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Accounting in a Troubled Economic World*

By ROY A. FOULKE

WE TALK AND READ about the science of economics. Economics should be a science but, strange as it may seem, up to this very time it has not been developed into a science. After making a statement of that nature, I must tell you why I feel that is so.

Why Economics is not a Science

IN 1775—177 years ago—and the same year in which the Declaration of Independence was penned by Thomas Jefferson—Adam Smith wrote the first classic concerned with the production and distribution of wealth, *The Wealth of Nations*. Carefully, almost minutely, Smith examined the then existing economic order. The days of the simple handicraft artisan were disappearing. In his place was appearing the skilled laborer who carried on one, or a limited number of specialized operations, to earn his livelihood. This “division of labor” was to become more and more marked as the years rolled by. The government was best which governs least, reasoned Smith, with irrefutable logic. Moreover, economic “problems” are temporary in their nature, and their very nature provides the corrective elements in the form of natural laws. How strange, even if true, such reasoning seems today.

Adam Smith lived in the day and age when the great search was being carried on to ascertain and achieve natural laws in all areas of action and knowledge. Eighty-nine years before the publication of *The Wealth of Nations*, Sir Isaac Newton had put in writing, in *Philosophiæ Naturalis Principia Mathematica*, the results of his exploration in mathematics and natural phenomenon, the greatest work published up to that time in physics. In this volume Newton explained, described, and established the law of inverse squares, the law of nature which explained how all movements in the skies can be described by one simple mathematical formula. That mathematical formula represented the first great synthesis of physical knowledge, just as Einstein’s mathematical formula, hundreds of years later, synthesized matter and energy.

In astronomy the search for natural laws had been carried on by Galileo, Tycho Brahe, and Johann Kepler; in physics the search for nat-

* Address presented before the New York Chapter, National Association of Cost Accountants, on April 21, 1952. [Mr. Foulke deals, in the latter portion of his paper, with issues raised by Anatol Murad in “Questions for Profit Theory.”—EDITOR.]

ural laws was being carried on in the days of Adam Smith by two Italians, Luigi Galvani and Count Alessandro Volta; and in chemistry by the Frenchman, Antoine Laurent Lavoisier (who proved that the total mass remained unchanged throughout a chemical reaction), and by the Englishmen, Joseph Priestley and Henry Cavendish. If there were natural laws in the field of astronomy, in electricity, and in the elements of matter, why should there not be natural laws in the field of economics? Adam Smith took it for granted that natural laws had to exist and to be discovered in this field of knowledge as in the other sciences, and he diligently applied himself to that task.

There is ample reason to believe that those who are applying themselves to the field of economics in this mid-twentieth century, have a radically different conception of true knowledge. Problems involved in the production and distribution of wealth today must be solved by man-made laws, positive law, not natural law. Man knows all the answers! Planning will do it!

A science, whether it be astronomy, chemistry, physics, or biology, is based on natural laws, that is, on laws of nature which are the same yesterday, today, and tomorrow, and the same in the United States, Greenland, and South Africa. In other words, in all real sciences, there are universal laws, the existence of which all who are specialists in the field concerned, agree. In economics, however, there is little on which there is agreement; one economist will interpret one set of observations in one way and another economist in another way. It is just as if one physicist would define a hydrogen atom in one way, and another physicist in another way.

In 1891, Henry George, who was one of the great social scientists and economists of all times, started to write a volume entitled "The Science of Political Economy." He devoted himself to this task continuously, off and on, for six years. In 1897, Henry George ran for mayor of New York City and while carrying on that strenuous campaign he died on the evening of October 29, 1897, after he had made four political speeches, one at Whitestone, one at College Point, and one at Flushing in Long Island, and one in the Central Opera House in New York City. That was just five days before the election. The volume, "The Science of Political Economy," while never completed by the author, was published in 1898 in its still unfinished state. In that study Henry George outlined compellingly the argument that what he termed "scholastic" economics had never been developed into a science.

