.W. Wolnizer for his supervision of my research work; for his constructive criticism; and for his encouragement and support at times when the task appeared too daunting.

To Emeritus Professor R.J. Chambers whose guidance, encouragement, and insightful comments were invaluable.

To my colleagues and family for their encouragement and support.
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*Martyn v Williams* [1857] IH &N. 817; 26 L.J. Ex 117
*Lord Hastings v North Eastern Railway Co. Hastings* [1898] 2 Ch. 674 67 L. J. Ch. 590.
*Re Pyle Works* (1890) 44 Ch.D.534
*Page v International Agency & Industrial Trust, Ltd.* (1893) 62 L.J.Ch.610
*Robertson v. Quiddington* (1860) 28 Beav.529
*Spanish Prospecting Case* [1908-10] All ER. 576-77
**Abbreviations**

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<thead>
<tr>
<th>AAA</th>
<th>American Accounting Association</th>
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<td>AARP</td>
<td>Australian Accounting Research Foundation</td>
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<td>AIA</td>
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<td>APB</td>
<td>Accounting Principles Board</td>
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<tr>
<td>ASA</td>
<td>Australian Society of Accountants (now the Australian Society of Certified Practising Accountants)</td>
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<td>ASC</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<td>IASC</td>
<td>International Accounting Standards Committee</td>
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<td>ICAA</td>
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<td>ICAEW</td>
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CHAPTER 1

INTRODUCTION

1.1 Commercial dealings

In the world of commerce individuals and organisations engage in buying, selling, borrowing and lending transactions with the object of increasing wealth. These transactions are facilitated by the use of money as a medium of exchange. Prices, which signify at a given time and place the number of money units for which specific goods and services may be exchanged, are generated through exchanges in the marketplace. Buying and selling decisions are made in light of prevailing prices.

Money and money prices are part of the accounting environment. Accounting entails the recording of, and reporting on, the financial consequences of dated transactions and events that have an impact upon the financial position and performance of specific entities. The money value of legal rights in goods and services determine an entity’s ability to engage in transactions in the marketplace. As a result of market transactions outside parties may have claims against those goods and services. In a market environment it might be assumed that those who use accounting information might expect that the assets shown in a statement of financial position would represent the means available to an entity to enter into transactions, and the security afforded to creditors. They might also assume that assets would be expressed in terms of money, or their current monetary equivalents - their selling prices.

1.2 The changing notion of assets in accounting

The term ‘assets’ was rarely used in accounting manuals until the latter part of the nineteenth century. ‘Property’ or ‘effects’ were the words most frequently used and they were used to denote debt paying ability. Property or assets represented things owned, the wherewithal to meet financial obligations. At any time, the money equivalent of property was compared with money owed to determine a trader’s state of affairs at that time.

Toward the end of the nineteenth century the term assets began to replace property in the accounting literature. Alongside the view that assets or property represented what
was owned and therefore available to pay debts there appeared a contrary view of assets as representing deferred (unallocated) costs. Outlays which were argued not to relate solely to the current period were recorded in the balance sheet as assets, without regard for whether such outlays represented assets in the commonly understood sense of rights of ownership or objects owned that could be exchanged for cash.

Subsequently, the notion that assets were unallocated costs was popularised - especially by those who argued that the focus of accounting should be on the profit and loss statement. For example: 'The measurement of efforts and accomplishments of business by rendering services is the ultimate goal of accounting, the actual subject of income accounting in particular' (Engleman, 1954, p.385). Littleton (1953, pp.22-23) was a strong advocate of this view which appears to be rooted in the perceived decision making needs of investors. It was argued that investors were primarily interested in earning power. Solvency, or debt paying power, was considered of secondary importance. The emphasis was on the allocation of revenues and expenses to accounting periods to determine income. The balance sheet, traditionally a statement of financial position, became a repository for items which were argued not to belong to the profit and loss account. There appeared to be little acknowledgment that balance sheet and profit and loss accounts were articulated statements. The headings 'assets' and 'liabilities' were totally misleading. Rather than indicating legal rights or obligations, items so described were merely items in the accounts left over from the calculation of profit.

What has developed through the accounting literature, as a result of an increasing emphasis on expectations rather than actuals, and the need to explain how all manner of deferred debits in the balance could be described as assets, is the much broader concept of assets as representing 'economic resources' or 'stores of services', and more recently, 'future economic benefits'. This expectational notion of assets, which came to prominence during the 1950s and 60s, and has since gained widespread acceptance, is a radical departure from the original notion of assets as property available for the payment of debts. This popular view of assets is reflected in the definitions promulgated by the professional accounting bodies in the United States (FASB, SFAC 3, 1980b, para.19) and Australia (AARF, SAC 4, 1992, para. 12).

In their efforts to support the notion of assets as service potential accounting authors have drawn on the writings of economists without giving due consideration to the framework in which those ideas were developed and their contextual 'fit' with financial reporting. Ideas are reproduced throughout the accounting literature without critical examination. The embracing, by accountants, of an accounting based on
conjecture and opinion has resulted in the reporting and aggregation of a heterogeneous mixture of values which are unintelligible in a commercial or financial context.

1.3 Purpose of the study

The function of accounting in the context of financial reporting is to provide factual and up-to-date information regarding the financial consequences of transactions and events upon a specific entity, to interested parties who do not have direct access to such information. Reports, such as the balance sheet, which is a dated statement of an entity's assets, and the claims against those assets, are used as a basis for financial action. In a commercial environment, where continuity is dependent on solvency, reliable information regarding borrowings and property available to meet those borrowings is essential to the protection of investors and creditors.

The purpose of this study is to demonstrate that the shifts in ideas away from the notion of assets as property which could be exchanged for cash, to unallocated costs and future services, are based on a number of fallacies and that such notions are unserviceable in the context of financial reporting. If the balance sheet, as a dated statement of financial position, is to serve as a reliable basis for action assets must represent exchangeable property, recorded in terms of money or exchange prices.

1.4 Research method

This study challenges the conventional notion of assets and their quantification. An historical focus has been adopted in an effort to gain an insight into the origin and development of the notion of assets through an etymological enquiry and an examination of law and accounting literature. An attempt is made to identify and explain key factors that have contributed to changes in the notion and quantification of assets as described in the accounting literature. These changes are critically evaluated in the context of financial reporting. The origin of the English use of the word 'asset' and its subsequent development, was established through references in the complete Oxford English Dictionary (1989). An examination of the accounting literature, principally from the eighteenth, nineteenth and twentieth centuries, was undertaken. Literature covering this period was chosen as it illustrates the change in the accounting notion of assets from the legal notion - property available for the payment of debts - to cost and cost allocation and future economic benefits.
The relationship between accounting and the law is critical to this evaluation. Commercial dealings, and hence the resulting accounting records, are governed by laws. Laws governing the financial reporting of companies are aimed at the protection of interested parties. 'Assets' and 'property' are important legal concepts. The notions of assets and property at law, and their significance for financial reporting purposes, were examined by reference to case law, statutes and accounting and law literature.

Economists, like accountants, are concerned with the events by which means are used to satisfy wants. In their efforts to support the conventional notion of assets accountants have drawn on the works of economists, notably Canning and Fisher. While drawing on the economics literature generally, the works of Canning and Fisher in particular were examined in order to establish whether the ideas developed therein were appropriate in the context of financial reporting.

It is generally agreed that the function of financial reporting is to provide information about the dated financial position and performance of firms as a guide to financial decision making. The relationship between accounting information and financial action is examined by reference to the literature of accounting and decision making.

Like all scientific enquiry and endeavour, historical research is subject to certain limitations. As in any interpretational research the interpretation of the data, or evidence gathered, may have been influenced by personal knowledge and experience. Gaffikin (1981, p.24) describes historical research as doubly subjective as it 'relies on 'evidence' selected by one person from the 'evidence' left by another person.' The selection of evidence is a result of a judgemental process constrained by time and the availability of evidence. The focus of this study is on the change in the accounting notion and quantification of assets as documented in the accounting literature. An examination of business records and/or historical studies of business records might have provided evidence as to whether actual practice moved from an emphasis on values to deferred costs. However, this was considered beyond the scope of this study. As Topolski (1976, p.462) stated, 'a historian cannot afford the luxury of comparing two or more sets of sources for one and the same problem ....'
CHAPTER 2

ASSETS: PROPERTY AVAILABLE FOR THE PAYMENT OF DEBTS

The orderly conduct of interpersonal affairs in an interdependent community depends on respect for the rights of parties to those affairs. Those rights are embedded in the law or laws of the community. To set aside the law is to put chaos in its place. Property law is concerned with protecting the rights of persons, or other legal entities, in things. Property (ownership) rights underpin spending or debt paying power. Any notion of control which lies outside of those rights would enable property acquired by theft or fraud to fall within the ambit of assets, and, given the possibility of recovery by a plaintiff, make any statements of assets and liabilities entirely unreliable grounds of judgement and action.

The object of this chapter is to demonstrate that if a dated statement of assets and liabilities is to be an accurate representation of the financial position of an entity at that date, and thereby serve as a reliable basis for action, the money amounts of property rights, and claims against those rights, must be presented therein. This conclusion is supported by reference to the law, or laws, relating to assets and property, and to the accounting literature which supports notions of property, and more recently assets, which are consistent with their legal form and with the concept of the balance sheet as a reliable statement of financial position.

2.1 Etymology of 'asset'

The *Oxford English Dictionary* (OED) provides illustrations of early English usage of the word asset dating back to 1531. The English word was adopted from the Anglo-French *assets*. This was the later form of the Old French *asez*, a form of the Latin *ad satis* 'to sufficiency'\(^1\), substituted for simple *satis* 'enough'. The origin of the English use 'is to be found in the Anglo-French law phrase aver assetz 'to have sufficient', viz. to meet certain claims ....' (OED, 1989, Vol. I, p.710)

Taken into the English language as a term used in law the original meaning of asset was 'Sufficient estate or effects', especially in the sense: "Goods enough to discharge that burthen, which is cast upon the executor or heir, in satisfying the testator's or

\(^1\) 'to sufficiency' was a phrase meaning 'in sufficient quantity'.
ancestor's debts and legacies' Cowell.' (OED). It was chiefly used in the phrase 'to have assets'. The following quotation from Blackstone's Commentaries of the Laws of England (1765-1769) illustrates the use of the word in this sense. 'This deed, obligation, or covenant, shall be binding on the heir, so far forth only as he had any estate of inheritance vested in him by descent from that ancestor, sufficient to answer the charge which sufficient estate is in law called assets' (OED).

By the end of the sixteenth century the meaning of asset had been extended and applied to any property or effects liable to be applied in satisfying the testator's or ancestor's debts, without regard to its being sufficient. It was used in this sense in the phrase 'assets in hand', meaning 'effects in the hands of executors which are applicable to discharge the testator's debts' (OED). By the early 1800's the term was used both in law and commerce in the sense: 'Effects of an insolvent debtor or bankrupt, applicable to the payment of his debts; and by extension: all the property of a person or company which may be made liable for his or their debts' (OED). A specific reference is made to accounting records. 'The Dr. and Cr. sides of a Balance Account contain 'Assets' and 'Liabilities' respectively' (OED).

An illustration of the early use of the word assets in the sense of 'property or effects applicable to the payment of debts' is provided by the following quotation taken from The History of British India, by James Mill (1817): 'The assets or effects of the London Company in India fell short of the debts of that concern' (OED). Spencer in 1855 in The Principles of Psychology wrote: 'Cheques and bills are accepted and passed on without enquiring whether there are assets to meet them' (OED).

2.2 Assets at law

An examination of the legal literature reveals that the word asset has retained its original meaning at law - 'property available for the payments of debts'. For example, assets are defined as 'such property as is available for the payment of the debts of an individual or company, or of a person deceased' (Mozley and Whiteley's Law Dictionary, 1977, p.28); 'property available for the payment of the debts of a person or corporation' (Jowitt's dictionary of English Law, 1977, p.144); 'Property available for the payment of debts' (Osborn, 1993, p.32).

The following are some examples of the explication of the notion of assets in case law.
In my opinion the ‘assets’ or ‘property’ of the company which are referred to in those sections [sas.98 and 133 of the Companies Act, 1862] must mean that portion of the capital which the directors have not actually dealt with before the winding-up commenced .... property which is in mortgage is not, in my opinion, ‘assets’ of the company, .... namely free assets, assets which can be dealt with by the company in the payment of their debts ....’ (Re Pyle Works (1890) 44 Ch.D.534, C.A., per Cotton, L.J., at pp.577, 578).

My opinion in this particular case goes on the word ‘assets’.... What is the meaning of the word? We generally use it in reference to a winding-up or bankruptcy. That is its first meaning - that which is available for payment of debts on taking proper accounts in the liquidation .... But the word has a second sense equally good and familiar .... Even such a well established corporation as the Bank of England publishes a statement of its assets and liabilities, the assets including everything that is available to meet the liabilities (Page v International Agency & Industrial Trust, Ltd. (1893) 62 L.J.Ch.610, per Kekewich, J., at pp.612, 613).

In the case of Lever Brothers & Unilever, Ltd. v Inland Revenue Comrs.,² the question was whether a company making contributions to a superannuation fund had acquired an asset. In concluding that the company had not acquired an asset the judge concluded:

‘If anyone were to ask: Do the assets of the company exceed its liabilities, and, if so, by how much? I do not think anyone would answer the question by taking into account payments of this description ....’

2.3 The origin and meaning of ‘property’

The use of the word property in the context of what is available to a person or organisation to pay debts, indicates that property is that which belongs to, or is owned by, that person or organisation. The legal right of ownership underpins exchangeability and therefore debt paying power.

Etymology of ‘property’

Different forms of the word property are ultimately English or French representations of the Latin proprietatem, from proprius meaning one’s own, (OED, 1989, Vol.XII, p.639). In its original sense, property meant the condition of being owned or belonging to some person or persons, or rights of ownership.

... hence the fact of owning a thing; the holding of something of one’s own; the right (esp. the exclusive right) to the possession, use or disposal of anything (usually of a tangible material thing); ownership, proprietorship...’ (1380 - 1876) (OED).

The following quotations taken from the OED (p.639) provide an illustration of property used in this sense. From John Gower's 'Confessio Amantis' (1390, p.357):

'Whan that a riche worthi king, .. Wol axe and cleyme propretie In thing to which he hath no riht'; from the French Termes de la Ley (1641, p.226): 'Propertie is the highest right that a man hath or can have to anything, which no way dependeth upon another mans curtesie.'

Around the seventeenth century property also began to be used in the sense of: 'That which one owns; a thing or things belonging to or owned by some person or persons; a possession (usually material), or possessions collectively; (one's) wealth or goods' (OED), and in reference to a piece of land owned. There are few examples of the use of the word in this sense before the seventeenth century.

Property at law

Rights of ownership are the basis of the legal notion of property. ‘Sometimes ... [the word property] is employed to indicate the physical object to which various legal rights, privileges, etc., relate; then again- with far greater discrimination and accuracy - the word is used to denote the legal interest (or aggregate of legal relations) appertaining to such physical object’ (Hohfeld, 1919, p.28). The following definitions emphasise property or ownership as a bundle of rights which together represent the highest right that can exist over the object of that right.

... property, or, as it is called, Ownership ... is an interest, recognised and protected by law, which entitles the person in whom it is vested, not as a matter of fact, but as a matter of right, to the full and complete enjoyment of the subject over which it is exercised (Jenks, 1913, p.189).

The term property is used properly as denoting the right of ownership, as where a rule of law provides for the passing of the property in a thing, but is also, and more commonly, used in a transferred sense, of the object of the right of property, i.e. for the thing owned .... In the former sense a right of property is the fullest right which may exist in and over the subject .... The right of property is best conceived not as a single right but as a bundle of distinct rights, some or even many of which may be relinquished temporarily without loss of ownership. The kinds of rights which a right of property confers over objects of that right vary according to the nature of the object, but they normally include the rights to possess, use, use up, abuse, lend, let on hire, grant as security, gift, sell and bequeath the object' (The Oxford Companion to Law, 1980, p.1007).³

Property has also been defined as 'the generic term for all that a person has dominion over' (Stroud's Judicial Dictionary, 1986, p.2057). Dominion is derived from the Latin dominium meaning property or ownership (OED, 1989, Vol IV, p.949). The relinquishment of some of the rights attached to ownership will be discussed below.

A historical feature of the notion of property was inheritability or transferability of ownership. In earlier times property of the deceased was transferred in one of two ways. While the deceased's land passed to his heir, the goods passed to those responsible to the church courts for executing the will. The churches control over wills was argued to be the cause of the division between the laws of real and personal property. Inheritability or transferability are emphasised in the following definitions, the latter incorporating more recent forms of property.

For what do we understand by Property? Is it not that interest, in tangible things which can be bought and sold, taken in execution for debt, left to descend to one's heirs, or disposed of by Will? These are the very essentials of our notion of property ... (Jenks, 1913, p.237-238).

In its largest sense property signifies things and rights considered as having a money value, especially with reference to transfer or succession, and to their capacity of being injured. Property includes ... rights such as trademarks, copyrights, patents, and rights in personam capable of transfer or transmission, such as debts. ... (Jowitt's Dictionary of English Law, 1977, p.1447).

This feature of property is illustrated in a number of court decisions. For example, in Martyn v Williams it was held that rights to dig for and carry away the clay, erect buildings etc., is an incorporeal hereditament, or real property, capable of being inherited. In Lord v North Eastern Railway Co. Byrne] concluded as follows:

The interest conferred upon a railway company - namely, a wayleave over land of the grantor, with the right to make a railway thereover, and with the other powers given to them - is, in my judgement an 'incorporeal hereditament, a

---

4 See Harding (1966). The legal distinction between these two types of property was manifested in the early rule that land was specifically recoverable by a 'real' action, whereas no action lay to compel restitution of other forms of property, the remedy for such cases being a mere 'personal' action for damages. (See Halsbury's Laws of England, 1981, Vol. 35, para. 1101 and The Oxford Companion to Law, 1980, p.1007). Therefore, under early law property was of two kinds; real property which denoted land and rights in the land which endured for a life, or were prior to 1926, inheritable "whether these rights involved full ownership or only some partial enjoyment of the land or the profits" (Halsbury's Laws of England, 1981, Vol. 39, para. 301) and; personal property which denoted rights in land which endured for a term of years only and rights in moveable possessions. The distinction between real property and personal property was broken down by legislation in the mid-nineteenth century. More modern types of intangible 'property' such as patents and copyrights (choises in action) are now recognised at law.

