1976

Fair Financial reporting - In Law and Practice

Raymond J. Chambers

FAIR FINANCIAL REPORTING IN LAW AND PRACTICE

by
Dr. Raymond J. Chambers
Professor of Accountancy
University of Sydney, Australia
October 28, 1976

[Introductory Note: Raymond J. Chambers is Professor of Accountancy in the University of Sydney in Australia. He holds the degrees of B. Econ. and D. Sc. Econ. of that University. He has been a visiting professor and lecturer at numerous universities throughout the world and at present is the 1976 American Accounting Association Distinguished International Lecturer in the United States.

Dr. Chambers is the author of five books and numerous articles on accounting, finance and management. He was the founder and for ten years the editor of Abacus. He is currently the Senior Vice President of the Australian Society of Accountants, a member of the American Accounting Association and a fellow of the Academy of Social Sciences in Australia.

Dr. Chambers will examine the notion of fair financial reporting of position and results as an over-riding determinant of accounting rules and principles. Although the statutes and legal precedents in the United States and in countries which follow the English pattern of corporate legislation are different in detail, there are similarities in substance in most developed economies. This would justify more precise definition of "financial position" and "results" and would remove many of the ambiguities and the vagueness which have long interfered with fair presentation. An advance in this direction would improve the quality of financial reporting to the advantage of all who are involved in any way in the conduct of corporate business.]

It is a considerable honor to present this lecture, named for Dr. Emanuel Saxe. I have long known his name, his reputation, and his association with Baruch College. But I met him personally only a few weeks ago, to be charmed by his geniality and awed by his firm and detailed grasp of the past and the present of accounting. This lecture will span a period of the past up to the present, of which he will have far greater and more intimate knowledge than any of us.

The standard auditor's unqualified opinion avers that the financial statement presents fairly the financial position of the subject company at a stated date, and the results of its operations and the changes in its financial position during the year then ended. It goes on to refer to conformity with generally accepted accounting principles and consistency with their application in the previous year. The opinion is the end-product of the auditor's work. By virtue of it, the financial and commercial community relies on financial statements, takes them to be "fairly" indicative of what has transpired. But there are several reasons why that reliance or confidence is not, as yet, justified. Those reasons strike at the very heart of present accounting practice, for which cause they deserve close analysis.

AUDIT CERTIFICATE: REPORT OR OPINION?

The setting of the phrase "present fairly" may be approached by considering the nature of the document in which it now appears. No more than 50 years ago (1) that document was generally described as a "certificate." It began: "We certify that ... etc. " To certify, of course, is to give an assurance of propriety, or veracity, or authenticity. That, surely, is the basic function of auditing. Those who rely on accounts, even when "those" were primarily the directors and senior executive officers of companies, need some assurance that what the financial statements state is worth depending on. The document then described as a "certificate" contained other words which support this idea. The balance sheet was said "to correctly set forth the company's position", and the profit and loss account was said to be correct. Other phrases used were "correctly record," "exhibit a true and correct view," "properly drawn up so as to show," "represents the true financial position." Some of these words are traceable to English law and practice. As early as 1844 it was enacted that directors of registered companies should cause "a full and fair balance sheet" to be made up periodically. Much later "a true and correct view," and later still "a true and fair view," was required by law to be given by the financial statements. In a number of decisions, the English courts held that "the accounts must show the truth," that a balance must "convey a truthful statement as to the company's position," and that an auditor must see that the balance sheet "was a true and accurate representation of the company's affairs." The same ideas occur in the works of Hatfield and Paton of 40 years ago. (2) To assert the veracity or authenticity of the accounts was implicitly proper; there was no other reason than that for the engagement of an outsider to audit the accounts -- in England or in the United States.

But "certify" did not seem to be the proper word to use in a report which also contained the words "in our opinion." As an editorial in the *Journal of Accountancy* of July 1931 opined: "It is absurd to speak of certifying an opinion." That is verbal quibbling, but it did have a point. From about 1931 "certify" was abandoned; the auditor's statement was described as a report; and it took the form: "We have examined the accounts ... etc. In our opinion ... etc. " The change may have eased the minds of accountants. But it did not affect the function of the report. In a letter to the presidents of listed corporations in January 1933, the President of the New York Stock Exchange stated that the public response to an announcement of the intention to require audited statements with listing applications indicates clearly that "...independent audits are regarded by investors as a useful safeguard." (3) There could be no such safeguard if they were not believed to give assurance of the veracity or authenticity of audited financial statements.