Let me quote a little from what he so carefully wrote in that fascinating volume. In economics, there is no body of accepted truth, no consensus of recognized authority, that one may without question accept. "In all other branches of knowledge properly called a science the inquirer may find certain fundamentals recognized by all and disputed by none who profess it, which he may safely take to embody the information and experience of his time. But, despite its long cultivation and the multitude of its professors, he cannot yet find this in political economy. If he accepts the teaching of one writer or one school, it will be to find it denied by other writers and other schools. This is not merely true of the more complex and delicate questions, but of primary questions. Even on matters such as in other sciences have long since been settled, he who today looks for guidance of general acceptance in political economy will find a chaos of discordant opinions. So far indeed are first principles from being agreed on, that it is still a matter of hot dispute whether protection or free trade is most conducive to prosperity—a question that in political economy ought to be capable of as certain an answer as in hydrodynamics the question whether a ship ought to be broader than she is long, or longer than she is broad." Today, fifty-five years later, that unfortunately is still true.

At this point, let me give you a basic definition of economics, with some supplemental explanations. Then we can get over to the accounting field and its influence, or lack of helpful influence, on economics.

Economics is the science of the nature, the production, and the distribution of wealth. From that definition, economics is concerned only with wealth; not with services or with what the social scientists term "satisfactions." So we must immediately ask ourselves what is wealth. Wealth is any material thing produced by man from land or the products of land which has exchange value. From that definition one wonders what production means. Production is the making, growing, transporting, exchanging, or otherwise modifying by human exertion, of any material object (other than man himself) having exchange value, where it is fitted for, or is brought nearer to the final consumer. The wealth of a country, that is, national wealth, is one big stockpile of tangible things. It is radios and television sets, breakfast cereal and men's neckties, warships and proximity tubes. It is not the services of a barber, an actor, or a bootblack. With that background of definitions and explanations perhaps we can carry on a little more reasoning.

History of Accounting

AS EARLY AS 1786, David Franks, who practiced law, advertised in *The New York Directory* that he also acted as an accountant. In fact this early public practice of accountancy, which consisted of little more than making the opening entries in books of account and explaining bookkeeping practices in theory rather than from experience, was considered a minor but integral department of the legal profession. In the early part of the nineteenth century, teachers and authors on the subject of bookkeeping occasionally sought outside engagements.

Norman E. Webster of the firm Webster, Horne and Elsdon has made a hobby of tracing the evolution of early accountancy in this country. According to his research, the earliest use of a firm name in accountancy in the United States seems to have been one Nelson, Shepard & Cooke of Cincinnati in 1876, a concern which apparently was in existence only a year or so and which operated as a "real-estate and collection agency" as well as a firm of accountants. The second firm was one Candor & Carnes, also listed in a Cincinnati directory, in 1881, as "expert accountants."

In 1883, Edwin Guthrie, a receiver for a bankrupt English financial organization, visited the United States to ascertain the value of certain assets which the bankrupt enterprise owned here. On arrival, Guthrie was able to find no public accounting firm to assist him in his investigations. He became acquainted with John Wylie Barrow, an actuary employed by the New York branches of certain British fire insurance companies, and out of this acquaintanceship grew the third known accounting firm, and the first one of importance on this side of the Atlantic Ocean. It was not until 1896, however, that the accounting profession was first legally recognized when New York State conferred the power upon the Regents of the University of the State of New York to grant certificates of qualification. Pennsylvania followed three years later in 1899, Maryland in 1900, and California in 1901. Similar recognition was not extended by the District of Columbia until 1923.