5 Martin, B., [1857] I & N. 817; 26 L.J. Ex 117; 156 BR 1430.

6 Hastings [1898] 2 Ch. 674 67 L. J. Ch. 590.
property, and an estate capable of being inherited by the heir' (if granted to an individual) 'and of being assigned to a purchaser'.

The right of ownership normally includes the right of possession.

... an owner ... may, however, voluntarily or involuntarily part with possession, for example by the pledging, lending, hiring out, bailment, theft or loss of his goods in any of which cases he is left with a right of ownership without possession, accompanied or not accompanied, as the case may be, by the right to possess (Halsbury's Laws of England, 1981, Vol.35, para.1128).

As indicated above an owner may surrender some of the rights attached to ownership, such as the right of possession, while retaining others. For example one person may own the rights to farm a piece of land, another the right of mining the minerals, and another the right to fish in the streams which run through it. At law: 'Ownership may be held by different persons for different interests, for example when a freehold owner grants a lease ....(A Concise Dictionary of Law, 1983, pp.255-256). 7

The divisibility of property rights has caused some confusion and has led to the introduction of such terms as 'limited ownership' and 'special property'.

A mere right to possession is something less than all the rights of ownership. It is said that the owner has the general property in the object while other persons may have a special property in it (such as the interest of a lessee) (Vermeeesch and Lindgren, 1992, p.416).

General property has been described as unrestricted rights; and special or qualified property as limited or partial rights. Limited rights are those where the thing can only be put to a particular use (eg., in the case of bailment), or where the subject matter is incapable of being in the absolute ownership of any person (eg., wild animals). 8 This idea of ownership is inconsistent with common usage and has attracted strong criticism in the legal literature. A bailee is described as having a 'special property' in goods. 'But men do not think of him as the owner ....' (Pollock and Maitland, 1968, p.178). 9 Jenks (1913) argued that the existence of such phrases as 'special property' and 'limited ownership' show that the idea of 'completeness' is recognised as the natural feature of property or ownership (p.189). 10 Pollock and Wright (1888, p.5) provide an explanation for this confusion.

So feeble and precarious was property without possession, or rather without possessory remedies, in the eyes of medieval lawyers, that possession largely usurped not only the substance but the name of property;

9 See also Bracton's Notebook (1887) and Jackson (1967, p.53).
10 See also Munzer (1990, p.23).
and when distinction became necessary in modern times, the clumsy term 'special property' was employed to denote the rights of a possessor not being owner.

'So possession is said to confer a special property, by which is meant that the possessor of a thing is deemed to be owner of it as against everyone who cannot show a better title' (Jowitt's Dictionary of English Law, 1977, p.1447). Where a person has a special property - limited rights - the rights held may not include the right of exchange or transfer as in the case with general property rights.

During the nineteenth century a number of cases before the courts required a decision as to whether 'goodwill' constituted 'property' of a business. In 1810 Lord Eldon described goodwill as 'nothing more than the probability that the old customers would resort to the old place.' It was held in Wilmot v Allon that 'property' did not comprise future receipts in a person's business. 'There must be a definite interest; a mere expectancy as distinguished from a conditional interest is not a subject of property' (Jowitt's Dictionary of English Law, 1977, p.1447). However, the courts began to recognise that certain rights, such as the right to represent that you are carrying on a business which has been carried on previously, and hence the right to prevent another person from holding out that they are carrying on the business, attached to the carrying on of a business or professional activity, and that these rights should be protected. In treating goodwill as property, the law assumes that it is inseparable from a business - an inseparable part of the exchangeable property. However, in some cases around the turn of the century judges drew on accounting practice in determining whether goodwill constituted property. In Re Leas Hotel Co it was held: 'If as regards a partnership the words 'partnership assets' or 'effects' cover goodwill, it would seem that the word 'property' must also cover 'goodwill'.' On the occasions that the courts have held goodwill in the accounts of a business to be property it must be assumed that they believed this 'goodwill' to be an interest that could be protected at law, not a 'mere expectancy'.

11 Crutwell v. Lye (1810) 17 Ves 335; 1 Rose 123; 34 ER 129.
12 Ex p. Nichols, [1897] 1 Q.B. 17
14 (1902) 1 Ch. 332, per Kekewich, J., at pp.333,334.
Property and debt paying power in accounting

Bookkeeping Manuals

The word 'asset' rarely appeared in accounting manuals before the end of the nineteenth century. The words 'property' or 'effects' were most commonly used - and, used in the context of debt paying power. Property (effects) represented what was owned - rights and objects which, by law, were transferable or exchangeable and therefore applicable to the payment of debts. Property was compared with what was owed to determine the facts regarding a trader's present financial condition or state of affairs. The provision of that information was regarded as the function of accounts.

The importance of knowing one's 'state of affairs', as represented by property/effects owned and debts owed, is stressed by Malcolm (1731) in his treatise of bookkeeping. He wrote that the first step to be taken by 'a Man either beginning to trade; or beginning a regular and orderly Method of Accounts, is, to make up a complete Account of the present State of his whole Affairs, ie. An Inventory of all his Effects and Debts; after which his work is to make daily a distinct and complete Record of all the Transactions that occur in his Business ...' (p.4). He stressed that 'unless that preceding State, and all these succeeding Transactions are seen together in one View, the present State of the Account cannot be known ...' (p.5).\(^\text{15}\) The emphasis was on the money values of effects and debts. This is illustrated by Malcolm's description of the final state of the Account, being the difference between one's effects and debts, as 'showing what one's free Estate is worth; or, what the Debts exceed the Effects' (p.3).\(^\text{16}\)

The role of accounts in the determination of the whole estate or state of affairs by taking an inventory of all property and debts was elucidated by North (1714/1986) and Gordon (1765/1986). North described the accounts that must be created in the ledger in order to comprehend a gentleman's business. Like Malcolm the first account North proposed that a Merchant may 'inscribe' to comprehend his business was The Personal Estate Account. His description of that account emphasised the relationship between effects and debts:

\(^{15}\) See also Gordon (1765, p.59), Jones (1796/1978, p.21) and Hamilton (1788/1982, p.266) for a discussion of the recording of property, debts and transactions in the Waste book or day book.

\(^{16}\) See also Dodson (1750/1984, p.iii) and Thompson (1777/1984, pp.57-68).
The Personal Estate, this on the Cr. side will carry the inventory of all the present Effects, and Dependencies, that are properly the Accompants own .... And the Dr. side ... all that is owing, or outgoing, from the proprietor, which may lessen his Interests in Credit on the other side ... so that here will at first be a perfect synopsis of the personal estate ... (p.118-119).

The need for a merchant to be conversant with his position as a whole, represented by what is owned less what is owed, is evident throughout Gordon's discussion. The importance of such a record in providing a reliable basis for assessing possible actions is simply, but clearly, articulated. 'A merchant ought to know, upon all occasions, what it is in his power to do without embarrassing himself ...' (Gordon, p.11).

Thompson (1777/1984, p.2) was more explicit. He wrote that one of the advantages of bookkeeping by double entry is 'that at any time we can know the exact state of our affairs, viz, what goods of every sort we have on hand; what payments we have to make, and what cash we can command ....' The following quotation highlights the relationship between property and debts and the importance of reliable knowledge of one's position with respect to both.

'... it is more than probable, that a trader who strains his credit, in coming under his obligations, will find reason enough to wish himself out before they are retired. A loss or disappointment will be sufficient to draw all his creditors on him at once, and render him incapable of drawing in so much of his scattered effects as will pay his debts ...' (Gordon, p.7).

These manuals (see also the works of Dodson (1750/1984, p.iii) and Hamilton (1788/1982, p.286)) illustrate the emphasis or importance placed on knowing one's present financial position - what means are available to pay debts, what obligations exist - and whether one is in a better or worse position than before. Other authors to articulate this role of accounts include Jones (1796/1978, p.21), Gordon (1765/1986, p.21) and Mair (1793/1978, p.1).

Dyer (1897) used the word 'asset' synonymously with 'property'. In his discussion of single and double entry accounts Dyer wrote: 'Capital is the excess of Assets over Liabilities, the excess of what I have and have owing to me over what I owe.... My assets are my property - what I already have, and what is owing to me' (p.11); and, 'The Double Entry accounts ... answer the questions, What am I worth? Have I increased or lessened what I began with? Has this transaction made me better or worse off? Whereas the Single-Entry accounts answer such questions as these: - If I am worth so much, in what form do I possess it? What are the actual properties? What cash have I? How much at Bank? How much in permanent Assets, such as buildings, horses and vans, fixtures etc.? How much owing to me? Answers are given in Balance Account, a summary of the Single-Entry Accounts' (p.47).
The notion of property presented in the accounting manuals is consistent with the legal notions of property and assets. Property represented objects owned or rights of ownership which were transferable or exchangeable and therefore represented the ability to discharge debts. The focus was not on rights or objects, or legal claims, per se, but on their money equivalents. This is evident in later works.

**Twentieth century thought**

Assets, rather than property, became the commonly used term in the twentieth century accounting literature. The notion of assets as property available for the satisfaction of debts is supported by notable twentieth century accounting writers such as Sprague and contemporary theorists Chambers and Sterling.

Like the writers of the early accounting manuals, Sprague emphasised ownership. Sprague (1907/1972, p.30) wrote that the Balance Sheet must comprise the ‘values of assets, consisting of property and claims, to which the person, or collection of persons, has title.’ He explained: ‘The property does not owe Mr. Jones anything; it belongs to him....’ (p.34) Ownership is reinforced in a later comment: ‘The rights of the proprietor involve dominion over the assets and power to use them as he pleases ....’ (p.53).

Likewise, Paton (1922/1973, p.37) argued: ‘... [M]ere physical possession does not, of course, make an item property.... the legal right of private property must be involved.’ Lisle (1900/1976), Dickinson (1913/1975, p.31), Sanders et al (1938/1968, p.58) and Fieldhouse et al (1930, p.28) also emphasised ownership.

Only objects or rights which are owned, and which are exchangeable for money, are applicable to the payment of debts. The following quotations stipulate exchangeability as an essential characteristic of assets. ‘The personality of the proprietor, his skill, his experience, though important elements of his capital can never be brought into his balance sheets. They cannot be bought nor sold and they only make themselves manifest through the services which he does sell’ (Sprague, 1907/1972, p.36). The ‘... word [assets]... is now broadly applied to all property available for the discharge of liabilities which can be converted into money or money’s worth’ (Cropper, 1927, p.661).

Lisle (1900/1976, p.67) and Rorem (1928/1982, p.20) also defined assets in terms of objects or rights having a money (exchange) value. Debt paying power is implicit in such a definition. The notion of assets as property applicable to the payment of debts
was emphasised by Cole (1908/1976, p.90) and Kester (1922, p.14). Sprague also
defined assets in this way.

... Ordinarily there is no designation of certain assets as destined to meet certain
liabilities, but any or all of the assets may, upon default, be expropriated to a
sufficient extent to pay any liability. The word 'assets,' meaning 'enough' or
'sufficient,' suggests this view of their nature from the point of view of the
creditor' (p.49-50).

Definitions of assets as objects owned or rights of ownership that can be exchanged
for money can also be found in later works; for example those by Goldberg and Hill

The notion of assets as property available for the satisfaction of debts has received
strong support from contemporary authors Chambers and Sterling.
Chambers (1966, p.103) defined an asset as:

any severable means in the possession of an entity....By severable means is
intended any means which, at any given time of action, may be converted to
other means by exchange or the processes of production, or which may be
alienated by way of gift.

Chambers argued that only if a good or right is severable can it be considered as a
means by the sale of which the operations of an entity may be adapted to its
circumstances and objectives (1965, p.153). Assets so defined represent the means
available to undertake alternative courses of action and, therefore, the means available
to pay debts. Munter and Ratcliffe (1980, p.122) also emphasised severability. Sterling
(1979, p.161) defined assets as 'items of wealth', where wealth is defined in terms of
command over goods (COG) (p.192). Command over goods in a market economy is
represented by exchangeable rights. Sterling writes: 'COG is relevant to all decisions
regarding actual or potential market exchanges ... it determines the available market
alternatives' (p.162). Available market alternatives include the payment of debts.

This notion of assets has also received the support of Walter Schuetze, the present
Chief Accountant of the Securities and Exchange Commission. Critical of the
conventional notion of assets, as 'probable future benefits', Schuetze (1993, p.69)
proposed that assets be defined as: 'Cash, contractual claims to cash or services, and
items that can be sold separately for cash.' He described exchangeability as a 'critical
element in that definition.'
Dated state of affairs

The writers of the early accounting manuals stressed the importance of the bookkeeping process in determining the extent of a person’s estate or 'state of affairs' and the change in that estate over time. For persons to be able to ascertain their position at any time, and therefore consider possible courses of action, properly prepared accounts were regarded as essential. This present position, or state, was determined by the extent to which property (rights and claims against others) exceeded or fell short of debts (claims against that property). The relationship between property, or assets, and debts has long been described as financial position.

There is wide agreement in the literature of the twentieth century that the balance sheet displays 'the [financial] position of the concern at the particular moment of time' while the profit and loss account shows 'the progress of the business during a period of time' (Lisle, 1900/1976, p.70). Cole expressed the relationship between the balance sheet and the income statement in a novel way: '...the two balance sheets give the terminals of the journey (the start and the finish), and the income sheet gives some of the details of the journey itself' (1921/1978, p.47). As Clarke (1982, p.74) points out: 'Journeys can be mapped only by reference to discoverable starting and finishing points.'

A dated balance sheet implies that the information contained therein represents the facts as at the stated date. Those who use metaphors such as map, photograph and true picture imply that a balance sheet should represent dated commercial reality.

It is coming to be clearly recognised that both the periodic statement of financial position and the report as to interim conditions of operation ... should consistently reflect true pictures of current business conditions and tendencies - as affecting the particular enterprise - if these statements are to form a basis for rational judgements ....' (Paton, 1922/1973, p.425, emphasis added).

'Shortly stated, one may say that the business man looks to a balance sheet to give him a photograph of his financial position as on a certain date, to indicate the amount of his fixed and liquid capital and, taken in conjunction with the profit and loss account, to show to what extent and how, his position has altered from the previous stock-taking' (Welch, 1932, p.865, emphasis added).17

The role of the balance sheet in presenting factual up-to-date information is emphasised throughout the literature. The balance sheet has been described as displaying 'the true financial condition at a given date of some individual or other financial unit' (Couchman, 1924/1982, p.3); showing 'the financial position of an

17 See also Couchman (1924/1982, p.8), Moonitz and Jordan (1963, p.16) and Edwards et al (1979, p.30).
enterprise at a particular moment, and is, so to speak, a snapshot of its assets and liabilities ...(Goldberg, 1948, pp.72-73); 'a report of conditions at a moment in time, conditions which existed and were measured as of a specific date' (Edwards et al, 1979, p.29). Montgomery (1912/1976, p.104) argued that the banker, creditor, and stockholder 'have a right to believe that the values stated are real values as of the date of the balance sheet.' Hatfield (1927/1971, p.21) wrote that 'the balance sheet ... must give, as far as possible, a correct showing of the facts'; and that 'The balance sheet is assumed to state present values' (p.25). MacNeal (1939/1970) insisted that financial statements must state economic values. The 'economic value of anything is its 'power in exchange', which, measured in money, is its market price. ... It is a fact' (p.87). The pronouncements of professional accounting bodies have also emphasised that balance sheets are to represent financial facts as at their date. In the American Accountants' Handbook published in 1923 the purpose of the balance sheet is stated as 'to show the financial condition of a business at a given date' (1923/1986, p.1426). The function of the balance sheet has also been stated as 'to give a true and fair view of the state of affairs of the company as on a particular date' (The Institute of Chartered Accountants in Australia, 1946, para 3). The balance sheet has been described as presenting an indication of 'the financial status of the enterprise at a particular point in time' (AICPA, 1970, para. 11). Financial status or position 'refers to state or status of assets or claims to assets at moments in time' (FASB, 1980b, para.4).

The financial position of an entity at a particular point in time is represented by the money amounts of exchangeable property and claims of others against that property. Property to which legally enforceable rights attach, and against which legally enforceable claims may be made, is real. Amounts of money and money prices are real. Only where assets represent property available for the payment of debts and assets are recorded at their money equivalents will the balance sheet represent an accurate picture of an entity's financial position, its capacity at balance date to take action in the market place - to borrow, to enter into exchanges, and to pay debts.

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18See also Dawson (1900, p.131), Cole (1908, p.70), Paton (1922/1973, pp. 31-37), Scott (1925, p.27), Kester (1930, p.25), Kelley (1935, p.52), and Kollaritsch (1960, p.486).
19See also Paton (1922/1973, p.429)
20See also FASB (1984, para. 26)
The Balance Sheet as an indicator of solvency

The relationship between assets and liabilities has long been recognised as an important indicator of solvency - the capacity to pay debts as they fall due. Solvency is a real world condition - a condition of survival. An entity which cannot pay its debts as they fall due is unlikely to survive in a competitive environment. As Kester (1930, pp. 593-594) stated:

The financial condition of a business has reference to its ability to finance its various activities. Conducting a business involves providing a home for it - secured by owning or leasing - a stock of merchandise to deal in, and a staff of employees to carry on the activities. All of this involves obligations. The business home, if owned, must be maintained and protected from fire and other hazards; if rented, the obligation to pay the rent must be assumed. The merchandise bought must be paid for and the staff of employees not only must be recompensed for their services but must be provided with whatever supplies and accessories are needed in the performance of their duties. To meet these obligations requires ready funds of cash. Unless these obligations are met, dissatisfaction on the part of the aggrieved parties is sure to exist. This may ultimately lead to the bankruptcy court where the business may be taken away from the owners and placed in the hands of an agent of the court who will hold it for the benefit of the creditors. Thus the financial condition of a business refers primarily to its ability to pay its debts as they come due, i.e. to its solvency.

Both creditors and investors are concerned with solvency as their investment is at risk. Consider the situation where a company is experiencing cash flow problems and management has resorted to additional borrowing. The cost of borrowed funds is likely to increase, due to the increased risk of insolvency, exacerbating the cash flow problem. This situation is likely to result in a fall in share price and, therefore, losses to shareholders. The company may be forced into liquidation and the amount realised from the sale of assets may be insufficient to cover creditors' and investors' claims in full. In this situation investors are likely to suffer even more than creditors as creditors' interests rank higher than those of investors in bankruptcy proceedings. Other parties such as employees and suppliers are also interested in solvency. Employees are concerned about payment of wages and the security of their jobs. Suppliers are concerned about customer stability and payment for goods supplied. The public's concern over the solvency of one large organisation is illustrated by the statement made by Rob Jolly, the Treasurer of the Victorian Government, on February 13, 1990, reassuring depositors and other interested parties as to the financial stability of the Pyramid Building Society.