More recently still, the auditor's statement has come to be described simply as an "opinion". This has removed the *appearance* of giving assurances of any kind to users of financial statements. But it has not removed the *function* of an audit or an auditor's opinion. It may have tended to cause auditors to relax their vigilance, especially under the cover of the phrase "in conformity with generally accepted accounting principles" introduced about 1939. However the number of legal suits involving auditors over the last 15 years should be warning enough that the use of the word "opinion" has provided no safe shelter.

The shift from "certificate" to "report" to "opinion" appears to signify a gradual attrition of responsibility for the veracity or authenticity of the contents of financial statements. The shift may now seem trivial or superficial. For decades, however, the profession has agonized over the forms of words it would adopt as descriptive of the audit report. And through that period of erosion, as we shall suggest, the substantive matters to which the report or opinion relates have gone unnoticed or suffered similar erosion.

"PRESENTS" WHAT?

The Balance Sheet. In the twenties, audit reports said of the balance sheet that it "correctly recorded the condition of the company's affairs," or that it "represented the true financial position of the company, " or that it "showed the financial condition of the company," or simply that it "correctly set forth the company's position." For a time during the Thirties and Forties, reference was made to "condition" or "position" without the qualifying term "financial." For the last 25 years "financial position" has been in common use. In England and other countries taking their corporation laws from that source, the corresponding term for a very long period was "state of the company's affairs"; more recently "financial position" has come into use.

It is a striking curiosity, or oversight, or act of negligence, that nowhere in the vast professional output of statements on accounting and auditing practice, in the United States or abroad, has financial position been described or defined. There are countless and voluminous detailed descriptions or prescriptions on particular balance sheet items. But there is no general framework indicating what a balance sheet is intended to represent. The professionally endorsed view, in the United States and elsewhere, has long been, and still is, that a balance sheet is a list of account balances. But the rules for arriving at those balances never at any point make reference to the representation of a dated financial position.

Some of those rules are perfectly proper, even in the context of deriving a statement of financial position. If there are discrepancies between the book balances and the actually *discovered* amounts of cash and receivables and payables, those balances are adjusted to their *discovered* amounts. But for all other items, no attempt is made to assert that the discovered money amounts, at or near a balance date, shall be the basis of closing adjustments and of the balance sheet. And no effort is made to argue that, in respect of those other items, the balances are in any way related or relatable to financial position.

Notwithstanding this neglect or oversight on the part of the profession, it is tolerably certain that the rest of the financial community expects a balance sheet to represent the *wealth* at the command of a company and the respective legal-financial interests in that wealth at a stated date. Bankers, financiers, creditors and analysts are interested in aggregate wealth, its composition and its growth; in the relationship of money available (or shortly to become available) and money shortly to be payable -- the current ratio: in the relationship of the money amount of total debt to the money amount of owners' equity in the net assets -- the leverage ratio: and in the relationship of periodical net profit to the amount of net assets -- the rate of return. None of these magnitudes or relationships is of any guidance or use unless the balance sheet *does* represent assets by their dated money amounts or dated money equivalents.

The characteristic features of wealth are well attested in the literature of economics. Everything which is exchangeable is a part of the wealth of its possessor (Smith, 1776; Courriot, 1837; Mill, 1848; Fawcett, 1863; Marshall, 1890; Hobson, 1911; etc. (4)) The magnitude of wealth is its "exchangeable value" (Smith), the amount which goods in possession "would sell for" (Mill), their "value in exchange" (Cournot), "marketable articles taken at their market value" (Hobson). From Smith to Keynes (1936), (5) wealth has signified the "power of purchasing" "unspecified goods at unspecified times -- in short, general purchasing power at a stated date. All of these usages of course conform with general usage and understanding. Further, when reference is made to persons or firms which borrow, net wealth or capital is the aggregate of wealth (calculated in the manner just described) minus the amount of outstanding debt (e.g., von Mises, 1949; Shackle, 1970) . (6)

These references to the literature of economics should not be taken lightly, as mere "theoretical" constructions. Any examination of the publications of the stock exchange information services, any examination of the finance and accounting literature dealing with the interpretation and analysis of accounts, and any examination of the daily and periodical press comment on the states of business firms, will support the contention that current ratios, leverage and the composition of assets from time to time are of practical significance to a variety of persons or institutions concerned with the financial affairs of business; a wide range of examples is given in Chambers, *Securities and Obscurities.* And given that these indicators are based on asset aggregates, it follows that all the component amounts of assets must be of the same kind; for otherwise the components would not be aggregable. It is futile to expect a "financial position" to be "fairly presented" if the asset components are represented variously by actual money amounts (e.g., for cash, receivables and payables), by historical costs (e.g., for investments in land and marketable securities), by depreciated historical costs (e.g., for plant and machinery, vehicles and buildings) and by such other odd amounts as LIFO, the lower of cost and market prices, and so on (e.g., for inventories). Aggregates of such amounts have no meaning whatever; they fairly present nothing in the nature of a dated financial position. Only if assets are represented by their "dated market values," "dated values in exchange" or "dated money equivalents" are their amounts aggregable, and in the aggregate indicative of a dated financial position.

The Income Account. Just as "financial position" has never been adequately described or specified, neither has "income." The usual unqualified opinion of an auditor refers to "the results of operations." This phrase, "the results of operations," is vague; for "operations" may be as extensive as all the events and transactions which affect a firm, or as restricted as whatever is meant by "normal trading operations." Attempts to limit its meaning have never been successful, as the persistence of the "all-inclusive" notion of income testifies.

In some jurisdictions, beyond the United States, the income (or profit and loss) account is expected by law to give a true and fair view of a company's "profit or loss" or "results" for the period specified. This may appear to be less confusing than "results of operations. " But in any case, in those jurisdictions as in the United States, there has been no serious attempt to define income or results. It is still common to find the view expressed that "there is no single concept of income which is serviceable for all purposes," and then to find this taken as good reason for specifying no concept whatever.

In commonsense usage "income" is what comes in. In ordinary personal affairs what comes in is so much money per period. In commercial affairs what comes in is a consequence or resultant of revenues and outlays -- both of money. That resultant is thus an *increment* in something which a company or firm had before (i.e., at the beginning of a period). For a purely cash business, the increment is a cash increment. But in all other types of business, what the firm has at the beginning of a period is its net wealth or net assets. The periodical increment is thus an increment in net assets.

Now, first, it is just as important for a firm to know the increment in its net assets as it is for a person to know his cash income. To know it enables the firm to compare increments of successive periods, to regulate its disbursements by way of dividends, to consider claims made against it for higher wages or lower prices, to plan accumulations of money or other assets to meet debts, to extend its business and so on. All of these matters entail getting money in or paying money out. It follows that if a calculated income amount is to be serviceable in these connections, income must be an increment in money or the equivalent of money.

Second, "increment" can only have a comprehensible meaning if the increment is the same in kind as the base from which it is calculated. An increment in a net asset total which includes assets at divergent valuations is meaningless.

From these two considerations and the preceding discussion of financial position, it should be clear that only a system of accounting which makes use of one valuation method will yield intelligible figures for assets and income, and figures which are consistent with one another; and that only if the valuation method is "dated value in exchange" or "dated money equivalent" will the balance sheet be serviceable as indicating "financial position" and the income account be serviceable as indicating a genuine increment in net wealth or general capacity to pay dividends, make new investments, repay debts and make other such financial arrangements. Further still, only if income and net wealth (i.e., capital employed) are thus calculated will the rate of return be a mathematically proper percentage and a percentage directly comparable with rates of interest or rates of return on straight money contracts.

This notion of income is supported by economists, just as is the notion of wealth already mentioned. The works of Simons (1938), Hicks (1946) and Lipsey and Steiner (1966) (7) are quite specific on the matter. The clearest judicial discussion of profits to my knowledge is that of Fletcher Moulton, L.J., in the *Spanish Prospecting Co.* case of 1911.