Kester (1930, p.25) illustrated that the balance sheet is an important indicator of solvency.
If the assets are in properties for which there is not a ready market and the liabilities are claims which mature soon and will have to be met, the situation is unfavorable. If there are large values invested in easily salable assets; if there is a large balance of cash on hand after meeting current claims and providing for those which will soon mature; if other liabilities are of a more permanent nature ... not requiring immediate attention - the situation from the standpoint of the ability of the business to pay its debts as they mature may be more favorable ...'

Assets represent the ability of an entity to adapt to changes in the market place. Where cash flow problems exist or are foreseen, as Kester indicated, cash can be generated by converting non-cash assets to cash. Assets can be used as security for borrowing. Assets can be exchanged for other assets which offer greater cash flow potential.

The importance of the balance sheet to the determination of solvency is emphasised throughout the literature. 'How sound a business may be ... is determined ... by the availability of the resources to meet the liabilities' (Cole, 1908/1976, p.50). Without question, the intention [of the balance sheet] is to afford the shareholder who has placed his capital in a concern, and the creditor who does business with it, an opportunity of estimating from time to time its financial stability (Tovey, 1946, p.5).21

An entity's ability to pay debts at a stated date is represented by the exchange values of objects and rights. Exchange values represent amounts for which non-monetary assets can be converted to money and are indicative of an entity's capacity to borrow. Exchange values are the only relevant measure of the security afforded to creditors. For the balance sheet to be a reliable statement of solvency at a particular point in time assets must be recorded at their exchange prices or money equivalents. As Chambers and Wolnizer (1991) indicated many deeds of settlement of British banks and joint stock companies, before statutory regulation, prescribed the valuation of assets at selling prices. Under the [Australian] Corporations Law (s592) it is an offence for a company to incur a debt where there are reasonable grounds to expect that the company would not be able to pay all its debts as and when due. How can the directors and other interested parties know that the company is solvent or insolvent if the amounts recorded in the accounts do not represent money and money equivalents?

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2.4 The significance to commercial enterprise of laws relating to assets and property

Enforceable rights of creditors

The importance of reliable knowledge of debts and property available to meet those debts has been emphasised. Creditors have always had legal and enforceable rights to satisfaction of their claims out of assets. In the Anglo-Saxon period, contracts could be enforced where these were made by the furnishing of sureties. At the beginning of the fifteenth century, there were a number of forms of action for recovering money. The oldest and most important was the action of debt. Contracts (the word contract here denotes a transaction, such as a sale or loan, which transferred property or generated debt) were enforceable under the action of debt where they were 'formal and supported by a deed under seal, or real, in which case the fact that the defendant has received a substantial thing will establish his liability' (Plucknett, 1956, p.635).

Merchants could also seek satisfaction for a debt in courts which administered the law established by the customs of merchants. Methingham J. said 'He who demands this debt is a merchant; and therefore if he can give us slight proof to support his tally we will incline to that side, and we will take it' (Y.B.21 & 22 Edw. I (R.S) p.456).

Where there was a sealed document, the action of covenant was also available to an aggrieved creditor. Originally, the action of covenant could not be used in cases where debt would lie; i.e. when the defendant's undertaking was to pay a definite sum of money. However, in the first half of the seventeenth century, it became an alternative to the action of debt (See Plucknett, 1956, p.634).

Notwithstanding its limited scope, the action of account was another form of action for the recovery of money. So too was the action of assumpsit. A broken promise to pay, that led to the incurrence of loss, was the basis for action. In Slade's case (in 1602), it was decided that the plaintiff should succeed despite the jury's finding that there was 'no promise or undertaking other than the said bargain' (Baker, 1971, pp.192-193). It was decided in that case that 'every contract executory imports in itself an assumpsit' to pay. Assumpsit was henceforth accepted as a general alternative to debt and came to dominate the field of contract. The decision in Slade's case paved

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22 The action of debt has been described as the sister of the action of detinue. The distinction between them came to be that while detinue was based on property, on an owning, debt was based on duty, on an owing' (Baker, 1971, p.177).

23 The earliest actions so far discovered of suing in assumpsit date from the 1520s (Baker, 1971, p.190).
the way for the development of modern contract law. Specific performance is a remedy available to creditors where a debtor has failed to meet a contractual obligation. Where a debtor fails to comply with a court judgement ordering payment a creditor can apply for a writ of execution against the debtor’s assets. A secured creditor or creditors, under a power of appointment, may appoint a receiver to realise the debtor’s assets for the satisfaction of debts.

Laws regulating the distribution of assets

Bankruptcy law is concerned with the availability of a person’s property or assets for the payment of debts. Regulation of the distribution of assets is designed to protect creditors’ interests. ‘Bankruptcy is a proceeding by which possession of the property of a debtor is taken for the benefit of his creditors generally ...’ (Halsbury’s Laws of England, 1981, Vol. 3, para.201). From the earliest bankruptcy legislation, the basis on which bankruptcy proceedings could be instituted by a creditor was the committing of an ‘act of bankruptcy’ by the debtor.24 In the earliest statutes acts of bankruptcy denoted some wrongdoing on the part of the debtor. Bankruptcy laws in England in the sixteenth century made the private property of a defrauding merchant available to his creditors. A statute of Henry VIII (1542) stated:

Where persons craftily obtain other men’s goods and do so suddenly flee to parts unknown or keep their houses, not minding to pay ... then the Lord Chancellor may seize and sell any property found and divide ratably among the creditors ... But the creditors still had a right against the debtor for any unsettled portion of the debt (34 Henry VIII c.4, cited in Littleton, 1933, p.250)

Regulation was also aimed at preventing, for the benefit of the bankrupt’s creditors, certain dispositions of property by the debtor before bankruptcy. The following quotation refers to the [UK] Bankruptcy Act, 1914.

The provisions of the Bankruptcy Act 1914, s42(1) are designed primarily to enable a trustee to frustrate attempts made by a bankrupt, in a fairly lengthy period leading up to the bankruptcy, to divest himself of assets in favour of his family or friends in an attempt to defeat his creditors (Berry & Bailey, 1987, p.80).

Similar provisions are contained in current legislation. Acts of bankruptcy are now defined in s40 of the Bankruptcy Act 1966 (Cth) and are sufficient evidence of a debtor’s insolvency. The basis of modern bankruptcy law is articulated by Vermeesch & Lindgren (1992, p.1067).

24Bankruptcy legislation was first enacted in England in 1542 (Vermeesch & Lindgren, 1992, p.1067).
If a person is in hopeless financial difficulties it is desirable that this fact be recognized and that a procedure be followed by which his assets are vested in some official, then collected and realised for division among his creditors equitably and for their maximum advantage.\textsuperscript{25}

Under \textit{The Corporations Law (ss.460-462)}, when a company is unable to pay its debts, one or more creditors may apply for a winding-up order.

On the winding up of a company all its assets, other than assets which it holds as trustee, are collected and realised and applied in payment of its debts, and, when these are satisfied, in returning to its members the sums which they have contributed to the company, or paying them other money due to them in their character of members' (\textit{Halsbury's Laws of England}, 1981, Vol.7, para. 1180).\textsuperscript{26}

Forcing a company into liquidation is generally a last resort. Reliable information as to a debtor's ability to adapt to unexpected or changed circumstances is, therefore, of great importance. Shareholders may resolve to wind up a company voluntarily.\textsuperscript{27} Reliable information regarding property and debts is essential to such a decision. Where assets do not represent exchangeable means stated at current exchange prices shareholders will be misled as to the possible scale of alternative investments. In the event of a voluntary liquidation, where the liquidator is of the opinion that the company is insolvent, a creditors' meeting must be called and a statement of assets and liabilities laid before that meeting (\textit{Corporations Law, s.496(4)}). Clearly, the intention of the statement is to demonstrate the extent of insolvency.

In order to protect creditors from sudden reductions in a company's ability to pay its debts, the law places restrictions on the ability of companies to distribute assets to members. The law requires that distributions, in the form of dividends, are only payable out of profits (s 201(1), \textit{Corporations Law}). Directors are liable to the company's creditors for the amount of the debts due by the company to them respectively to the extent by which the dividends so paid have exceeded the profits (s201(2)). Profits are not defined in statute law. In the late nineteenth and early twentieth centuries, however, there were a number of court decisions on the distribution of business assets in the form of divisible profits. A particularly clear definition of profit was provided in the \textit{Spanish Prospecting Case}\textsuperscript{28} - 'the amount of

\textsuperscript{25}The other principle underlying modern bankruptcy law is that if a debtor has not been fraudulent, after a certain period, and after the assets have been taken and applied for the benefit of creditors, the debtor should be released and discharged from further liability (\textit{Vermeesch & Lindgren}, 1992, p.1057).

\textsuperscript{26}Company winding-up is governed by Pts. 5.4 - 5.7 (ss 460-588) of \textit{The Corporations Law}.

\textsuperscript{27}The only limitation being where an application has been filed with the court for the winding up of a company on the ground that it is unable to pay its debts.

\textsuperscript{28} [1908-10] All ER. 576-77.
gain made by a business during the year ... can only be ascertained by a comparison of
the assets at the two dates .... because the market value - the value in exchange - of
these assets might have altered greatly in the meanwhile.' In City of Glasgow Bank v
Mackinnon29 it was stated:

In order to ascertain the profits earned and divisible at any time, the balance sheet
must contain a fair statement of the liabilities of the company, including its paid up
capital; and on the other hand, a fair or more properly bona fide valuation of assets,
the balance, if any, in favour of the company being profits. These profits may ... be
represented by obligations of debtors, often secured, and by direct securities over
property. They are not the less profits fairly realised and divisible because they
exist in that form and have not been received in cash.

Implicit in the judgements in these cases is the idea that profit was to be calculated by
reference to dated statements of financial position based on dated money values of
assets and liabilities.30 Dated values of assets represent the measure of protection
afforded to creditors.

Another area of the law which is concerned with the availability of assets for the
payment of debts is the administration of estates.

A deceased person’s legal and equitable real and personal estate, to the extent of
his beneficial interest in it, and the real and personal estate of which he disposes
by will in pursuance of any general power, ... are assets for payment of his debts
... [UK Administration of Estates Act 1925, s.32(1)]. Any disposition by will
inconsistent with this rule is void as against the creditors, and the court must, if
necessary, administer the property for the purpose of the payment of the debts

Regulation of accounts

The extent to which property owned covers debts owed, has long been of concern to
the regulators of business. Prior to the introduction of limited liability creditors could
pursue debtors to the full extent of business and personal property and to this end the
threat of bankruptcy had a strong disciplinary effect. The suppression of fraudulent
bankruptcies was the aim of a bill regulating commerce which was prepared by Jacques
Savary in France in the middle of the sixteenth century (Have, 1976, p.57). The bill
required that merchants make an ‘inventory’ every two years of all their properties and
of their debts receivable and payable (Pour le Commerce, 1673, cited in Howard, 1932,
p.91). ‘The intention was to aid possible bankruptcy proceedings by preserving an
overview of each firm up to the latest statement date’ (Chatfield, 1974, p.68). The

29 (1882) 9 R Ct of Sess, 4th series, 535.
30 See also Binney v. Ince Hall Coal & Cannel Co. (1866) 35 LJ 363.
Savary bill was the basis of Napoleon's *Code de Commerce* which required that an inventory of property and debts be made yearly (*Bulletin des Lois*, 1807 cited in Howard, 1932, p.95-96). If these requirements were not met the merchant could be declared bankrupt (Littleton, 1953, p.84). The balance sheet was also given special prominence in nineteenth century Germany (see Littleton, 1953, p.84). It could be surmised that the German regulation, which required business firms to keep records according to bookkeeping principles and to make an annual balance sheet, was also aimed at the prevention of fraud.

The introduction of limited liability corporations around the middle of the nineteenth century removed the threat of bankruptcy in respect to those having interests in limited companies. Creditors then had recourse only to the property of companies, not of their members. Knowledge of the extent of company property was therefore vital to the protection of creditors' interests. About the same time the scale of borrowing increased, to finance the opportunities afforded by the industrial revolution, and this tendency persisted to the present. Lending would become more risky; but the extent of risk could only be assessed if lenders and shareholders were to be informed reliably of the property on which credit had been based. An examination of laws regulating commerce in the nineteenth and twentieth centuries reveals the increasing importance placed by regulators on the provision of reliable information as the extent of property owned and debts owed.

During 1841 to 1844 a select Committee of the UK Parliament was convened to consider possible company legislation. In spite of the fact that little consideration was given to the balance sheet, the *Joint Stock Companies Act, 1844* provided for a full and fair Balance Sheet to be made up (sec. XXXV) that was to be audited by persons other than the directors (sec. XXXIX). Todd (1936) indicated that the accounting section of the Act focussed on the balance sheet alone because in the government's concern for the prevention of fraud, it desired to place emphasis upon the evidence of financial stability and soundness. The Act did not specify what the contents of the balance sheet should be. However, the first draft bill submitted to Parliament required that the balance sheet exhibit a true statement of the capital stock, credits and property of every description belonging to the company and the debts due by the company at that date (*House of Commons, Sessional Papers, 1844 (244) II, 688, sec. 46*). This was a requirement of the *Companies Clauses Consolidation Act, 1845* (sec. CVI).

A major revision of company law was enacted in the *Joint Stock Companies Act, 1856*. The provisions contained in the 1845 Act were removed from the statute and included in a model set of articles of association (called Table A from the *Companies Act, 1862*).
onwards) appended to the Act. However, the regulations applied to all limited companies unless excluded or modified by the articles adopted by the company. Under Table A directors were required to cause true accounts to be kept of the goods, of money received and expended, and of creditors and liabilities (sec. 78), and to make out once a year a balance sheet containing a summary of the property and liabilities, a copy of which was to be served on every member, and a statement of income and expenditures (secs. 79,81,82). Importantly, the correctness of the balance sheet was to be ascertained by one or more auditors who were to report to the members 'whether, in their opinion, the Balance Sheet is a full and fair Balance Sheet containing the Particulars required by these Regulations and properly drawn up so as to exhibit a true and correct View of the State of the Company's Affairs' (sec. 94). The aim was clearly to ensure that truthful information about the financial state, and changes in the state, of companies was made available to interested parties for their protection.

While the disclosure requirements of the 1856 and 1862 Acts were not mandatory, the growth of the 'limited corporation' was accompanied by demands for more reliable information.

Contributing to the change in public opinion was the spectacular failure of City of Glasgow Bank. By overvaluing assets, undervaluing debts, and misdescribing balance sheet items, the bank's directors had for years hidden its insolvency while continuing to pay dividends. The immediate response to this fraud was a clause in the 1879 Companies Act requiring annual audits for all banks registered thereafter with limited liability (Chatfield, 1974, p.116).

The Regulation of Railways Act, 1868 required that financial statements, be prepared and submitted to the auditors (sec. 3). This was a forerunner of similar laws prescribing accounting methods and audit for building societies and friendly societies. The Building Societies Act, 1874 required a statement of liabilities and assets ($40). The Friendly Societies Act, 1875 required a statement of receipts and expenditure, funds and effects (s.14). In 1870 the Life Assurance Companies Bill was introduced. In the debate on the second reading (February 23, 1870) Cave spoke thus of the bill:

It provides that assurance companies shall make simple uniform statements every year, according to the model forms in the Schedules, which together with the actuarial report ... will enable people to compare the position of one office with that of another, and to judge of the solvency of any particular company (Hansard, v. 199, col. 727).

The Life Assurance Companies Act, 1870 required the preparation of a statement of revenue account and a balance sheet (sec.5). The Companies Act, 1900 required that all
registered companies be subject to annual audit. The auditors were required to report to a company's shareholders as to whether in their opinion that company's balance sheet represented a true and fair view of its state of affairs (sec. 23). The Companies Act, 1907 required that publicly held corporations file annual audited balance sheets containing 'a summary of its [the company's] capital, its liabilities and its assets' (sec. 21). Mill (1909/1976, p.900) wrote:

The law is warranted in requiring from all joint stock associations with limited responsibility ... that such accounts should be kept, accessible to individuals, and if needful, published to the world, as shall render it possible to ascertain at any time the existing state of the company's affairs ... the fidelity of such accounts being safeguarded by sufficient penalties.

The Companies (Consolidation) Act, 1908 provided that the balance sheet should be drawn up so as to exhibit a true and correct view of the state of the company's affairs' (sec. 113, 2b). The presentation of a true and fair view was the overriding requirement of the Companies Act, 1948 (sec.149 (1)). The presentation of a true and fair view is the overriding requirement of Australian Company legislation (Corporations Law, sec. 299). However, the law has recently been changed to require compliance with applicable accounting standards (sec.298). Where such application would not otherwise result in a true and fair view additional information and explanations as will give a true and fair view must be provided (s.299).

2.5 Analysis and interpretation of financial information

The balance sheet and income statement are forms of business statistics valuable chiefly for the relationships which they disclose. The abstract facts contained in these statements are in themselves of little value; they should be used to make comparisons and show relationships (Accountants' handbook, 1923/1986, p.320).

Statements throughout the accounting literature imply that the relationships disclosed in the financial reports provide a reliable basis upon which to make comparisons and to form judgements as to the financial state of affairs, and changes in the state of affairs, of business entities. Hatsfield (1927/1971) included a chapter in his book on the interpretation of the balance sheet. The first paragraph begins as follows:

Accounting is not merely the working out of an intricate puzzle consisting in carefully matching debits and credits so that they will form a nicely balanced equation. It is an attempt by the means of debits and credits to present a picture of business conditions which will be of significance to all concerned (Hatsfield, p.456).
Hatfield described the relationship between assets and liabilities as the most obvious displayed in the balance sheet. He described the current ratio as of 'prime importance' in assessing debt paying ability. He discussed several other relationships or ratios, used to analyse and interpret the facts in the financial statements, including the 'acid test' ratio and total liabilities to net worth, the latter indicating the 'extent to which the owners of the concern have contributed capital as a guaranty fund for the protection of creditors' (p.458). Gilman (1925) produced a similar list of ratios in Analyzing Financial Statements.