> Profit "is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates [which define the

> year] ... Even if the assets were identical at the two dates it would by no means follow that there had been neither gain nor loss because the market value -- the value in exchange -- of these assets may have altered greatly in the meanwhile. ... To render the ascertainment of the profits of a business of practical use it is evident that the assets, of whatever nature they may be, must be represented by their money value.

Further, this is the notion widely entertained by those who rely on financial statements. The income account and the balance sheet are expected to be integrally related. They are expected to be "taken as a whole", even by those who have formulated the principles of present practice. (8) The statements cannot be significant "as a whole," however, unless there is a consistent set of rules governing the whole of their contents.

Needless to say, the present rules are varied, variable and inconsistent among themselves. Accounts based on them represent particular elements of company affairs in different fashions and cannot possibly convey any realistic impression of those affairs as a whole. And the availability of alternative rules makes it possible for companies to select sets of rules which "on the whole" grossly misrepresent income. There have been classic cases of this -- in Australia, the Reid Murray Holdings affair and others in the early Sixties: in the United Kingdom, the Pergamon Press affair and others in the late Sixties; and in the United States, the Penn Central affair and others like it. In all these cases, the rules used were all tolerable under "generally accepted principles"; but taken together their effect was quite intolerable. The Chairman of the SEC, commenting on the Penn Central case, observed that "reported income was not of a character to make a contribution to the pressing debt maturities or liquidity needs of Penn Central, nor was it of the sort that might reasonably be expected to be evidence of continuing earning power." (9) Note the words "a contribution to the pressing debt maturities or liquidity needs." This clearly implies that "income" is expected to be indicative of a real money inflow, not just a conventionalized product of a conventional calculation.

"GENERALLY ACCEPTED ACCOUNTING PRINCIPLES"

The present audit report in some sense qualifies the words "present fairly" by use of the phrase "in conformity with generally accepted accounting principles. " Reference in the report to "accepted principles of accounting" dates from about 1933, and the phrase "generally accepted accounting principles" from 1939. The abandonment of words suggesting "truth" or "correctness" is indicative of some apprehension that the figures being produced *could not* be described as true or correct; and the introduction of the reference to generally accepted accounting principles seems to have been intended to put users of financial statements on notice of what has been called the "limitations" of financial statements. But the notice is almost completely nugatory.

If there had been, or if there were now, an identifiable set of generally accepted accounting principles, or if "generally accepted" meant accepted by *most* accountants or reporting companies, the qualifying phrase would have been serviceable. But in fact there is scarcely a single practice or rule which is endorsed or followed by *most* companies or accountants; for almost every item in the accounts there are two or more possible rules. And there is no clear source of what are generally accepted principles. *Statement on Auditing Standards No 5* of the AICPA (July 1975) indicates the varied and diffuse sources of "accepted principles." They include (1) statements and interpretations issued by the Financial Accounting Standards Board, (2) APB statements and opinions, (3) AICPA accounting research bulletins, (4) AICPA account-ing interpretations and statements of position, (5) AICPA industry audit guides and accounting guides, (6) industry accounting practices (7) pronouncements of other professional associations, (8) statements of regulatory agencies, such as the SEC, (9) accounting textbooks and articles and (10) common business usage. This whole array of sources is so open-ended that it is no exaggeration to say that *almost anything* can be a "generally accepted principle."

It is this undisciplined, unstructured character of the corpus of principles which has defeated the protective intentions of the legislation. Professor Sanders, a consultant to the SEC in its early years, was of the opinion that the Securities Act of 1933 was intended to require a balance sheet which was actually a statement of financial condition at a specified date. (10) Only such a balance sheet would "provide full and fair disclosure of the character of securities," as the title of the Act proposed. But the SEC itself, by adopting rules which have persisted ever since the Thirties, seems to have undermined that intention. For there is *no possibility* that a balance sheet, in which past prices of assets, present holdings of cash and estimates of future expectations, are aggregated, can represent the financial condition of a company at a specified date.