Throughout the accounting literature considerable emphasis is placed on the relationship between assets and liabilities. Kester (1922, p. 22) wrote: 'The ratio of total assets to total liabilities is almost as important information to an investor, purchaser, banker or creditor as is the character of the assets and liabilities.' MacNeal (1939/1970, p.190) suggested that the values of fixed assets should indicate the status of a mortgage as regards its security. Goldberg (1948, p.143) wrote:

The percentage of fixed assets to total assets should not be too large. Over-investment in fixed assets is one of the most common causes of business failure. The old saying that 'bricks and mortar cannot be used to pay debts' sums up the difficulties that may arise through investing too much of the resources of an enterprise in fixed assets.... Group totals of assets should be compared with corresponding group totals of equities. A primary condition of financial stability and security is that funds should be available to meet commitments as they mature. Total current assets should therefore exceed total current liabilities.

Kenley and Staubus (1972, p.46) observe that lenders give a good deal of attention to the current ratio, the debt equity ratio and the underlying concepts, in assessing the borrowers ability to pay. This is supported by the evidence that lenders, in order to protect their interests, frequently include restrictive covenants, such as debt/equity or debt/assets ratios, in lending agreements.\(^{31}\)

Hatfield also discussed comparisons over time. 'The attempt to estimate the condition of a concern by a single balance sheet is ... always difficult. Much better results are obtained by comparing at least two successive balance sheets' (p.459).\(^{32}\) The analysis of performance or profitability is also emphasised. Kester (1930, p.595) wrote that 'the ratio between net profits and capital investment is one measure of the results of operation.' MacNeal described the relationship between earnings and capital as a measure of management efficiency (p.193). Goldberg (1948) included a chapter on the analysis and interpretation of accounting reports and discussed a number of

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\(^{32}\)See also Cole (1908) and Couchman (1924) who discussed comparative balance sheets and the importance of relationships such as represented in the working capital ratio.
performance, financial stability and liquidity ratios, including the working capital ratio, asset turnover ratios and net profit to capital. Carter (1956) discussed various relationships represented in ratios relating to trading position, financial position, and performance ratios such as net profit to paid up capital and return on fixed assets.

A chapter on financial ratio analysis is a feature of most modern financial accounting textbooks. The publication of financial ratios by a range of sources including the Australian Stock Exchange body Statex and the financial press, the emphasis given to ratios in the financial press and the financial accounting and finance literature, and the use of financial ratios in agency contracts, indicates that they are widely used in assessing performance and financial stability.

The informed use of financial ratios requires that the components of those ratios comply with the rules of measurement. Measurements are taken to enable the comparison of one thing with another or with a standard. For example the width of a refrigerator is relevant when the available space is limited. A refrigerator with a width of .8 metres is of no use when the available space is only .7 metres wide. Any comparison or mathematical manipulation of magnitudes requires the use of a common unit of measurement and the measurement of a common property. This was emphasised by Canning (1929, p.199):

> If individual measures are to be merged by summation or otherwise, the individual things measured should belong to a common population .... the unit of measure must have a sensible common significance throughout the measuring .... the unit of measure must either be uniform throughout the measuring, or all units employed must be convertible into the unit in terms of which the measures are merged .... the method and circumstances of measuring should be as nearly as possible common to all measures ....'

Using the above example, the determination of whether the refrigerator will fit into the available space requires that the same unit of measurement be used to measure both the refrigerator and the space. The measurement of the refrigerator in metres and the space in yards results in useless information for the purpose described, unless the rate of conversion is known. It is also necessary to measure the same property of the space and refrigerator, i.e. the width. The height of the refrigerator is a useless measurement in ascertaining whether the refrigerator will fit into the available width of space. Where individual magnitudes have been derived by the measurement of different properties or by using a different unit of measure any summation or comparison of those magnitudes will be uninterpretable.
Money and money prices are the substance of all financial dealings. For accounting numbers to have real world significance the property to be measured must be money likeness. As the purchasing power of money changes over time a financial ratio will only be mathematically valid where amounts are expressed in units of the same dated general purchasing power. This requires that the elements of a statement of financial position be similarly dated and that the magnitudes assigned to assets and liabilities represent money and money equivalents at that date. If magnitudes expressed in different purchasing power units are to be compared these must first be adjusted to equivalent units. When these principles are applied, income, as the change in net assets between two points in time, represents an increase in purchasing power and is logically comparable to assets and capital. Only a profit so determined can be used to calculate a return which is comparable with other investments such as a bank interest rate or the rate on government bonds.

2.6 Summary

The relationship between assets and liabilities is the basis of the balance sheet as a statement of financial position. A position, a place occupied by a person or thing, is always relative. A firm's financial position relative to other persons or firms is represented by the money amounts of rights to property, rights against all others which are transferable or exchangeable; and claims of others against that property. Only severable rights represent means available for the payment of debts and the capacity to continue in business. These are the only things to which creditors have recourse where a debtor fails to meet a contractual obligation. Asset has a very specific meaning at law. A periodical statement of assets and liabilities is required by the Australian Corporations Law and those who rely on these statements are entitled to believe that assets represent property available for the payment of debts. To use the word in accounting in any other sense is to misrepresent the situation. As Chambers (1991, p.49) argued, the law is aimed at protecting the rights of interested parties, in this context the right to receive reliable information, and accounting rules or procedures cannot legitimately interfere with those rights. If the balance sheet is to be an accurate representation of an entity's financial position and, hence, a reliable indicator of solvency, assets must be recorded at their money equivalents. 'As creditors are quitted by cash payments, and as investors may divest themselves of their interests by sale of their 'share' or by liquidation of a company or by swapping securities, protection is, in fact, assured only by using present resale market prices of assets in statements of present condition' (Chambers, 1971b, p.84).
CHAPTER 3

EROSION OF THE 'DEBT PAYING POWER' NOTION

In the accounting literature, up until the late nineteenth century, the terms asset and property were synonymous and were used in the sense of rights and objects owned and in the context of debt paying power. The focus was on the present, on determining the current state of affairs from an examination of what was owned and what was owed. During the latter part of the nineteenth century a new school of thought began to emerge which challenged the conventional notion of assets and the function of the balance sheet. The emphasis moved away from property rights, and the money values thereof, to cost and cost allocation.

Despite an ongoing preoccupation with past costs, the accounting profession has embraced a future oriented notion of assets - assets as expected future economic benefits. The notion of assets as property available for the payment of debts has virtually disappeared from the contemporary accounting literature. The contemporary notion of assets makes no reference to debt paying power. Exchangeability is no longer considered to be an essential characteristic of an asset. Wolk et al. (1992, p.301) argued: 'The severability-exchangeability approach ... seems to restrict unnecessarily what is included in the balance sheet as an asset'

The aim of this chapter is to provide an explanation for the shift in ideas away from assets as real means of paying real debts, to notions which lead to the inclusion of all kinds of hypothetical and prospective 'potentials' rather than actuals in the financial statements. Fallacious arguments used to perpetuate such ideas will be identified.

3.1 The personification of accounts

Conventional accounting is firmly rooted in the historical cost doctrine, despite its widely acknowledged flaws. The origin of the cost doctrine is uncertain. However, Chambers (1994, p.78) suggested it may have grown out of a method adopted by some writers and teachers, following the extension of the double entry process from a record of debts owed (creditor) and owing (debtor), to explain the application of the rules of debit and credit to other kinds of property. Drawing on the stewardship
notion, teachers encouraged students of accounting to view all accounts of property as if they were records of relations with persons, as givers and receivers.\textsuperscript{33}

The recording of assets at cost became part of the rules associated with the personification of accounts. For example, Donn (1765, p.5 cited in Jackson, J.G.C., 1956, p.297) wrote: 'As I may expect to make of my goods as much as they cost me, they are in Effect the same to me as if their Value was due to me from some person; and as, in such Case, that Person would be Debtor, so I may make the Goods in my Possession Debtor for their first cost.' The following quotation also illustrates the link between the personification of accounts and cost. Explaining the application of 'debit' and 'credit' to 'real' accounts, Malcolm (1731/1986, p.13) wrote: '... when any thing becomes mine, I consider it a subject which owes or is accountable to me for such a sum of money as it has cost me.' Balances of merchandise and other property accounts, carried through to periodical summaries, would appear in those summaries at their costs. 'But all of that would rest, not on the notion that costs per se were the subject of the record, but on the supposition that items of nonmoney property could be treated as if they were debts. The procedure thus rested on a counterfactual proposition, advanced as a teaching device ...' (Chambers, 1994, p.78).

It could be surmised that in their preoccupation with the teaching of rules, teachers of accounting lost sight of the function of accounts. The irrelevance of cost to the determination of the facts relating to the trader's present financial condition - to the determination of solvency - appears to have been overlooked. They were concerned only with justification of the rules. 'Teachers limited their aim to making the application of the rules a matter of reason. The premises and justification of the rules themselves did not arise' (Jackson, 1956, p.302). There is evidence to suggest that there was much copying of early accounting works. Teachers and writers, many of them mathematicians, perhaps with little practical knowledge of commercial affairs, perpetuated the carrying forward of costs, giving little thought to whether the ideas that they were espousing were consistent with the conduct of commercial affairs.

3.2 Cost allocation

A possible factor in the shift in emphasis from dated values to cost was the official authorisation, by The [UK] Companies Act, 1862, of the carrying forward of costs to be allocated over a number of periods. The Act provided that: 'in Cases where any Item of Expenditure which may in Fairness be distributed over several Years has been

\textsuperscript{33}See for example Dyer (1997, pp.3-5).
incurred in any One Year, the whole Amount of such Item shall be stated, with the Addition of the Reasons why only a Portion of such Expenditure is charged against the Income of the Year' (Companies Act, 1862, sec.80). The rationale for this provision is not known. As Chambers suggested, it may have been designed to apply in a limited fashion to unusual expenditures, but it is feasible that this was seen as authority for carrying forward all expenditures which were seen as relating to more than one period and allocating them over successive periods. 'Then just as unrecovered amounts of debts receivable were carried as amounts of assets in the balance sheet, so also would the 'unrecovered' amounts of expenditures on goods, buildings, machinery and anything else be so treated' (Chambers, 1994, p.81).

Cost based 'depreciation' charges

During the nineteenth century the growth of corporations with large capital investment gave rise to concerns regarding capital maintenance. During the 1840's large amounts of invested capital were lost to owners as a result of railroad companies paying dividends out of capital. As a result, it was argued that a regular charge, a percentage of cost, should be made out of profit for wear and tear on assets 'occasioned by use'. In respect of properties not for sale but for business use, Pillsen (1877, cited in Littleton, 1933, p.226) argued that an entity 'take off a percentage rate of total cost for wear and tear.' The idea of cost recovery, to allow for the physical deterioration of assets, became popular toward the end of the nineteenth century. Unrecovered costs were carried forward and reported in balance sheets as assets. Chatfield (1974) wrote that some railroads adopted cost-based 'depreciation' but in most cases abandoned it when such provisions were found inadequate to replace fixed assets.

The accounting literature reveals a growing emphasis on cost and cost based 'depreciation' in the latter part of the nineteenth century. Writers began to justify the carrying forward and allocation of the cost of 'fixed assets', and other costs, on the basis that these costs would result in services or benefits over a period of time. Ladelle (1890), for example, described the cost of an asset as 'joint to the periods during which it is in use, and the allocation of depreciation to each period must be based on the expected net enjoyment to be derived during the period ... Hatfield (1927, p.130) wrote that depreciation was defined by the Interstate Commerce Commission as 'the lessening in cost value due to the smaller number of service units in the property

\[34\text{See Inglis (1884, p.102),Matheson (1893/1976, p.1) Montgomery (1912/1976, p.119) and Hatfield (1927/1971, p.76).}\]

\[35\text{Some writers suggested that the rate of depreciation include a factor for obsolescence.}\]

\[36\text{See also Guthrie (1883, p.6).}\]
as found in the same property new.' The erroneous belief that cost is a measure of future services or benefits will be discussed in Section 3.5. Aided by the going concern convention and the growing emphasis on the income statement, depreciation as an allocation of the cost of an asset over its useful life became a commonly accepted doctrine in the twentieth century.37

To depreciate means to 'diminish in value' (OED, 1989, Vol. IV, p.486). While a diminution of value is a result of real events and conditions, the allocation of the cost of an asset over its useful life is an arbitrary process based on estimates of the asset's useful life, its residual value and the pattern of benefits. The following references highlight the ambiguity of this concept which equates systematic cost allocation with market value. Spicer and Pegler (1910) defined depreciation as the 'shrinking in value of an asset from any cause during a period.' However, they went on to describe depreciation as a process whereby the original cost of the asset is written off each year (p.43). Leake (1912, p.77) wrote: 'It has been shown that depreciation is the fall in exchangeable value of industrial plant computed on the basis of cost expired during the period of its use in seeking profits, and that this fall is due to natural decay, wear and tear and obsolescence ...'.38 Smails (1927, p.105) highlights this confusion, by accountants, of cost and value.

Do we not too often speak of depreciation as 'shrinkage in value due to wear and tear, obsolescence, etc.,' leaving the layman (who inevitably associates the word 'value' with exchange value) to solve the paradox of an asset bought in 1941 for $1000 shrinking in value steadily at the rate of five per cent per annum and yet possessing today a value of, say, $1050?

It is curious that accountants advocate the measurement of the change in an asset's value over time, being the difference between the initial exchange value and the final exchange value, by a systematic process of cost allocation which completely disregards exchange values during the intervening period. Accountants have attributed a meaning to depreciation which is inconsistent with common usage and can only serve to confuse those relying on the information in financial reports.

37See Rowland and Magee (1934, p.283), Leake (1929, p.12), Sanders et al (1938/1968, p.57) and AAA (1941, p.53). This view was adopted in Accounting Terminology Bulletin No. 1 (AICPA, 1953, p.25) and in AAS 4 Depreciation of Non-Current assets (ASA & ICAA, 1993).
38See also Fieldhouse et al (1950, p.76), Saliers (1955, pp.204-205) and Dickinson (1913/1987, p.153).
Assets as unallocated costs

In the latter part of the nineteenth century it became common practice to carry forward all manner of costs on the basis that they were relevant to more than one period. Some public utility companies in the late nineteenth century began carrying forward such costs as costs of private Acts of Parliament, and fixed asset construction costs. The intangible item goodwill began to appear in the balance sheet notwithstanding the disagreement in the courts and amongst accountants as to whether this item constituted property. There was a view that where goodwill had been paid for it was assumed that the goodwill was of value and therefore had a rightful place in the balance sheet.\textsuperscript{39} Dicksee (1892/1976, p.27) described the amount recorded in the accounts as goodwill as 'absolutely meaningless'. However, he was not critical of the carrying forward as assets amounts representing 'nothing more than the probability that the old customers would resort to the old place.'\textsuperscript{40}

By 1900 it was being openly admitted that balance sheets included 'items which are not strictly assets (such as expenditure being spread over a period) and items which are not really liabilities ...' (Dawson, 1900, p.131).\textsuperscript{41} Carter (1910, p.563) wrote that 'the value attached to nearly every Balance Sheet asset involves some sort of estimate or forecast of the future... if an annual Balance Sheet is to be correct, prophetic vision is needed.' Despite the fact that these statements were not representative of actual conditions obtaining at their date, and that many items appearing as assets did not constitute exchangeable property or property rights, balance sheets continued to be held out to be dated statements of financial position.\textsuperscript{42} The essential nature of assets was ignored. Definitions of assets in terms of costs and unexpired costs began to appear in the literature. 'That portion of an expenditure the beneficial effect of which is expected to be experienced measurably in future fiscal periods is commonly called an 'asset'\textsuperscript{43}' (Gilman, 1939, p.292). '... [T]he organisation expense of a corporation .... is not property owned nor legal rights to property, nor does it strictly represent a prepaid service .... Nevertheless, it is accepted by accountants as a proper asset if other treatment would result in a violation of any accounting principle' (Couchman, 1924/1982, p.28).\textsuperscript{44}

\textsuperscript{39}For example see Roth (1929, p.103).
\textsuperscript{40}\textit{Crutwell v. Lye} [1803] per Lord Eldon.
\textsuperscript{41}See also Dicksee (1910, pp.218-219)
\textsuperscript{42}See Dawson (1900, p.131).
Accounting bodies codified generally accepted practice. In Accounting Research Bulletin No. 9 (AICPA, 1941, p.70) it was stated that any expenditure which is properly applicable to the future is 'presumptive grounds for carrying the balance forward'. The significance of such expenditures to financial matters, such as the ability to pay debts, at a particular date, was ignored.

Cost allocation became entrenched with the shift in focus from the balance sheet, and balance sheet determined income, to income per se. The determination of income was argued to be the function of accounts. Assets, including deferred charges, were considered residuals that must be carried forward to future periods in order to ensure proper matching of costs with revenues. The balance sheet, regarded as the vehicle for the distribution of charges and credits between successive income statements, became a repository for items that were not deemed to belong to the profit and loss. Some writers suggested that the term 'assets' be dropped and a more descriptive term such as deferred charges, unallocated costs or debit balances be adopted. The Committee on Cooperation with Stock Exchanges (American Institute of Accountants, 1934) declared that to speak of the balance sheet as reflecting the values of assets and liabilities on a particular date seems 'to involve a misconception of the nature of the balance sheet'. Kollaritsch (1960, p.488, original emphasis) wrote: '... [the purpose of] the general balance sheet ... is not to reveal the financial position, but rather it is to show the deferred charges and the unconsumed or unapportioned values for future operations and their financing.'

A residual of accounting procedures is contrary to popular understanding of what a balance sheet is intended to convey. As Fitzgerald (1963, p.127) writes: 'the belief that a balance sheet is a statement of realisable values is fairly widely held.' Littleton (1953, p.89) conceded that 'It is evident that most uses of the balance sheet involve

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44See AAA (1948, p.14) and AICPA (1953, para. 26).
45See, for example, Carter (1910, p.562).
46The matching principle was articulated at length in Paton and Littleton's (1940) monograph.
48The balance sheet as a sheet of balances, a list of leftovers, is manifested in Accounting Terminology Bulletin No.1 (AICPA, 1953, p.12), Accounting Research Bulletin No. 9 (AIA, 1941, pp.68-9), and APB Statement No.4 (APB, 1970). See also Cropper (1927, p.127), Parkinson (1931, p.546), Smith (1931) and Tovey (1946, p.2).
49See Fitzgerald (1938, p.86), Editorial (The Australian Accountant, 1936, p.75) and Whitney (1941, p.430).
50According to Bottrill (1973, p.143) this was also the view taken by the Company Law Revision Committee of England (1945). The balance sheet was regarded simply as a summary of unallocated costs. See also Anthony (1985, p.269). The failure of the American accounting profession to address the problems associated with the cost allocation doctrine are evident in their second formal attempt to define assets. See AICPA (1970, para. 132).
people who are protection conscious. They tend to view assets as protective values ....51 A balance sheet which represents unconsumed or unapportioned costs as assets cannot serve as a reliable basis for action. Assets may wear out, become obsolete, or for other reasons cease to be of use. Cost based charges are not representative of such events. Cost allocation has nothing to do with commercial reality. Costs do not expire in any determinable or comprehensible way. The results of such a process bear no correspondence to anything in the real world and have no relevance to financial matters such as the ability to take advantage of opportunities in the market place and the ability to pay debts. The relationship, or lack of, between 'assets' as unallocated costs and the claims against those assets, as presented on the other side of the balance sheet was ignored by those advocating or condoning this practice.