The present state of the art has been roundly denounced. Only a few years ago, Bayless A. Manning, then Dean of the Stanford School of Law observed: 'It is clear that what we call accounting and the standard methods of accounting are of remarkably limited usefulness for purposes of figuring out what is going on in the real world of economic activity."(11) A staff report of the Federal Trade Commission published in 1969 pointed out the desirability of accurate and consistent representations in financial statements but also pointed out that inconsistencies in practice made comparisons of the statements of successive years and of different firms impossible.(12) In a number of litigated cases, in the United States and elsewhere, defences based on practice in conformity with generally accepted accounting principles have been found insufficient, because those practices yielded unrealistic figures.

The list of sources of generally accepted principles mentioned previously should itself make plain the fact that the whole art is esoteric in the extreme. No one but an accountant is likely to have access to, or to be able to comprehend, the array of material specified. Which means that the whole intention of communication is circumvented. Accountants have been so concerned with their "mechanics" that they have disregarded the informative and instructive function of accounts. It is as if no one could expect to use a car or a watch unless he understood the principles of their construction. But as Professor Kripke has observed "...accounting cannot be a closed system based on rules that are meaningless and misleading to others."(13)

The recent proposal of the SEC (ASR 190, March 1976), that information based on replacement costs should be given in supplementary form, threatens to introduce even more variety and inconsistency into the accounting process. It is true that the figures are not yet required to be embodied in the accounts proper. But the open-ended nature of the proposal and the freedom of experimentation it permits, is almost certain, if past experience is any guide, to reinforce the present well established practice of idiosyncratic, non-interpretabIe, accounting.

In another place I have examined the notion of a "true and fair view" of position and results which is required in jurisdictions under the English pattern.(14) My examination was by way of the established law relating to the interpretation of statutes. Its conclusion is that "true and fair" must be interpreted in their ordinary and natural sense. I believe this to be well supported by the frequency with which references to "true financial position", full and fair portrayal of "the actual financial condition", "realistic reflection of the true situation" and similar words occur in the dicta of the courts and commissions in the United States and elsewhere.(15) There are no other words which could possibly describe the kind of information necessary for informed judgements of the wealth and progress of companies from time to time.

CONCLUSION

When the discussion of what financial statements purport to do gets fragmented, it is perhaps necessary to consider the fragments. What I have tried to do in this paper is to point out that hitherto the professional discussion has disregarded the major fragments -- the meaning of "financial position" and the meaning of "results." These things have to do with real money's worth, not just with book balances. Book balances may be made up from imagination, expectation and wild guesses; but that was not the intention of the securities laws. They were and are good laws, in my view. It is only the practice under them which has gone astray.

A financial position cannot be expressed otherwise then by dated quantities of dated dollars, representing actual wealth at the stated date. And my wealth, your wealth and the wealth of any corporation cannot be stated otherwise than by reference to the values in exchange or market selling prices of assets. That is an idea common to and understandable by all people; it is therefore *fair* to all people who have dealings with companies. Results cannot be significant unless they represent an increment in wealth. And that too is an idea understandable by all kinds of people. Those are the basic ideas upheld in common criticisms of financial statements, in litigation where the propriety of financial statements has been in question, and by users of financial statements no matter what their financial interests have been. Never yet have I encountered any circumstances in which people anxious to know the financial positions and results of companies have wanted to know the historical costs, or the estimated future replacement prices, or the price level adjusted historical costs of assets. As representations of position and results those kinds of figures are meaningless, irrelevant. I have no time to expound here the style of accounting I have described as continuously contemporary accounting, CoCoA, for short. But because it is based on the periodical rediscovery of the money equivalents of assets, it alone gives up to date and realistic representations of financial positions and results. It alone is free of the subjective choices of accounting method and free of the subjective expectations of corporate officers. It alone would free auditors from the quicksands of the presently indefinable set of generally accepted accounting principles. Only of its products could it be boldly said that they *fairly present* the financial positions and results of companies.

NOTES

(1) For the dating of the use of some of the ideas and terms to be mentioned I have drawn on the excellent survey of George Cochrane, "The Auditors' Report: Its Evolution in the U.S.A.," *The Accountant*, November 4, 1950.

(2) For details see Chambers. *Securities and Obscurities*, 1973, Ch.3.

(3) See Hunt (ed.), *Twenty Five Years of Accounting Responsibility*. Essays and Discussions of George Oliver May, Vol. 1. p. 127.

(4) Adam Smith, *The Wealth of Nations*. 1776; Augustin Cournot, *Mathematical Principles of the Theory of Wealth*, 1837; J.S. Mill, Principles of Political Economy. 1848; H. Fawcett, *Manual of Political Economy*, 1863; A. Marshall, *Principles of Economics*. 1890; J. A. Hobson, *The Science of Wealth*. 1911.

(5) J. M. Keynes. *The General Theory of Employment, Interest and Money*. 1936.

(6) "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," L. von Mises, Human Action. 1949, p.262. Similarly G.L.S. Shackle, *Expectation, Enterprise and Profit*, 1970, p.28.

(7) H. C. Simons, *Personal Income Taxation*, 1939; J. R. Hicks, *Value and Capital*, 1946; Richard G. Lipsey and Peter O. Steiner. *Economics*. 1966.

(8) See A.I.C.P.A., *Statement an Auditing Standards No5*, July 1975.

(9) Staff Report of the Securities and Exchange Commission, *The Financial Collapse of the Penn Central Company*, 1972, p.x.

(10) T.H. Sanders, "Accounting Aspects of the Securities Act", *Law and Contemporary Problems*, Vol. 12, No 2. April 1937, p.195.

(11) Henry G. Manne (ed.), *Economic policy and Regulation of Corporate Securities*, 1969, p.85.

(12) *Economic Report on Corporate Mergers*, 1969. p. 120.

(13) Homer Kripke, "The S. E. C., The Accountants, Some Myths and Some Realities". *New York University Law Review*, Vol. 45, No 6, December 1970.

(14) "Accounting Principles and the Law". *Australian Business Law Review*, Vol. 1, No. 2, June 1973.

(15) For a recent interpretation of the U.S. law, consider the judicial opinion in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath* (1974): "The policy underlying the securities laws of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company."

SELECTED QUESTIONS AND ANSWERS

Question: First of all I would like to congratulate you and some other professors for expanding the vocabulary of the accounting profession. We now have such terms as NOD and COG and your own CoCoA and Sandy Burton's PuPU accounting. In your last year's article on CoCoA, you took issue with replacement cost accounting. Recently in the *Financial Analysts Journal* Professors Vancil and Weil disputed your contention that replacement cost accounting will not provide for the maintenance of physical capacity. They argued that you did not take into account the proceeds from reinvesting the amounts of the depreciation provisions. Do you intend to rebut that argument in the journal or will you do so now?

Answer: I expect to respond to the argument of Professors Vancil and Weil. The question at issue is whether a form of replacement cost accounting will necessarily provide for the replacement of an asset whose price is rising. Suppose an asset is bought for $ 1000 and its replacement price rises by $200 each year over its four-year life. The depreciation charges based on year-end replacement prices would be $300, $350, $400 and $450. The sum of these amounts is $1500 which is $300 less than the replacement price at the end of the fourth year. Vancil and Weil contend that by reinvesting the amount of the annual provision the full $1800 may be accumulated. It may; and it may not. But no investment can reasonably be selected on the basis of what may accumulate from the reinvestment of its proceeds. This leads to an infinite progression which could be used to justify anything. Every possible investment must be judged on its own terms with reference to its own expected outcome.

Question: Professor Chambers, I agree very much with your indictment of current practice. I am reminded of George May's observation some 40 years ago that periodical accounting would be indefensible if it were not indispensable. I cannot tell what "fair presentation" is, just as I probably cannot define "fresh fish." But I've made it a practice of trying to identify "stinking fish" in accounting, and I can identify bad accounting in some contexts. What bothers me about your proposal is that I am afraid it will open up a Pandora's box. I understand what you are saying about value in exchange. But you and I have observed what happens when managements and their auditors are let loose in the determination of asset values. We've seen Bernie Cornfeld take that frozen block of land up in the Arctic which cost $17 million and whoop it up to $117 million so that he could skim off $ 10 million as his commission on the appreciation. There are many cases in which highly imaginative "market" valuations may be found. I sense that, if the use of fair values was opened up, we would have far greater confusion than we have today. This is the root of my concern with respect to the fair value proposals you and others are making.