... the real significance of assets is the relation between the asset notion and other ideas, such as expense, equities, revenue, income, and the like. Unless there is some fundamental pattern of relationships, recognised in terms of some underlying principle or phenomenon, these terms can have little meaning in the larger sense ... (Vatter, 1947, p.51).

No intelligible concept of income could be related to a notion of assets which relies on an arbitrary allocation process.

3.3 Cost and the 'going concern' notion

Another circumstance which gave impetus to the cost doctrine was the accounting prescribed for certain parliamentary companies constituted for the purpose of undertaking definite public works. Dicksee (1892/1976) wrote that in order that the capital expenditure account show that, and how, the capital raised had been spent only on the authorised works, it was necessary that the actual amount expended on the works alone be debited to the account, regardless of any fluctuations in value that might afterwards occur. Fluctuations in market value were ignored on the basis that they were not expected to be realised.

... having regard to the fact that no such fluctuation could in any way practically affect the company, so long as it carried on business, and bearing in mind also the fact that it was contemplated that the company should permanently carry on business, it would appear that all consideration of these fluctuations was considered superfluous (Dicksee, p.118, original emphasis).

Dicksee (1903/1976, p.5) later used this argument to justify ignoring fluctuations in the value of 'fixed' assets of non-public entities.

\(^{51}\)See also Dickinson (1913/1987, p.80) and Whitney (1941, p.434).
... these assets have been acquired, and are being permanently retained, not with a view to their being eventually realised at a profit in the ordinary course of business, but with a view to their being *used* for the purpose of enabling trading profits to be made in other ways.... For practical purposes, therefore, these fluctuations may fairly be said to be of no account .... \(^{52}\)

The continuing, or ‘going concern’, nature of business was frequently volunteered without question as the rationale for recording ‘fixed assets’ at cost (see, for example May, 1943, p.86). Hatfield (1927/1971, p.76), discussing the purchase of a piece of land, argued:

> Its services are presumably perpetual and undiminishing; the value to the company was, in the first instance, represented by its full cost price; its services and hence its value to the going concern are therefore the same as before. It is therefore proper to continue in the inventory the cost price of the land quite irrespective of changes in its market value.... \(^{53}\)

The argument that cost represents ‘economic value’ or ‘value in use’ can be found throughout the literature. ‘... [A]cquisition cost represents the evaluation of the market at that time and therefore represents prima facie evidence of an objective ... appraisal of the economic value of the assets’ (Dicksee, 1903/1976, p.26). ‘Assuming a free market, acquisition cost expressed in the bargaining price of an asset is presumed to be a satisfactory quantification of future service expectations at the time of acquisition’ (AAA, 1957, p.4). \(^{54}\) Where markets exist for the exchange of goods and services the market (exchange) values of those goods and services can be objectively determined - prices are observable. However, as will be discussed in Section 3.5, value in use is a subjective value, individual to each user and use.

Changes in market values were ignored on the basis that ‘realization was not contemplated; such assets were bought to be used, not to be sold at a profit’ (Chatfield, 1974, p.234). \(^{55}\) Represented as a dated statement of financial facts, a balance sheet ought not deal with intentions or speculations. The fact that a sale is not contemplated is no justification for recording assets in the balance sheet at cost. What is not contemplated today may be a sensible or necessary action in the future.

Continuity or going concern is dependent upon the capacity of an entity to pay its

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\(^{52}\)Brief (1976, p.738) observed that one of the first expositions of the “going concern” concept, and its corollary the “cost” principle, appeared in an article published in *The Accountant* in 1883 (Guthrie, p.7).


\(^{55}\)See also Esquerre (1927, p.179)
debts. This requires an element of flexibility as all entities experience some level of change in their operations over time due to new technology, consumer tastes, economic and other factors. Continuity is represented by the money equivalent of exchangeable goods and rights. Past costs have no significance to any decisions that might be made with regard to a going concern.

3.4 Decision making

The shift in focus from the balance sheet to the profit and loss statement was a result of the perceived importance of the investor who, it was argued, required information relating to the entities future cash flows or earning power. Finney and Miller (1963, p.54) suggest that the shift in emphasis from solvency to earning power can be traced, in part, to the increase in the number of investors in corporate securities who ‘are disposed to measure the attractiveness of securities by the earnings of the issuing company’, and in part, to the change in the point of view of credit grantors, ‘their current approach placing more emphasis on the earnings (net income) potential as an indication of debt-paying ability.’ According to Nelson (1947, p.348):

A society with a growing accumulation of capital owned by corporations, and with governments casting an analytical eye over financial reports while groping for nebulous concepts of ‘fair return’ is not likely to be satisfied by an accounting which emphasises ownership and debts.

An alternative explanation offered for the shift in attention from the balance sheet to the profit and loss statement was the failure of the balance sheet to present a current assessment of the present value of the proprietors’ worth (Editorial, The Accountant, 1946, p.293-294).

Those advocating the matching concept and the primacy of the profit and loss statement, have failed to give due consideration to the importance of the balance sheet and the link between that report and the profit and loss statement. Income represents the change in net assets over a period of time, and cannot be determined independently of the financial valuation of the assets. Only assets and liabilities can be measured directly. If the asset valuation rules are flawed so too will be those that govern the determination of income. Profitability (earning power) and solvency are clearly related. Long-term solvency depends on long-term profitability, on an entity’s ability to maintain and increase its assets. No means of obtaining money to pay debts will be available in the long run to a

business which is unprofitable. Declining returns and net assets will deter lenders and investors. Profit is therefore vital to long term viability. However, solvency does not depend solely on profitability. Not only is the ability to earn income important, but equally important is the structure of resources and equities which produces that income to keep the firm solvent.

Financial flexibility enables corrective action to be taken when there is an unexpected decline in sales, a slowdown in the collection of receivables, a shrinking of credit facilities or other, perhaps more serious, financial crises. A firm which has a low debt to asset ratio will normally have less difficulty borrowing funds in an emergency than a firm that has a relatively high level of debts. Its assets offer a greater level of protection for lenders. Firms may change the composition of their assets from time to time in light of the risks to which they are then exposed. Businesses may dispose of assets which are generally considered by accountants to be ‘fixed’. In 1993 MIM announced to shareholders that it was considering selling off key assets in a bid to remain competitive amid a continuing slump in base metal prices. The financial press regularly report divestments of divisions or segments of a business. Firms which have a large investment in specialised equipment have less flexibility than firms which hold assets which are readily exchangeable, and therefore may be at greater risk of insolvency.

As the preceding discussion indicates there is a close relationship between profitability and solvency. However, these interests are antithetical and management must strike a proper balance between the two. ‘A policy which aims resolutely to remain solvent may avoid debt or keep ample readily available or near-liquid assets; but on both counts its profitability may be reduced. A firm which aims resolutely to maximise profits will tend to borrow all it can and to minimise its holdings of liquid assets; on both counts its solvency is at risk’ (Chambers, 1986, p.47). The company collapses of the seventies and eighties are testament to the hazards of pursuing profitability in a manner which prejudices solvency.

Likewise, a policy aimed at maximising income for the current year may not be inimical to future profits and therefore solvency. A policy which gives promise of large future earnings may not be favourable to the current financial position of the firm or to earnings of the current year. Capital investments offering potentially high returns may appear extremely attractive. However, they may also be subject to a high level of risk. Capital expenditure projects usually require the investment of large amounts of funds.

\[\text{\textsuperscript{57}Herald-Sun, Wednesday, November 10, 1993, p.37.}\]
and once committed the recovery of much of the investment, if the project is unsuccessful, is practically impossible. An unsuccessful project may result in financial disaster. The cash flows of a potentially profitable project may not be expected for quite some time. In the meantime costs have to be met. Any deviation of cash flows from those expected may threaten a firm's viability. Lags between recognising revenue and the receipt of cash, and leads between payment of cash and recognising expenses may place a profitable entity in a position where it is unable to pay its debts and meet other short-term outlays.

The relationship between profitability and financial position was ignored by those focussing on cost and matching, to the detriment of many investors and creditors who found that they could not rely on the information in the financial reports as a representation of the actual position and profitability of a firm. As Standish (1975, p.636) suggested, all parties who have a relationship with an entity are interested in its profitability and solvency: 'Without profitability [an entity] cannot produce benefits in the future and without solvency it cannot continue to operate.'

3.5 Assets as 'service potential'

A widely accepted notion

The shift in emphasis away from the balance sheet and debt paying ability, to the profit and loss statement and earning power, provides some explanation for the development of the notion of assets as future economic benefits, or service potential. As cost allocations (eg. depreciation), based on expectations of future earnings and asset usage, came to dominate practice, the accounting profession struggled to find a suitable explanation for the unallocated costs reported in the balance sheet. A criterion of service potential or future economic benefit provided a rationale for most items appearing under the asset heading in the balance sheet; not only items with an 'exchange' value or a value to the entity as a 'going concern' but also deferred charges. Couchman defined assets as 'all property owned, all legal rights to property and all prepaid rights to service' (1924/1982, p.28). The value of fixed or permanent assets he suggested 'lies in their use or service' (p.30).58 In time the future service came to be regarded as the asset.

58 See also Rorem (1928/1982, p.287), and Edwards (1938, p.46).
In 1929, the economist Canning constructed the following asset definition from his observation of accounting practice.

... any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some person or set of persons. Such a service is an asset only to that person or set of persons to whom it runs. (p22).

Under this definition, an asset is not a resource, a right or an object but a future service. In Canning's words: 'It is the anticipated service, the payment of money at some future time, that is valued and that is fundamental to the existence of the asset' (p15). He argued that one could have an enforceable right to the services of a thing and have no asset: 'The service must either be itself a money income or it must have a money income consequence' (Canning, p.20).

From his observation of accounting practice Canning concluded that ownership and therefore transferability were not essential to the existence of an asset. He emphasised that 'legal title is not determining' (p.14). Prior to Canning's work there had been references in the accounting literature to the services to be derived from assets.\(^{59}\) However, as is clear from the previous discussion, 'future services' was not an accepted view of assets at that time. Following Canning's exposition, definitions of assets as future services began to appear in the accounting literature. During the 1960s and 1970s the notion of assets as future services, or stores of services, was taken up with enthusiasm.

While some writers emphasised the source of the future service or benefit other authors focused on the service itself. Nelson argued that: 'Wealth and property are evidence of an expectation, but they are not assets ... Assets are future enterprise services ...' (1935, p.313). Like Nelson, Vatter (1947, p.15) described assets as future services or service potentials 'not physical things, legal rights or money claims' (p. 17). Edwards described assets as 'the sources of future services ...' (1938).\(^ {60}\) The existence of some future service or benefit is also the cornerstone of the definitions proposed by Sprouse and Moonitz (1962, p.20) and Kenley and Staubus (1972, p.94).\(^ {61}\)


\(^{60}\)See also Kelley (1941, p.511).

\(^{61}\)Future benefits are also emphasised by Staubus (1961/1971, p.29), Dixon, Hepworth and Paton (1966, p.6), Moonitz and Jordan (1963, p.163, Lall (1968, p.133), Sorter and Ingberman (1987, pp.100-101) and in a document published by Arthur Anderson and Co in 1984 (p.24) in contrast to the definition proposed ten years earlier which specified exchangeability as an essential asset characteristic (Arthur Anderson, 1974).
The latter made some attempt to clarify what was meant by service potential. ‘Positive cash flow potential is a more practical version of this attribute for ordinary business situations, but the broader term, which encompasses capacity to yield future benefits in any form, may be preferable’ (p.94). However, benefits other than cash flows, were not clarified. Sprouse and Moonitz (1962, p.21) suggested the economic service or usefulness of cash lies in its function as a store of value and as a medium of exchange. What ‘store of value’ cash can have, other than as a means of purchasing other goods or services, was not explained. Of materials they wrote: ‘Materials will be physically transformed into a finished product and finished product will be transferred to customers in exchange for cash and claims to cash’ (p.22). A physical notion of service potential was emphasised for non-monetary assets. ‘Other assets, such as plant and equipment, ... are utilized in obtaining shelter, mechanical assistance, and the other economic services which they are capable of providing.... ’ (p.22). Vatter (p.54) suggested that ‘there may be different aspects of service potentials that ought to be considered ... ’ However, he did not discuss these different aspects.

The adoption of this concept of assets in the pronouncements of accounting bodies, both in Australia and overseas, is testament to the extent to which this concept has gained general (but not universal) acceptance. In 1957 the Committee on Concepts and Standards of the AAA abandoned the definition of assets as ‘rights in property’ (AAA, 1948, p.14) in favour of a service potential notion (AAA, 1957, p.538). What constituted service-potentials was not explained. The FASB codified this popular view of assets in SFAC No.6 (1985). Assets are defined in that document as ‘probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.’ With regard to the form economic benefits may take, both financial and physical aspects of service potential are identified: ‘Money ... is valuable for what it can buy.... Money’s ‘command over resources’ - its purchasing power - is the basis of its value and future economic benefits (FASB, 1980b, para. 23). ‘Assets other than cash benefit a business enterprise by being exchanged for cash or other goods or services, by being used to produce or otherwise increase the value of other assets, or by being used to settle liabilities’ (para. 24).

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62 This followed a discussion memorandum in which service potential was argued to be an essential characteristic of an asset (FASB, 1976, p.60)
63 SFAC No. 6 replaces the earlier SFAC No. 3 (FASB, 1980) which contained the same definition of assets.
The professional accounting bodies in Australia (AARF, 1992, para. 12) adopted a similar definition to that promulgated in SFAC No.6. With regard to the United Kingdom, the definition proposed in ED 42 (ASC, 1988, para. 14) is almost identical to that in the American SFAC 6 (FASB, 1985). Solomons (1988, p.20) and the IASC (1988, para.49) proposed similar definitions. These are quoted with approval in ED 47 (ASC, 1990, Appendix, para.9).

It is perhaps a reflection of the intellectual poverty of much of the accounting literature that despite having devoted time and space (at times considerable) to defining assets many of these writers, and committees, have made little or no attempt to clarify what is meant by future economic benefit. Even less effort has been directed at a critical examination of this notion of assets in the context of financial reporting. The piecemeal approach adopted by professional accounting bodies in Australia and the United States to deal with the treatment of different costs illustrates the lack of a clearly explicated notion of assets.

A non-monetary right or object may simultaneously have four kinds of service potential. These are identified by Chambers (1975b, p.100).

It may be able to produce a certain quantity of a class of products .... It may serve as a liquidity reserve; it may be sold if any circumstance, such as a liquidity crisis or a change in output composition, justifies its sale. It may serve as part of a borrowing base .... And it may serve as a hedge against inflation, to the extent that its resale price rises as the general level of prices rises ....

However, as Chambers (p.100) remarked: 'It is at least curious that only the first of these is commonly noticed, and that it is a physical, not a financial, notion. And it is curious that a physical capacity test is used in respect of the magnitude of an item which is to appear in a statement of financial characteristics ....' The focus on physical capacities, such as the number of units that a machine can produce, demonstrates the accountants' preoccupation with 'value in use', which like service potential and future benefit defy unambiguous definition. As discussed below this aspect of service potential cannot be measured.

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64 The definition was recommended in a monograph prepared by Miller and Islam (1988). The definition of an asset adopted by the Australian ASRB in Release 100 also focuses on future benefits (1985, para.38).
Service potential - estimation not measurement

Three of the aspects of service potential described by Chambers are financial and can be measured, on the basis of market prices, at a particular point in time. However the first mentioned aspect, which is emphasised in the accounting literature, relies on expectations about the future, and is, therefore, inconsistent with the balance sheet as a dated statement of facts.

Supporters of the future benefits notion argue that the value of any asset is the present value of its service potentials. ‘Conceptually, this is the sum of the future market prices of all streams of service to be derived, discounted by probability and interest factors to their present worth’ (AAA, 1957, p.4). If an asset can simultaneously have four kinds of service potential no amount can be assigned which will represent the sum of those service potentials. The service to be derived from an asset in the future can only be imagined. It cannot be measured. To measure is to 'ascertain or determine the spatial magnitude or quantity of (something); properly, by the application of some object of known size or capacity. Also, in extended sense, to ascertain the quantity of (e.g. force, heat, time) by comparison with some fixed unit' (OED, 1989, Vol. IX, p.528). A yardstick cannot be applied to an expectation. Recognising that measurement is an empirical process, Sterling (1970, p.95) argued: ‘... measurement concerns an existing condition ... predictions are of a fundamentally different nature.’ Discounted values are not representative of existing conditions and cannot serve as a reliable basis for action.

Further, the benefits provided by a particular asset such as the shelter provided by a building, or the lifting power of a crane or hoist, cannot be disentangled from the benefits provided by a complex combination of assets which contribute to the production of a product or service. An asset may be made to yield quite different benefits depending on the way it is combined with other assets. This is the essence of the following quotations.

The economic theorist ... will tell us that a capital instrument, for example, a lathe in a machine shop, derives its value from the value of the lathe's future services and disservices - that the true valuation of the machine is determined by capitalizing its future money-valued service and disservice series. But unless the service of the lathe consists of bringing in a sale price either for the lathe itself or for a separately sold schedule of its technical services no series of future services independently valued in money can exist outside the imagination (Canning, 1929b, p.5).

65 For further examples of this view see Staubus (1977, p.140) and Rorem (1928/1982, p.287).
... in principle, no stream of receipts can be identified as attaching to those assets and to no others. In other words, any valuation shown for these assets is an imputed valuation, based on some method or basis of valuation other than that of the present value of a flow of dollars' (Moonitz and Jordan, 1963, p.166).