Answer: Professor Briloff is concerned with the possibility that, under CoCoA, asset valuations may be extraordinarily diverse and highly imaginative. This would only be the case, and it has been the case in the past, because "value" is used of so many different quantifications. A value can be an imaginative and highly optimistic or pessimistic money amount. That is why, in CoCoA, reference is made, not to value, but to selling price, which is a dated and discovered "value in exchange." That is not any value," or an imaginative value; it is a quite specific and independently verifiable price. There is a further constraint under CoCoA on excessive or over-optimistic valuations. If for any asset no such selling price is discoverable, no money equivalent would be shown for it in the balance sheet. A balance sheet under CoCoA represents the financial capacity of the firm; an asset with no selling price adds nothing to financial capacity. To the extent of the price paid for it, the financial capacity of the firm is diminished. The financial capacity of a firm is its ability at any time to pay for tomorrow's wages or supplies, to liquidate its debts and to conduct and modify its business. Assets which have no resale price cannot contribute in any way to these things for they all depend on the accessibility of money. This aspect of CoCoA would cut down severely the use of imaginative values where there are no discoverable prices.

The primary flaw in the existing body of rules -- and I agree with Professor Briloff on the multiplicity of flaws -- is the liberty available of switching from one valuation rule to another. The inquiry of the Federal Trade Commission, which I mentioned, drew attention to the possibility of "keeping up appearances" for long periods simply by switching valuation rules. But, under CoCoA, there is no way of switching rules; for there is only one rule. That rule serves also both to discipline and to protect auditors. Under the present system, auditors are in many respects at the mercy of the officers of client companies. But if clients had to support their balance sheet figures with independently discovered prices or quotations, and if the auditor were to check their authenticity, the grounds for indictment of auditors would contract dramatically.

CoCoA has also a disciplinary effect on management. If the situation of one year is in some sense over-painted, management cannot escape the consequences in the next by switching to other valuation rules. The closing balances of one year become the opening balances of the next, and affect the results of that year. The uncertainty of the future and the impossibility of "covering up" by switching the rules will tend to prevent asset values and financial positions from being seriously overstated.

I do not deny that there may be some difficulties in finding market selling prices or money equivalents. But that is the kind of problem to which the profession could well direct its attention instead of discussing matters at great length without adequate initial definition (of things such as financial position, income and value) to constrain and give firm shape to conclusions. I do not believe the difficulties of finding selling prices are as great as others suppose. CoCoA has in fact been applied in a number of New Zealand companies. The results of its application so far have not been as outrageous as Professor Briloff fears. But I suspect that the results of the guesswork required by replacement cost accounting (or current cost accounting) will be different to a material degree from a fair statement of financial position and net income.

Question: I would like you to clarify your contention that the accounting based on exit values can be more easily implemented than the replacement cost system which the SEC is attempting to introduce, on a limited and unambitious scale, with the assistance of an advisory committee of 30 people from all kinds of industries. By what magical process would you find the cash equivalent of a half-built piano, or a half-completed missile system, or some new product that a manufacturer is just ready to market?

Answer: There's nothing magical about finding cash equivalents of half-finished goods. If at balance date they have no market selling price, they do not represent money's worth. They have no cash equivalent. Finance is money. Here is a dollar bill. With it I can buy a dollar's worth of whatever I choose. I can "finance" the purchase. A statement of financial position should represent the capacity of a company to finance things of its choice; and that can only be done if assets are represented by amounts of money available or accessible (for non-monetary assets, their approximate resale prices or money equivalents).

The trouble is that balance sheets do not represent financial position. The money that has been spent on half-finished goods and on intangibles which are not yet salable is no longer accessible. The money was laid out in the *expectation* of getting money back. But whether or not that money will ever flow in depends on the survival of the firm up to the inflow date. In the interval the firm does *not* have access to money or money's worth, to the extent of the outlay. The long-standing practice is to accumulate such outlays and represent them as if they were of the same financial kind as cash available or accessible at balance date. This creates the impression that a company is sound, stable and well-endowed with money, when it may not be the case. Indeed the Penn Central company had vast quantities of assets -- but insufficient of them represented accessible money. In a very real sense, sums outlaid on assets which have no current cash equivalent are either sunk costs (with no further financial relevance) or "in suspense" (with no immediate financial relevance). In either case they have nothing to do with a dated financial position.

So much for dated cash equivalents. But cash equivalents at different dates do not mean the same thing. This dollar bill is dated "1974. " If spent in 1974 it would have bought about 10 percent more goods (in general) than if I spent it today. I cannot go into a store, tender this bill, and ask for goods at 1974 prices. Those prices are entirely irrelevant to anything I can do with money today. If, by holding this dollar bill since 1974, I have lost 10 percent of its command over goods, that is important for me to know. Equally important is it to know what I have gained or lost, in terms of command over goods generally, through holding other assets. But these things are concealed in the ordinary course of accounting. Old prices or their calculated residuals are reported in balance sheets as if they were as relevant to financial position and present action as cash equivalents or cash in hand at balance dates. Some might think that to use old prices and disregard losses in purchasing power is conservative. It is not; it is just unrealistic. Some might think that to disregard assets which have no cash equivalent (such as non-vendible partly processed inventories) is conservative. It is not; it is just realistic.

Question: I've been looking forward to meeting you, Dr. Chambers, for seven years, and I feel in tune with you as does Dr. Briloff. I would like to make several comments. Fundamentally, the scientific process consists in taking what one scientist says, trying to use it well and to build on it further. That's my approach to what you are doing. You've gone so far, I think, that accounting will go further standing on your shoulders. Dr. Briloff has been doing an excellent job in showing us the Pandora's box of present accounting. With his demonstration of the pathology of accounting and with the approach you suggest, I feel we have a solid foundation for moving forward.

In the case of the half-built piano, your answer is directly in line with modern physics. You take a "quantum" approach. The energy of an atomic body increases or decreases by discrete quanta. Likewise the energy (financial capacity) of a firm changes in discrete lumps. Mother Nature herself is behind you.

My second point relates to the concept of competition in economics and the idea of an efficient market. An efficient market is taken to be one in which information is generally available, and all decision makers at all points are reacting more or less properly. I call your attention to the book *Modern Capitalism* by Andrew Shonfield. The idea of "administration in a gold fish bowl" that he discusses when dealing with public affairs in Sweden may suggest to you how your CoCoA proposal could be implemented.

Answer: I am grateful for the expression of trust in the possibility of building on my ideas. Let me deal first with "administration in a gold fish bowl." To make reliable information widely available is a policy more feasible, or likely to be considered more tolerable, in respect of government than in respect of private competitive business. But it is no less proper in business. I have contended for years that the publication of the most reliable factual information on financial affairs available to management would remove from management the threat of disbelief and distrust and poorly founded (because misinformed) claims and charges. And since the managers of particular firms themselves must use financial information on other firms, as spurs to improve efficiency or as premises of decisions, reliable current financial information is surely what they would like to have. The free availability of this information would, I am confident, improve the efficiency of the interactions of firms, governments and individuals -- in short, improve the efficiency of a market-regulated economic system. However, the argument has not yet attracted much support.

I may seem to be rather dogmatic, even over-confident, about my proposals. The confidence arises, however, from the extent and duration of the work which led to my conclusions. I have been concerned not only to construct a set of ideas, but equally to examine it from every possible angle to discover in what respects it could be shown to be defective. I do not expect the SEC or the FASB or any similar body simply to accept my conclusions. But I would like them to examine in depth the technical words and phrases which are so central to the rigorous study of accounting but which hitherto have been taken for granted. Some 25 years ago I suggested to a professional committee on terminology that it define the terms "financial position" and "income"; so crucial are these to much of accounting that their definition would assist in dealing with everything else. The task was considered "too hard." Apparently it is still "too hard," for there are no firm definitions yet.

That any other proposals, arising from a different viewpoint, might differ from my own does not concern me. If it can be shown that a coherent body of ideas, entailing a realistic and serviceable form of accounting other than CoCoA, can be developed from different premises, I would have good cause to reexamine my own notions. We need a body of ideas which is consistent with how we think ourselves in ordinary commercial dealing, with the relevant parts of the literature of economics and finance, and with the matters of financial consequence which are the focus of attention of analysts and the financial press. I believe CoCoA represents such a body of ideas.

NEWMAN LIBRARY digital collections