Even if the selling price of the product is 'assured,' the portion of that selling price attributable to the particular input under examination - a raw material, an item of supplies, a machine, - cannot be determined in any objective way. This 'allocation problem', ... is ... a weakness in the reliability of the discounted future cash flow method' (Staubus, 1977, p.168).66

Given the uncertainties and subjectivity associated with estimating and valuing future services, accountants have made the convenient assumption that 'the value of the asset is equal to its money cost, less a deduction to provide for that proportion of its power to render service which has been used up' (Kelley, 1935, p.51). The use of cost as a surrogate measure was accepted without critical comment by the AAA.67

The value of an asset is the money equivalent of its service potentials. Conceptually this is the sum of the future market prices of all streams of service to be derived, discounted ... to their present worths. However, this conception of value is an abstraction which yields but limited practical basis for quantification. Consequently, the measurement of assets is commonly made by other more feasible means ... Non-monetary assets ... are typically stated at acquisition cost or some derivative thereof' (AAA, 1957, p.4).68

The notion of assets as future economic benefits is completely at odds with the recording of assets at historical cost. There is no evidence to suggest that cost represents or is equivalent to any expected physical or financial benefit. As Schuetze (1993, p.69) argued, 'the probable future economic benefit of a successful, direct-response advertising campaign may be many multiples of the cost. The future benefit of a discovery of mineral deposits generally bears no relationship whatsoever to the costs of finding the deposits. The future benefits of successful research and development also bear little or no relationship to the costs incurred.' The probability that a past cost, or an unallocated (residual) cost will represent the expected future benefit is extremely remote. The determination of the extent to which the cost or value of services have, or have not, been consumed is necessarily ad hoc and dependent on individual judgement.

Decisions as to whether expenditures will result in a future benefit rely on individual judgement. Estimates of the extent of future benefits or services are personal, subjective and changeable over time. Given the uncertainties it is only to be expected that serious errors of judgement can and have been made in acquiring and using

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66 See also Bottrell (1973, p.146).
67 See also Staubus (1977, p.118).
68 See also Edwards (1938, p.81).
economic resources. The purchase, by Alan Bond in 1987, of Channel 9 for $1 billion may be cited as an example. Cost is significant only in that it represents an amount the buyer was prepared to pay which was acceptable to the seller. The exchange indicates that the buyer put a higher value on the goods or services purchased than on the money or goods that were used to purchase them, and that the seller put a higher value on the money or goods received as payment than on the goods or services sold. "... if price is equal to value, what is the point of an exchange? The parties do not expect to be just as well off afterwards as before; both expect to be better off." (Chambers, 1964-1965, p.81)

It is evident from the literature review that the notion of assets as future benefits has been quoted, cited and repeated so many times that it has become generally accepted with little or no critical thought. This is the subject of Chapter 4. It is readily apparent that accountants have given little or no thought to the incongruity of attempting to measure a characteristic of assets which is incapable of measurement.

The Balance sheet as a prospective statement

It appears that the case for a future oriented notion of assets rests on the needs of users for information about future cash flows. Staubus (1961/1971) suggested that if the firm can provide accounting information which will be of assistance in making investment decisions, it must be information related to the times and amounts of the future cash flows resulting from the investment. Staubus emphasised the importance to investors of information about the future course of the firm’s cash balance and hence, in any evidence of the firm’s future cash receipts and disbursements (p.16).

In stark contrast to the view that a balance sheet is no more than a statement of unallocated costs, and the body of opinion which regarded the balance sheet as a statement of present financial position, the economist Fisher described the accountant’s balance sheet as a ‘statement of the prospects of a business’ (1906/1965, p.264). Canning also described the balance sheet in prospective terms. He concluded that the balance sheet, as a statement of financial position, was a statement of fund procurements and fund distributions expected to occur (1929, p.182). This theme gained support in the accounting literature. Nelson (1935, p.315), drawing extensively on Fisher and Canning, wrote that the balance sheet exhibits future enterprise services in three different ways: the assets, which represent future services that the proprietor may ‘reasonably expect’, the liabilities which represent the services which the proprietor will ‘presumably’ render to other parties, and net worth which is a measure of the proprietor’s beneficial interest in the future services. He suggested that
accountants are essentially engaged in economic forecasting. Their schedules are statements of opinion about the future of the enterprise: they are not assertions about things that are known to exist’ (p.316). Moonitz and Jordan (1963) and Sprouse (1970) supported this view.

Kenley and Staubus (1972, p.93) also supported an expectational notion of assets on the basis of their view of the balance sheet. ‘If a balance sheet is to be thought of as a useful statement of financial position it should give a future-oriented report of the current stocks of the wealth-related items it covers.’ This is assumed to result in information which is indicative of future cash flows and therefore useful in assessing short term debt paying ability, solvency, and the ability to take advantage of opportunities that may arise. Staubus (1977, p.119) also emphasised the importance to decision makers of prospective information. He argued that ‘the primary function of the balance sheet, as a report to outside decision makers, must relate to the decision maker’s need to predict the firm’s capacity to pay’.

... But the concept of financial position may connote, in addition to the firm’s prospects for remaining solvent, an ability to take advantage of opportunities that may arise and that require cash ... the concept of financial position ... is future-oriented; information about financial position must be relevant to the future if it is to be useful to decision makers. A report of past receipts and disbursements, for example, tells us little about financial position except the cash balance.... we may define financial position as an entity’s cash flow potentials, their distribution over time, the relationships between their positive and negative elements, and their risk and uncertainty attributes. (p.121-122, original emphasis).

The implication is that prospective information is useful to the users of that information as a basis for action. However, these authors focus on only one aspect of the decision making process - the formation of expectations about the future. The needs of decision makers for factual information are ignored. This will be discussed in Chapter 5.

3.6 Alternative valuations

With the shift in ideas away from assets as real means for paying real debts the valuations appearing under the asset heading in periodic statements became a diverse mixture of costs, unallocated costs, net realisable values and money equivalents. While valuation at cost was advocated for ‘fixed assets’, valuation at lower of cost or market became the generally accepted practice in the case of inventories.69 The

69This was the method adopted in AAS 2 Measurement and Presentation of Inventories in the Context of the Historical Cost System (ASA & ICAA, 1989).
following authors support this practice on the basis of conservatism, despite demonstrating that its application results in inaccurate and therefore misleading information.70 Dickinson (1913/1975, p.94 & p.117) accepted this practice for both inventories and investments despite his contention that a balance sheet is required to show the true financial position as a going concern, and that the inventory at actual cost may represent more or less than the market value, and, therefore, overstate or understate the assets (p.94). Montgomery (1912/1976, p.104) argued that placing ‘a higher value on an inventory item than the price at which the same thing can be duplicated in the open market ... deceives the banker, creditor, and stockholder who have a right to believe that the values stated are real values as at the date of the balance sheet’ However, he advocated that ‘when purchases have been made in a rising market and where the goods cannot be duplicated, except at a higher price ... the conservative course is to carry the items at cost and thus do away with the objectionable practice of anticipating a profit’ (p.104).

Practices based on conservatism result in a distortion of the facts. Sterling wrote ‘Since verity is a sine qua non of information, we must conclude that conservatism yields, not only zero information, but also, misinformation’ (Sterling, 1967, p.131). As Belkaoui (1981, p.143) argued, failure to recognise unrealised increases in values of assets held in a given period ‘allows disclosure of a heterogeneous mix of gains from the prior and current period. The net result does not correspond effectively to the income of the current period.’71 All changes in the values of assets must be recorded in the period in which they occur if the financial statements are to be a true representation of the actual situation. Those relying on the accuracy of information prepared on the basis of conservatism may be grossly misled. Consider the investor: ‘Conservative representation robs the holder of securities who is obliged to sell during the period in which conservatism is applied of the advantage of knowledge of the actual rights then attaching to his securities ...’ (Chambers, 1969, p.601). 72

Studies have shown that the revaluation by companies of certain non-current assets, for example land and buildings, is common practice in Australia.73 In response to a growing trend the accounting profession, in 1981, issued AAS 10 Accounting for the Revaluation of Non-Current Assets (AARF). AAS 10 prescribes methods of accounting

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71See also MacNeal (1939/1970, p.62).
72See also Blumen (1965, p.38).
for the revaluation of non-current assets. It does not prescribe how or when assets should be revalued except to require that non-current assets are to be revalued downwards when their carrying amount is greater that recoverable amount. There have, however, been recent moves by the accounting profession towards the reporting of market prices for certain assets. For example, in AAS 25 Financial Reporting by Superannuation Plans (AARF, 1990c, para. 39) it is argued that in the case of 'defined benefit plans' measuring assets at net market value as at the reporting date 'provides more relevant information to users about the resources available to pay benefits than does the cost basis of measurement.' AAS 26 Financial Reporting of General Insurance Activities (AARF, 1990d, para. 78) requires that 'Investments that are integral to the reporting entity's general insurance activities shall be measured at net market values as at the reporting date.' The rationale for using market values is contained in paragraphs 88 and 89. Comment is made that in many cases the net market values of assets are far removed from their costs. 'This can be of major concern in relation to assets held as investments which are integral to the reporting entity's general insurance activities because increments in the net market values of such assets may be relied upon by insurers to meet their liabilities for outstanding claims' (para. 88). One can only wonder why the profession has not applied this rationale to other organisations. While the recognition of market values should be commended, the recognition of market values for certain assets results in the aggregation of unlike things.

The aggregation of a heterogeneous mix of values such as money equivalents, costs and net realisable values is considered acceptable practice by the majority of accountants.

... in accounting, 'values' ... although not homogeneous, may be aggregated or deducted from one another. Thus it is a universally accepted practice to add the cost value of one asset to the market value of another, and to deduct from the sum the nominal value of a liability ... This procedure, although open to obvious criticism of its mathematical propriety, possesses so many practical advantages and is so well established both here and abroad ... that it is not likely to be abandoned (AIA, 1940, p.53).

The Australian accounting profession have indicated that financial reports should be prepared for those users who have the proficiency necessary to comprehend the significance of accounting principles, implying that an understanding of the principles used in the preparation of financial reports will render the information contained in those reports useful as a basis for decision making. This is an incorrect premise. The

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74 Defined in AAS 25 (para. 10) as 'a superannuation plan where the amounts to be paid to one or more members ... are specified, or are determined, at least in part, by reference to a formula based on their years of membership and/or salary levels ....'
aggregation of heterogeneous values such as cost and market value results in financial statements which are unintelligible in a commercial or financial context. Such magnitudes have no significance to financial dealings. Money and prices are the substance of financial dealings. As Chambers (1975, p.642) argued: ‘... a statement of financial position is only understandable and significant in relation to financial dealings if its components are amounts of money and prices expressed in money.’

3.7 Summary

The balance sheet is held out to be a statement of financial position at a particular point in time. Notions of assets as unallocated costs, and service potential, which rely on expectations about the future, are contrary to such a notion of the balance sheet. Such notions have no significance in a statement of financial position. 'Unallocated costs' and 'future economic benefits' do not represent rights or objects which exist in the present; they do not represent an entity's ability to trade in the marketplace at a particular point in time; they do not represent property to which creditors can seek satisfaction of their claims. The move away from observables to hypotheticals is a result of lack of care in definition, lack of rigour in discourse, intellectual laziness and a disregard for the function of accounting reports. Financial statements based on unallocated costs and future economic benefits cannot be reliable indicators of financial position and progress.
CHAPTER 4

THE INFLUENCE OF ECONOMISTS ON THE NOTION OF ASSETS

4.1 Source of the service potential notion

'Economics ... examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisite of well being' (Marshall, 1947, p.1). '... [T]he economic activity of man looks to a provision of the material means to satisfy his wants and those of his household' (Mill, 1909/1976, p.4). As these quotations indicate accounting has much in common with economics. Both are concerned with the transactions and events by which wants are satisfied. It has been suggested that the similarities and differences between accounting and economics have drawn little discussion from accountants and economists. 'Indeed, in some respects in which the [accounting] literature purports to borrow from economics, the borrowing is mistaken and misleading (Chambers, 1991, p.52).

It is apparent that the introduction, and subsequent general acceptance by the accounting fraternity, of the notion of assets as future economic benefit was a result of accountants having drawn, directly and indirectly, on the writings of the economist Canning. Canning, as he acknowledged in the preface to his book The Economics of Accountancy (1929), was strongly influenced by the writings of fellow economist Fisher. This influence is clearly evident throughout Canning's book, in which he attempted to clear away some of the confusion which surrounded economists' understanding of accounting concepts. Fisher's influence on Sprague (1907), who referred to Fisher's (1906) work in his discussion of assets, is also evident.

The object of this chapter is to examine the writings of Canning, Fisher and other economists, as they relate to the notion of assets, and the manner in which some of the ideas elucidated have been drawn into accounting. It will be demonstrated that economists have expounded an interrelated set of ideas within the context of action - the satisfaction of wants. However, most accountants have ignored those ideas. They have drawn instead on the writings of Fisher and Canning, to support the ambiguous notion of assets as 'service potential', without regard for whether those ideas were appropriate in a financial reporting context.
4.2 The works of Economists

Irving Fisher’s ‘The Nature of Capital and Income’

Fisher described his book *The Nature of Capital and Income* (1906) as an attempt to put the concepts and fundamental theorems of capital and income on a rational foundation. He hoped that it ‘may supply a link long missing between the ideas and usages underlying practical business transactions and the theories of abstract economics’ (preface, p.vii).

Fundamental concepts

*Property and wealth*

Fisher’s first task was to define wealth and property. Wealth was defined as the ‘material objects owned by human beings’ (p.3) - concrete material things appropriated to the use of mankind. Fisher described wealth in its broadest sense as including human beings although he agreed that freemen are not ordinarily counted as wealth as they cannot be exchanged.

... they are not, like ordinary wealth, bought and sold ... in order to concede as much as possible to popular usage, the following supplementary definition is framed: By wealth (in its more restricted sense) we mean material objects owned by man and external to the owner (original emphasis).

Ownership or property is a right protected by law. Fisher defined property, or a property right, as the right to use wealth (p.18). This is defined as a person’s ‘liberty, under the sanction of law and society, to enjoy the services of that article’ (p.20). Consistent with including humans in wealth, Fisher described property in its broadest sense as including both proprietary and personal rights. He acknowledged that personal rights ‘are not ordinarily called property rights, just as persons are not ordinarily called wealth, and for a similar reason - they do not enter into trade’ (p.21). Fisher (p.21) argued that for the economist to confine the terms ‘wealth’ and ‘property’ to objects which are exchangeable would be to sacrifice simplicity and logical convenience.

Fisher was concerned to clarify the distinction between the concepts of wealth and property. ‘... property rights are not wealth, though they are intimately related to wealth’ (p.18). He described the contemporaneous correspondence between property and wealth: ‘... the existing property rights are rights to the existing wealth, so that
existing wealth underlies all existing property rights' (p.32-33). Wealth is described as 'existing means toward future services', and property as constituting an interest in the present means' (pp.33-34). Consistent with the notion of present rights or means the value of a quantity of wealth or property is described as the quantity multiplied by the exchange price.

Services are described as the benefits of wealth.

The services of an instrument of wealth are the desirable changes effected (or the undesirable changes prevented) by means of that instrument. For instance, the services of a loom consist in changing yarn into cloth, or what is called weaving. Similarly, a plow performs the service of changing the soil in a particular manner ... ' (p.19).

Fisher emphasised the uncertainty associated with services which 'are always and necessarily future services ...'. He emphasised that the chance of obtaining any future benefit was dependent on existing wealth. He stressed that services are a possible consequence of wealth but the services are not wealth. '... swift horses are wealth, but not their swiftness ...' (Fisher, 1906, p.39).

There is a correspondence between Fisher’s concepts of wealth and property, in the restricted sense, and the notion of assets which emphasises legal substance - rights of ownership or objects owned. Fisher defined the assets or resources of the owner as 'all his property-rights ...' (p.68). Present means - means for paying debts - are implied in Fisher’s discussion of the relationship between assets and liabilities. 'The assets include both the property which makes good the liabilities, and the property, if any, in excess of the liabilities' (p.68). He also wrote: 'A wise merchant ... will not only keep his assets in excess of his liabilities by a safe margin, but will also see his assets invested in the right form so as to enable him to cancel each claim at the time and in the manner agreed upon' (p.82). Capital (assets less liabilities) is described as a buffer to keep the liabilities from overtaking the assets (p.81).

**Fisher’s Framework of Capital and Income**

The ideas expressed by Fisher later in his book are at variance with the earlier ideas. Whereas wealth and property were defined as present means and rights in present means, Fisher’s framework of capital and income is based on the expected benefits of wealth. Income is defined as a 'stream of services through time' (Fisher, 1906, p.324), services being the desirable events yielded by wealth or capital (the 'stock of wealth existing at an instant of time' (p.52)). For example, 'the service of a dwelling to its
owner (shelter or money rental), the service of a piano (music), and the service of food (nourishment) ...' (p.106). Net income is defined as the difference between the value of desirable events flowing from wealth through a period and the value of undesirable events, where value is determined by multiplying the quantities of services and disservices by their prices. Fisher’s model leads ultimately to psychic income - the satisfaction derived from desirable services. There are no prices for satisfaction.

Fisher wrote: ‘When values are considered the causal relation is not from capital to income, but from income to capital; not from present to future, but from future to present; in other words, the value of capital is the discounted value of the expected income’ (p.328). It was assumed that expected income was foreknown with certainty - that expected income would equal actual income (p.223).

Fisher (p.264) concluded that the theory of capital and income applies practically to the accounting ordinarily employed in business.

Such accounting is, in fact, nothing but a method of recording the items of income and their capitalization at different points of time. A merchant’s balance sheet is a statement of the prospects of a business. Each item in it represents the discounted value of items which he may expect later to enter in his income account.... In all cases the income account simply records the values of the services and disservices of articles of property through any given period; and the capital account records the present value of those articles, as resulting at any given instant from the expected values of their services and disservices.

Chambers suggested Fisher could not have reached this conclusion about ‘the accounting ordinarily employed in business’ from an observation of accounting practice. ‘Accounting did not, at the beginning of the century, and does not now yield balance sheets in which assets are shown at the discounted values of their expected yields’ (Chambers, 1971, p.145). As Chambers pointed out, it is curious that Fisher did not relate his earlier considerations of the measurement of wealth to accounting practice as they were closer in nature than the business balance sheets and the capitalised balance sheets of Fisher’s later chapters.

An observation of accounting practice should have revealed that the balance in the income account is equal to the change in net assets between two points in time. If the balance sheet at the beginning of a period represents the discounted values of expected incomes, and the income account represents actual values of services and disservices, the accumulation of the opening balances and income account items will not result in a balance sheet which represents the discounted values of expected incomes at the end of the period, except, of course, in the case of perfect foreknowledge. As Chambers
(1971, p.145) suggested: 'It is reasonable to make the assumption of perfect knowledge for expository purposes. It seems quite improper, however, to proceed from this to conclusions about the 'accounting ordinarily employed in business'; for in business there is no such thing as perfect foreknowledge.'

Fisher's framework is developed under conditions of certainty. However, the future is not certain. Fisher suggested that the introduction of the element of chance, i.e. of uncertainty, 'does not greatly affect bookkeeping except to impair somewhat the correspondence between capital accounts and income accounts' (p.287). In the context of financial reporting the introduction of uncertainty is of great significance. Where balance sheet values are determined by discounting future 'services' or 'income' they will not be representative of the underlying reality. Income, representing the change in net assets over a period of time, will be based on expectations. It will not be a measure of success or the change in the real wealth of an entity over a past period. Income determined as the actual services and disservices of the period will not equal the change in net assets over a period of time where the underlying values are based on expectations. Actual income will never equal expected income.

Canning's 'Economics of Accountancy'

Meriam (1931, p.242) suggested that in undertaking a critical analysis of the principal concepts and operations of the accountant Canning had three main purposes: 'to equip the economist with safeguards against improper use of statistical data taken from accounts; to enrich accounting theory by Professor Fisher's income concept, the flow of services; and to improve accounting definitions and procedures.' The Economics of Accountancy (1929) was Canning's Ph.D dissertation. Smith (1974, p.6) described it as 'the culmination of a decade of study into the unexplored areas of convergence between accounting and economics.'

In his attempt to determine what accountants meant by the term assets, Canning (1929, p.13) noted that most writers offered no definition at all and those that did were confusingly diverse. For this reason Canning looked to accounting practice to build a definition. However, in the preface to his book, Canning (p.iv) acknowledged the extent of Fisher's influence on his writing and that influence is clearly evident in Canning's asset definition.

An asset is any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or
equitably secured to some person or set of persons. Such a service is an asset only to that person or set of persons to whom it runs (1929, p22).

Canning stressed that the essential idea of an asset is that it stands for a separable series of future services. He links the concept of a series of services (Fisher's income notion) with the concept of assets. 'For income in essence is services - the desired element in economic events. Change the sign and you have the undesired element in economic events, disservices, or expense. Consider the sources of service and you think of tangible assets' (1929b, p.8). Unlike the definitions of wealth and property proposed by Fisher which focused on present means and interests in the present means, Canning's asset definition focused on future services. Canning (1929, p.45), concluded that not all items with the characteristics of assets, as he defined them, were commonly included on the balance sheet, while some items outside of that definition were included. In linking Fisher's income notion to the notion of assets Canning may also have been influenced by Sprague (1907, p.46), who argued that assets are, in part, 'a storage of service to be received'. As discussed below, Sprague's references to services appear to have resulted from his exposure to Fisher's work.

In his chapter on the measurement of income, Canning sought to compare and contrast the accountants' notion of income and Fisher's ex-post income notion, which he regarded as closely allied (p.143). However, Canning had great difficulty in clarifying the accounting concept of income (p.160), noting that what accountants described as income did not conform to Fisher's notion (p.94). Canning noted: 'The preoccupation of the accountant is with the question of what is the amount of the income of a particular year or series of years in the past - not with income as a continuing, flowing thing extending indefinitely into the future' (p.94). Of income as future services, he wrote: 'Income' so far as I am aware has never been given so broad a meaning by any writer on accounting' (p.14).

Canning's aim was to improve economists' understanding of accounting concepts and, it is suggested, to persuade readers of the merits of Fisher's income concept. Canning was not seeking to develop concepts of income and assets within the context of providing factual information as a basis for decision making. As will be demonstrated below many economists have proffered definitions which are suitable in this context. Given the above, the inconsistencies between Canning's proposed asset definition and accounting practice, and the apparent lack of any logical link between the accountant's concept of income and the implied asset definition, critical examination of these concepts would be expected in the accounting literature. There has been no such examination.
Views of other economists

Wealth and capital

Unlike Canning’s asset definition which is future oriented, Fisher’s definition of wealth, in the restricted sense, and the definitions of wealth offered by notable economists such as Marshall and Smith correspond to the property notion of assets - rights or objects which are exchangeable for money.

A man’s wealth ... is to be taken to be his stock of ... those material goods to which he has (by law or custom) private rights of property and which are therefore transferable and exchangeable ... [and] ... those immaterial goods which belong to him, are external to him, and serve directly as the means of enabling him to acquire material goods.... Wealth ... includes all those things, external to a man, which ... belong to him ... and which ... are directly capable of a money measure ...’ (Marshall, 1947, pp.56-57).

Wealth ... is power ... the power of purchasing; a certain command over all the labour, or over all the produce of labour, which is then in the market ... The exchangeable value of everything [owned] must be equal to the extent of this power which it will convey to its owner (Smith, 1893, p.23).

Other economists offer similar definitions. For example: ‘Wealth may ... be defined as consisting of all potentially exchangeable means of satisfying human needs’ (Keynes, 1917, p.95). ‘... wealth ... is anything that can be exchanged, or that possesses an exchange value.... wealth is ... money’s worth’ (Seligman, 1907, p.19).75

These economists and others, like Fisher, argued that the contribution of an item to a person’s wealth is measured by market exchange prices. ‘It is probably obvious to most people that market value is the appropriate measure of well-being associated with each item of wealth in a man’s possession’ (Alexander, 1950/1973, p.13).
‘Common usage ... confines the term ‘Wealth’ to things capable of being bought and sold, measuring the amount of wealth they represent by the quantity of money they would fetch in the market’ (Hobson, 1914, p.9). ‘In common discourse, wealth is always expressed in money .... in the inventory of a person’s fortune are included, not only the money in his actual possession, or due to him, but all other articles of value. These, however, enter not in their own character, but in virtue of the sums of money which they would sell for ....’ (Mill, 1909/1976, p.3).

Capital, whether regarded as a stock of wealth, or that part of a person’s or firm’s wealth that is devoted to the derivation of income76, is also defined by many economists in terms of purchasing power, or exchange prices. For example: ‘Capital’

75See also Roll (1938, p.51) and (Mill, 1909/1976, p.6 & p.9)
76See for example Marshall (1947, p.71) and Seligman (1907, p.17).
should be defined to mean the monetary summation and expression of enterpriser’s purchasing power’ (Fetter, 1937, p.9); ‘Capital is the sum of the money equivalent of all assets minus the sum of the money equivalent of all liabilities as dedicated at a definite date to the conduct of the operations of a definite business unit’ (Von Mises, 1963, p.262); ‘The firm’s fortune at any moment comprises the market value at that moment of all the material objects and legal rights which it then possesses, plus the debts owed to it less those it owes to others (Shackle, 1970, p.28).

**Income**

Fisher’s model is based on a prospective or ex ante notion of income. Economists are concerned with the allocation of scarce resources and since expectations determine how resources are allocated economists are directly concerned with such expectations. However, economists have propounded both ex ante and ex post notions of income and the different nature of these concepts is made clear. ‘Past profit is known, a recorded fact; expected profit is a creation of the mind, in essence no more than a conjecture, however subtle and exhaustive the comparisons which the enterpriser has made between the circumstances of past success or failure and his apparent situation at the moment of deciding ... these two meanings of the word [profit] are essentially and radically different’ (Shackle, 1959, p.111).

Ex post notions of income, found throughout the economics literature, are consistent with the definitions of wealth and capital presented above, and imply a necessity to determine income on the basis of a discoverable store of purchasing power or wealth, as represented by the exchange prices of exchangeable means (assets) and money amounts of liabilities, at successive dates. Income ex post has been defined as ‘the increase or accretion in one’s power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or, (b) anything susceptible of valuation in terms of money’ (Haig, 1921, p.146); and, ‘the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question ... measured ... by appeal to market prices’ (Simons, 1938, p.49-50). Haig (1921, p.150) wrote: ‘... whether a particular item is income or not income, must, in the opinion of the writer, ... depend upon whether the receipt of that item has increased the economic power of the recipient to command satisfaction yielding goods or services.77

77See also Hicks (1946, p.179) and Haig (1921, p.166).
Income ex post, as defined above, represents an increase in purchasing power. This concept of income, and the associated concepts of assets, capital and wealth, have been elucidated by economists in the context of economic behaviour - action aimed at the satisfaction of wants. These concepts are suitable to the context of financial reporting. The money amounts of exchangeable means at a particular date represent an entity’s purchasing power, its ability to engage in transactions in the market place. Liabilities reduce that capacity. Income represents a change in that capacity.

4.3 The dissemination of the notion of future services through the accounting literature

In 1907 Sprague wrote that in one aspect assets are a ‘storage of services to be received’ (p.46). Although Sprague did not quote Fisher at this point in his book he did comment on the view, put forward by Fisher (1906), that all assets are capital. As Fisher (1906) based his framework of ideas on the notion of income as a ‘stream of services through time’, and defined the value of any capital good as ‘the discounted value of that income’ (p.223) we can infer that Sprague’s ideas were influenced by Fisher.

Paton and Stevenson (1916/1976, p.21) introduced the notion of services and included in property or assets, services which represent a future benefit. They may have been influenced by the writings of Sprague to which they refer. Nelson (1935) relied heavily upon Fisher and Canning. He argued that the ‘value of capital or a set of property rights is determined alone by its future’ and that the ‘material of the balance sheet is the future enterprise services that, as of the given date, may reasonably be expected.’ He continued: ‘Wealth and property are evidence of an expectation, but they are not assets. The accountant ... is primarily concerned with the magnitude of the future events in which the instruments may participate with benefit to the given proprietor. Assets are future enterprise services’ (p.314). It should be emphasised that this statement was made at a time when the generally accepted view was that assets were unallocated costs.

Gilman (1939) referred extensively to Canning throughout his book which was directed primarily to ‘the accountant in search of accounting ‘principles’ articulating with present day practice ....’ When discussing assets, Gilman quoted both Canning and Sprague. He also quoted Perry Mason (1937, p.13) who described an investment in an asset as the price paid for a series of future services. Although Paton and Littleton (1940/1970, p.26) described assets as costs representing ‘charges awaiting future
revenue’ they were to influence later writers with the attention given to the service aspect of business operations. They described ‘service’ as the ‘significant element behind the accounts.’ ‘Behind accounting’s array of figures, which laymen may think represent values or money, or, at best, price, lie the tangible and intangible embodiments of services. Accounting is, therefore, strongly rooted in economics....’ (Paton and Littleton, p.13). Although not citing any sources directly the reference to economics could indicate the influence of Fisher, or Canning, or both. Expenses are described as ‘services received’ (p.26), the implication being that ‘assets’ are services yet to be received, or expected future services.

Kelley (1935, p.51), revealing the influence of Sprague, described assets as ‘in essence a storage of service.’ In a later paper he suggested that the virtue of the definition of assets as ‘a storage of service, or anything that renders or is capable of rendering a service to the enterprise’ is its comprehensiveness and simplicity, and that it is easily understood by everyone (1941, p.511).

The introduction of the idea of assets as future services has been attributed by some authors to Vatter. Vatter (1947), in his attempt to define accounting principles, concluded that assets are ‘embodiments of future want satisfaction in the form of service potentials that may be transformed, exchanged, or stored against future events.... assets are service potentials, not physical things, legal rights, or money claims’ (p.53). Vatter (p.52) quoted Paton and Littleton’s reference to ‘service’ and ‘service potentialities’ and Canning (1929, p.188) who described the essence of enterprise assets as constituting ‘the assured, separable service-series’.

The same pattern is found throughout the accounting literature. Describing assets as ‘stores of services’ Staubus (1961/1971, p.29) noted that the ‘service’ aspect of assets had been emphasised by other writers. He made specific reference to Paton and Littleton (1940/1970) and Vatter (1947). In a later work Staubus (1977, p.122) again quoted Canning. Sprouse and Moonitz (1962, pp.19-20) referred to Sprague’s ‘description’ of assets as ‘store of services’; to Paton and Littleton’s statement that service is the significant element behind the accounts; to Vatter’s description of assets as ‘service potentials’; to the definition promulgated by the Committee on Terminology in 1953 (AICPA, 1953), in which assets were defined in terms of generally accepted accounting practice; and to the Committee on Concepts and Standards of the AAA (1957, p.538) which stated that assets are ‘aggregates of service-potentials’. Sprouse and Moonitz (p.20) adopted the majority view. Moonitz and Jordan (1963, pp.162-3)

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76 See Kenley and Staubus (1972, p.93) and Staubus (1977, p.123).
quoted Sprague - 'a storage of services to be received', Canning - 'any future service in money ... , Vatter - '... embodiments of future want satisfaction ...', and the AICPA (1953), concluding that despite some differences the definitions agree on certain essentials. They defined an asset as a 'right, residing in the owner, to prospective benefits' (p.163).

The notion of assets as future benefits was by this time becoming generally accepted.\textsuperscript{79} Prospective cash inflows, or future services, service potentials or future economic benefits, were described as an essential characteristic of an asset in the FASB discussion memo on 'Elements of Financial Statements and Their Measurement' (FASB, 1976). The definitions proposed by Canning (1929), Vatter (1947), the AAA (1957), Sprouse and Moonitz (1962), Mautz (1970), and in 'A Statement of Basic Accounting Postulates and Principles' (Study Group at the University of Illinois, 1964) were quoted (p.60). However, there is no discussion of the rationale behind such a notion in terms of the purpose for which the information is prepared. The literature is characterised by the lack of critical examination of these ideas in the context of financial reporting.

Canning's definition continues to be cited in the literature as authority for the notion of assets as service potentials or future economic benefits. Hendrikson (1977, p.257) quoted Canning and concluded that the emphasis on economic resources representing service potentials or rights to prospective benefits provides for an all-inclusive definition. Henderson and Peirson (1984) discussed Canning's asset definition at length. They concluded, without critique: 'There is no reason to believe that the characteristics of an asset identified in 1929 are not the same as the characteristics of an asset in contemporary accounting' (p.30). They proceeded to define an asset, 'as that term is understood in contemporary accounting' in the same terms as Canning.\textsuperscript{80}

\section*{4.4 Recourse to the literature incomplete}

Sprague (1907/1972) is cited frequently in the accounting literature as 'authority' for the notion of assets as 'stores of services'. According to Canning (1929, p.22), Sprague 'says of assets 'they are a storage of services to be received.' Gilman (1939, p.291) alleged Sprague 'referred' to assets as 'a storage of services to be received.' Nelson (1935, p.314, emphasis added) wrote: 'Sprague declares that assets are a storage of


\textsuperscript{80}See also Kam (1990, p.102-104).
services to be received.’ Although not citing Sprague, Kelley (1935, p.51) described every asset of a business as ‘in essence ‘a storage of service’ ....’ and in a later work an asset is defined as ‘a storage of service, or anything that renders or is capable of rendering a service to the enterprise’ (1941, p.511).

Sprague’s influence is also evident in Paton and Littleton’s (1940/1970, p.13) description of accounting. ‘Behind accounting’s array of figures, which laymen may think represent values or money, or, at best, price, lie the tangible and intangible embodiments of services’. Sprouse and Moonitz (1962, p.19) referred to Sprague’s ‘description’ of assets as ‘store of services’. Moonitz and Jordan (1963, p.162) professed that Sprague ‘asserted’ of assets that they are a storage of services to be received. Kam (1990, p.102) wrote that Sprague ‘saw’ an asset as a storage of services to be received.

Staubus (1961, p.29) also described assets as ‘stores of services’. In a later work he listed the seven ways in which Sprague proposed that assets could be considered. He described the breadth of the listing as indicating a potential for confusion, ‘and Sprague did not emphasise any one view enough to dispel it’ (1977, p.122). Miller and Islam (1988) presented the same list. They concluded that ‘Sprague expressed some significant ideas such as ‘all our ‘things’ may be looked upon as merely rights of dominion’ (p.44) and assets ‘are a storage of services to be received’ (p.46). But these ideas were given no more stress than many other blurring notions’ (p.11). These conclusions would indicate that neither Staubus, nor Miller and Islam, read Sprague closely.

Accountants have drawn on the writings of Sprague to support the notion of assets as service potential. However, recourse to Sprague’s discussion of assets has been incomplete. In his discussion of the balance sheet Sprague emphasised the notion of property or assets as something owned and/or rights of ownership, and its representation of debt paying ability. He wrote that the Balance Sheet must comprise: ‘The values of assets, consisting of property and claims, to which the person, or collection of persons, has title’ (p.30). Ownership is also emphasised in the following quotation. ‘Looking at the left-hand side, we see that it consists of three kinds of property, and a collection of debtors. The property does not owe Mr. Jones anything; it belongs to him ....’ (p.34).

The emphasis on legal rights continued. Sprague wrote that the values of the asset side of the balance sheet are composed of two classes: ‘Things and rights’, or ‘Things belonging to us and debts owing to us’, or again: ‘Possessions and Expectations’.
We shall see that these classes imperceptibly blend into each other and that every asset may be looked upon either as a 'thing' or as a 'right. Possession of a thing is merely the right to use it and control it. Therefore all our 'things' may be looked upon as merely rights of dominion (p.44).

Rights of dominion represent rights of 'ownership' (OED, 1989, Vol. IV, p.949) defined as '... the right (esp. the exclusive right) to the possession, use or disposal of anything (OED,)'. That the financial reports should be representative of the underlying legal rights and claims is also evident in Sprague's description of liabilities as 'the rights of others against us and our property' (p.49).

Assets are viewed as exchangeable means - means for paying debts.

Ordinarily there is no designation of certain assets as destined to meet certain liabilities, but any or all of the assets may, upon default, be expropriated to a sufficient extent to pay any liability. The word 'assets,' meaning 'enough' or 'sufficient,' suggests this view of their nature from the point of view of the creditor (p.49-50).

That exchangeability is considered an essential characteristic of assets is evident in the following quotations. 'Where there are any liabilities, no list of things can be drawn up which represents the proprietorship because the liabilities may be cancelled by disposing of whatever assets are chosen for disposal by the proprietor (p.52). 'The personality of the proprietor, his skill, his experience, though important elements of his capital, can never be brought into his balance sheets. They cannot be bought nor sold and they only make themselves manifest through the services which he does sell ....(p.36)

It is in the discussion of different aspects or phases of assets that Sprague introduced the notion of assets as future services. He suggested: 'In another aspect all assets are the embodiment of services previously given; and in still another they are a storage of services to be received. It is this reference to assets as a 'storage of services' which has been cited extensively in the accounting literature. However, Sprague did not suggest that this was an appropriate notion for accounting purposes. He proposed that assets could be considered in one or more of the following ways (p.47).

1. As things possessed, directly or indirectly, or physical assets.
2. As rights over things and persons, for use, for services, or for exchange.
3. As incomplete contracts, whereof our part has been performed in whole or in part; or contractual assets.
4. As a result of services previously given, or cost.
5. As the present worth of expected services to be received.
6. As capital for the conduct of business operations.
7. As investment in the hands of another who uses it as capital.

Sprague stressed ‘that the aspect of assets as the present worth of future services is entirely based upon opinion...’ (p. 46-47). This could be taken as an indication that Sprague had serious misgivings with regard to a future services notion of assets.

4.5 Summary

The notions of wealth and property proposed by Fisher, as representing means - purchasing power - and rights in means, are consistent with the notions of wealth and assets found in the accounting manuals of the eighteenth and nineteenth century. Ex post notions of income as the increment in one’s purchasing power, one’s power to satisfy wants in a given period, and the associated ideas of wealth and capital, are supported by many leading economists. These notions accord with the commercial environment in which firms operate, where continuity is determined by the firm’s ability to interact with other players in the market. In such an environment the money amounts of means and debts are necessary information. This fact has been ignored by writers in the accounting literature espousing the notion of assets as ‘future benefits’.

The definition of assets as ‘future services’ was taken up by accountants without consideration for whether such a concept was appropriate to the context of financial reporting. Frequent references are made to Sprague’s work, in an attempt to support the services notion. Those references are incomplete and ignore Sprague’s emphasis on exchangeability and debt paying power. Expectations and desirable services are not the concern of the accountant. The accountant is concerned with recording and reporting those events which have affected the financial position of a business entity, its solvency, its capacity to act. Information reported in financial statements based on a future oriented notion of assets is unreliable and can only serve to mislead persons relying on those reports as a basis for action.
CHAPTER 5

CONCLUSION

The accounting literature reveals a change in the accounting notion of assets from a legal orientation, where assets, or property, represented what was owned and therefore available to pay debts, to notions of assets as deferred costs and future economic benefits. This change has occurred despite the accepted view that the function of accounting is to provide reliable information as a basis for decision making. Decision making is a process of choosing between alternative courses of action. Rational and informed choice will be based on knowledge about the past and present, expectations of the future, and the evaluation of alternative actions. The change in the accounting notion of assets is based on a number of fallacies, in particular the notion that financial statements based on conjecture and opinion can be the basis of informed action. As history has proven such statements are unreliable indicators of financial position and progress.

5.1 Function of accounts

Since Pacioli accountants have regarded the discovery of a dated state of affairs as the function of accounts. It was said that from the books of account you could learn 'the entire value of your business' (Pacioli, 1494/1963, p.97). Dodson (1750, p.i) wrote: 'Book-keeping is the Method of entering, or registering, the Transactions occurring in Trade and Business, in order to enable the transactor to know the true State of his Affairs.' A knowledge of present state was regarded as a prerequisite for future action. 'A merchant ought to know, upon all occasions, what it is in his power to do without embarrassing himself ...' (Gordon, 1765/1986, p.11). In a more recent publication it was stated:

Accounting is the science of producing promptly and presenting clearly the facts relating to financial condition and operations that are required as a basis of management. The prime function of accounting is thus the clear and prompt presentation of all the facts that are essential to good judgement and effective action (Oakey, 1921, p.1 cited in Goldberg, 1948, p.24).

That the function of accounting is to provide reliable information as a basis for informed judgements has been confirmed in a number of pronouncements by accounting bodies. In 1936 the AAA (p.60) published a statement of 'tentative principles' relating to corporate financial reports in which it was stated: '... it should
be possible for a person moderately experienced in business and finance to examine such statements with the expectation of deriving from them the basic facts on which at least tentative business judgements may be premised'. In a statement issued in 1941 it was stated: 'The purpose of periodic financial statements of a corporation is to furnish information that is necessary for the formulation of dependable judgements' (AAA, 1941, p.52).81 In *A Statement of Basic Accounting Theory* (AAA, 1966, p.1) accounting was defined as the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.

APB *Statement No. 4* (AICPA, 1970) was the first of a succession of AICPA documents to postulate the decision usefulness objective. The importance of providing reliable information as a basis for decision making is implicit in the following statement from one of those documents, known as the Trueblood Report (AICPA, 1973).

An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise’s economic activities' (AICPA, 1973, p.17).

The FASB (1980) specified reliability as a necessary characteristic of information if it was to assist the making of 'rational investment, credit, and similar decisions' (FASB, 1978, para.34).

Statements emphasising the decision usefulness objective were also issued in the United Kingdom82 and Australia83 during the 1970’s. The Australian study by Kenley and Staubus (1972) was followed by *Proposed Statement of Accounting Concepts ED42A The Objectives of Financial Reporting* (AARF, 1987). This statement formed the basis of *SAC 2 Objectives of General Purpose Financial Reporting* (AARF, 1990) which proposed that general purpose financial reporting aims to provide information necessary for the making of ‘reasoned choices among alternative uses of scarce resources’ (para.12). Reliability was specified as a required characteristic of information if it was to serve as a basis for reasoned choices (AARF, 1990b, para. 7).

As evidenced by the numerous publications on the subject, considerable time and money has been spent on the formulation of the objectives of accounting. Much

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81 Decision making was also emphasised in a later report. See AAA (1957, p.7).
82 In 1976 the Accounting Standards Steering Committee of the ICAEW published The Corporate Report.
83 Decision useful was emphasised in a research study sponsored by the AARF (Kenley and Staubus, 1972) aimed at documenting the objectives of accounting.
attention has been given to the identification of the perceived information needs of users. What is lacking in these documents is a consideration of the posited connection between financial information and financial action.

5.2 Accounting information and action

Shackle described decision as ‘choice among rival available courses of action’ (1970, p.106). Rational and informed choice, where the consequences are significant, will be based on factual knowledge of past events and present position (available means)\(^{84}\), and the prediction, comparison and evaluation (or ranking) of the consequences - the expected gains and expected costs - of alternative actions.\(^{85}\) The alternative chosen would be that perceived as most consistent with desired ends. ‘Behaviour is purposive in so far as it is guided by general goals or objectives; it is rational in so far as it selects alternatives which are conducive to the achievement of the previously selected goals’ (Simon, 1976, p.5).\(^{86}\)

Knowledge of present position is essential to choice. Generally the means available for the achievement of desired ends are limited. Without knowledge of financial position, represented by the money equivalents of exchangeable property, and claims against that property, management cannot know what alternative positions are possible. ‘... it is necessary to determine the resources available to the firm for implementation of the respective changes’ (Simons, 1938, p.140). ‘... [Financial position] does not limit the courses of action which can be conceived but it does limit the courses of action which are financially feasible’ (Chambers, 1973, p.413).\(^{87}\) Decisions instigating action will be made in the expectation that the action will result in the firm being in a better position.\(^{88}\) Without knowledge of an entity’s present financial position management cannot assess whether a possible future position is preferable. ‘... [B]y what test, and by comparison with what, would the sequels [expected outcomes] be judged good or bad? It seems natural that a man should compare them with his present or recent experience. A sequel is good if it is an improvement on the existing situation, bad if it is a worsening’ (Shackle, 1970, p.113).\(^{89}\)

\(^{85}\)See Sorter (1973, p.3), Braybrooke and Lindblom (1963, p.86), and Shackle (1970, p.113).
\(^{86}\)See also Simons (1938, p.62).
\(^{87}\)See also Braybrooke and Lindblom, 1963/1970, p.93)
\(^{88}\) See Von Mises (1963, p.97).
\(^{89}\)See also Braybrooke and Lindblom (1963/1970, pp. 85).
Knowledge of the past also provides a basis for action. Past results of business operations may be used by management as a basis for performance appraisal. To enable corrective action to be taken, management requires ‘timely and reliable information on how operations are proceeding ....’ (Barton, 1974, p.679). As Chambers (1979, p.77) suggested ‘the progress made up to any present date is discoverable; and when it is discovered one can then decide whether to continue with any such action or to abandon it, in the light of past progress and the currently expected outcome....’ Past results may assist management in the formulation of policies for the future, eg. directions in which alternatives should be sought. Past information is frequently used as a basis for forming expectations about future courses of action. We learn from past experience. ‘We generally say that one event is more probable than another if it has happened more often in the past’ (Cohen & Christensen, 1970, p.71).

Investors and creditors require reliable information about the past performance and present financial position of an entity as a basis for investment and lending decisions. A statement of financial position provides a basis for assessing an entity’s capacity to pay debts and to adapt to changing market conditions. Creditors’ concerns with financial position are illustrated by an examination of debenture trust deeds and debt covenants. These contain, with few if any exceptions, some restrictions on borrowing by reference to the amount of the assets of the borrower.¹⁰ Information about the results of past operations provides a basis for assessing investment and lending risk, and predicting future trends. Investors can compare return on investment with returns on similar investments. If financial information is to be useful in the ways described it must be a comprehensive and accurate representation of the events that have taken place. An inaccurate representation of the facts will lead to erroneous inferences.

Decision making relies on factual knowledge of past events and a present state. Where the figures in financial reports are based on expectations rather than an accurate representation of the financial consequences of transactions and events that have impacted upon the financial position and performance of specific entities, users are denied a reliable basis for making decisions. This is the substance of the following quotations.

The evaluations and interpretations made by investors based in part on information provided by financial statements should not be allowed to affect or be introduced directly into those financial statements. While financial statements should be presented in a manner that will assist as much as possible in assessing the future and its risks, the role of accounting and the resulting financial statements is not to predict or to interpret the future. Making predictions and reaching economic decisions are the responsibilities of management in operating

the enterprise, and of the investors and other users of financial statements for
their various purposes (Arthur Andersen, 1974, p.15).

... 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 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 ....
What people do depends on what they think ... the accountant is concerned with
measuring the results of what they have done (Goldberg, 1965, p.251).91

5.3 Accounting as a matter of opinion

The conventional balance sheet denies users a reliable basis for decision making.
Unallocated costs and economic benefits are based on expectations of the future. They
are not a measure of the results of activities previously undertaken. They are not
representative of an underlying reality.

The shifts in ideas away from the notion of assets as property available for the
payment of debts to the ideas of cost and cost allocation and, subsequently, assets as
future benefits or service potential are based on a number of fallacies. One is the
confusion of 'the thing with the word. Intelligible discourse is concerned with objects,
events and their relationships on the one hand, and with the language in which they
are described on the other. If the description is to be representative of reality the
language must correspond with the facts. Departures are common in accounting.
Accountants have taken words used in general parlance, which are descriptive of real
events, and invented their own meanings.

In order to be understandable a language must possess a clearly defined
terminology, and the lack of this is the chief defect of accounting.... no new
vocabulary has been adopted ... but the ordinary language of the market place
has been used in senses the market knew not of .... (Hatfield, 1927, p.271).

'Personification' of real (property) accounts is one example of the language of
accountants not corresponding to the facts. Learners of accounting were encouraged to
view all property accounts as if they were in effect persons - stewards who acted as
despatchers and receivers. The confusion of cost price with 'value in use' is another.
Value in use is a subjective value, unique to each user and use. Cost represents the

91See also Chambers (1964-65, p.82), Barton (1974, pp.680-681), Holgate (1992, p.78) and
Sorter (1973, p.33). Sorter was the Research Director of the Trueblood study into the
objectives of accounting.
money exchanged for goods or services and indicates only that the buyer put a higher value on the goods purchased than on the money outlaid. The use of the word depreciation to describe a fact, a fall in price, and the use of the same term to describe cost allocation, an invention of accountants which has nothing to do with real events, is another example.

Heath (1987, p. 2-3) wrote: 'To reify a concept means to speak of it as if it were a physical thing ... Often accountants ... become so accustomed to viewing real world events through the accounting model that they confuse the model with the events themselves.' The notion of assets as unexpired costs is an example. Costs do not expire in any understandable sense. Expired or unexpired costs are not representative of any actual events or conditions. As Storey (1981, p.3 cited in Heath, 1987, p.7) commented:

accountants sometimes have not been able, or have not tried, to distinguish the assets from the attribute measured. The result has been proliferation of 'what-you-may-call-its' - debits (and credits) in balance sheets that are recorded without much consideration of whether they refer to anything in the real world.

The service potential notion is another example. The word asset is used in accounting discourse as if it were representative of something real. Objects and rights are real. Future services are an abstraction. As Schuetze (1993, p.69) argued: 'Real things such as trucks can be sold. Real things can be pledged as collateral. Real things can be given to charity. Abstract future benefits cannot be sold, pledged, or given away.' The benefits expected to be derived from assets are generally a result of combining those assets with other assets to produce a particular output. The future benefits attached to a particular input cannot be determined in an objective way. Measurement is an empirical process. Future benefits cannot be measured. They can only be imagined.

If amounts recorded as assets do not represent real things, income cannot correspond to anything real. Accountants attempt to 'measure' business income through the application of various accounting procedures. According to Gerboth (1987, p.97) accounting resembles a game. That is, its results cannot be independently verified, at least not in the satisfying way of some other disciplines ... measurement in accounting is not measurement in the usual sense of the word. It is not the application of measurement techniques to something that exists apart from those techniques. We do not walk up to income and slap a yardstick against it. Accounting income exists solely as a product of the techniques for measuring it.
Income as a result of the application of arbitrary and flawed techniques is not a measurement and cannot be independently verified. It has no real world referent. The income earned during a period can, however, be measured by comparing financial position at two points in time.

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; 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 (Goldberg. 1965, pp.250-251).

At any time, the financial significance of assets, as real objects or rights, and liabilities, as real claims, are their current money equivalents. The money equivalents of assets can be measured directly by recourse to the market in which those rights or objects are exchanged. Changes in assets (exchangeable goods and rights) and liabilities can be independently verified just as scores in games can be independently verified. Where assets and liabilities are measured in terms of money and money equivalents, income represents an increase in purchasing power. This notion of income has been elucidated by economists, by accountants, and described in a court of law as coinciding with ‘the fundamental conception of profits in general parlance’ (Spanish Prospecting Case [1908-10] All ER. 576). Income as an increase in purchasing power has real world referents. Money, money prices and purchasing power are part of everyday experience.

Underlying the move away from financial statements as an accurate representation of events and conditions, is the mistaken belief that accounting is not constrained by rules or laws but is largely a matter of opinion. When this move began is a matter of conjecture, perhaps with the allocation permissions of the [UK] Companies Act, 1862. By 1900 it was being observed that assets and liabilities were not assets and liabilities of the substantive kind, the relations between which genuinely represented a dated financial position. They included assorted deferred debits and credits which were in no way indicative of the real means of paying real debts, or of changing the composition of assets or operations. As definitions devised as rationalisations of practice took the place of definitions in terms of real world events, and as various allocation rules and arbitrary recognition rules were introduced guesswork became the dominant element in discourse and practice.

In the 1920’s and 1930’s Paton, Montgomery and others argued that accounting was concerned with the ‘truth’ of financial matters. The provision of up-to-date factual information has been considered by many accountants to be the function of accounts. They recognised that reasoned financial choices must be based, in part, on factual
knowledge of past progress and present financial position. Many more accountants, however, have uncritically embraced an accounting based on conjecture and opinion. In conventional practice, hypothetical statements of assets as potential future economic benefits have replaced factual statements of the values in exchange of exchangeable property. This has allowed all manner of ‘creative’ accounting and ‘window dressing’. Accounting statements can no longer be relied upon as representations of the underlying reality.

Evidence of the potentially disastrous consequences of relying on conventionally prepared accounts was available in abundance by the 1960s. Before and since, in company collapses, corporate takeovers and litigated cases, countless investors, creditors, and others have discovered to their financial detriment and ruin, the consequences of having relied upon accounts attested to by auditors of international repute (Wolnizer, 1990, p.10).

The departure of accounting practice and doctrine from representing commercial reality has attracted considerable criticism (eg. by Schuetze, 1993). The financial collapses continue despite accounting reports which indicate financial stability. Accountants lay the blame everywhere but at their own door.

5.4 Summary

Users of accounting information have a right to believe that a dated statement of financial position is a representation of the facts at that date. The only facts which are intelligible in the context of financial position, the capacity to act and to interact with others in the marketplace, are the money amounts of property - which by virtue of the law establish rights against all others - and legal claims against that property. Only exchangeable objects or rights represent the means available to pay debts, the security offered to creditors. These are things which ordinary people have experience of and understand. In the words of the Chief Accountant of the Securities and Exchange Commission (Schuetze, 1993, pp.69-70):

... in today's practice, the asset represented on the balance sheet is a truck, and users of the financial statements see it as a truck.... I think that ordinary people who are not accountants think that when they see an asset in a balance sheet that the asset is something real, and that it represents value, that is, if it is not cash or a claim to cash, that it can be sold separately for cash. Accounting should result in financial statements that ordinary people will understand and therefore be able to use to make investment and credit decisions.

Factual information is a necessary basis for informed action. Where assets represent ‘future economic benefits’ and valuation of assets is on the basis of cost, unallocated
cost and various other bases, the resulting financial statements are unintelligible. If the balance sheet is not correct and valid 'on the basis of economic conditions' at any given present point of time, it cannot serve as an aid to action in the economic conditions at that point of time .... ' (Chambers, 1964-65, p.83). If accounting is to serve this function standard setters 'need to take another look at the definition [and the quantification] of assets' (Schuetze, 1993, p.70).

5.5 Implications of this study

All parties who have an interest in a business entity are concerned as to its ability to pay debts. Continuity is dependent on solvency. The importance of a statement of assets and liabilities to the determination of solvency is emphasised throughout the literature. Where a statement of assets and liabilities is based on expectations rather than observables users are denied a reliable basis for assessing solvency. If users are not to be denied this information - if they are not to be misled by conventional balance sheets, held out to be dated statements of financial position - the accounting profession must revert to the exchangeable property notion of assets and quantification in terms of money and money equivalents. Where assets are so defined and quantified, items such as goodwill, which are not exchangeable for cash, will be excluded from a statement of assets and liabilities. The relevance or otherwise of such information is not the issue here. The point at issue is that such information has no place in a statement which is held out to be a dated statement of financial position.

The rights of investors and creditors to factual up-to-date information about the financial state of affairs of companies, given the advent of limited liability, underscored the early company legislation that required the preparation and auditing of statements of property and debts. The protection of interested parties underpins existing company regulation which requires the preparation and auditing of statements of assets and liabilities. The regulators have failed to ensure that the rights of these parties to reliable information is protected. As casualties of corporate failure, investors, creditors and other interested parties have discovered too late the consequences of having relied on conventionally prepared financial statements. If a statement of assets and liabilities is to be a realistic representation of debt paying power the notion of assets as exchangeable property should be clearly articulated in company regulation.
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