During the early years of accountancy, the profession had no specialized field of activity. What little business came its way, and it was very little, generally consisted of opening and balancing sets of books, of "straightening out" books that had become "mixed up" because of the inexperience of amateur bookkeepers. Some managements considered the early accountant "an experienced bookkeeper and no more, others looked upon him as a man whose business it was to detect fraud, embezzlement,

and stealing, and that his employment was of value only in this direction, while quite a few had a vague idea that he was merely a man of figures, a rapid and unerring calculator who could add up two or three columns of figures at a time, could tell you immediately the square or cube root of any given number, or say off-hand, for example, what one dollar put out at six per cent compound interest per annum at the time Columbus discovered America would amount to today.”¹

It was often feared that the employment of public accountants would be looked upon as evidence of “suspected fraud or irregularity, losses, and doubt regarding financial strength.” As late as 1907 investigations by public accountants were at times made secretly, and often at night and on Sunday. The field of making audits and of verifying financial statements was to be developed as commercial banking institutions, and mercantile creditors began to insist upon receiving exact financial statements as the basis for the extension of credit, as investment bankers needed the verification of earnings from a qualified source outside the management as a basis for pricing and selling securities to the public, and as the sixteenth amendment to the Federal Constitution became effective in 1913 and Congress was empowered “to lay and collect taxes on income, from whatever source derived.” Officials of business enterprises who had never realized the necessity for having a correct system of accounting now found themselves compelled to prepare statements of income and expenditures. The passage of the War Revenue Act of October 3, 1917, containing the first effective excess-profits tax, finally heightened this emphasis as nothing else could possibly have done.

Accounting Adapts Itself to Business Procedure

IN 1938 the American Institute Publishing Company printed a volume entitled “Origin and Evolution of Double Entry Bookkeeping” written by Edward Peragallo. That book contained a concise but fascinating “Foreword” written by Robert H. Montgomery. Mr. Montgomery wrote “. . . that by its very nature accounting adapts itself to business procedure” That is almost axiomatic. Accounting is a profession which serves the needs of business, and in that process, simultaneously serves the government and the public.

In the relatively short time that accounting has existed in the United States, evolutionary standards in theory and practice have been gradually

¹ James T. Anyon, *Recollections of the Early Days of American Accountancy*, (Privately printed, 1925), p. 41.

developed by forward-looking individual accountants, bank lending officers, underwriting investment banking firms, commercial paper brokers, the Federal Reserve Bank of New York, the New York Stock Exchange, the American Institute of Accountants, the American Accounting Association, and federal agencies such as the Interstate Commerce Commission and the Securities and Exchange Commission. As the profession expanded in importance, more and more institutions have become interested in its evolution. In seventy-five years a profession of tremendous influence has arisen. It represents the extensive application of the great science of applied mathematics to the world of everyday affairs and all of us are affected.

There are, however, two elements in the changing needs of business in a changing world. One element is the inherent need of business itself. The other element is the need which is forced upon business by legislation; that is, the necessity of fulfilling man-made laws in the political State. Those needs are extraordinarily large today and they are constantly expanding.

Real estate taxes are levied by local taxing units; sales, transfer and license taxes by many state and local units; profits taxes and social security taxes by the federal government and by the states. Accounting for business must arrive at the "correct" figure for each and every tax. No tax must be under-estimated, and no tax must be over-estimated. The tax which is of the greatest importance to the business enterprise, of course, is the federal income and excess profits tax. In 1950 aggregate federal corporate income taxes amounted to \$18.6 billion; in 1951 federal corporate income and excess profit taxes are estimated to have amounted to the not inconsiderable sum of \$26.6 billion.

Profit is a Man-Made Concept

NOW ACCOUNTING PROFIT, itself, is a man-made concept and as a man-made concept is subject to man-made laws in the political State, and the judicial interpretations of those laws. It has absolutely no connection, even in the faintest degree, with natural laws, that is, universal laws of nature such as the law of gravity. As a result, accounting has had to be evolved to meet the twin needs of business and government; that is, to provide a figure for taxes for the individual business enterprise consonant with man-made laws.

In the colonial days that was not difficult. It was not difficult because (1) taxes were relatively few and small in amount, and (2) what we

today call accounting conventions were different. A separate set of books, for example, was often opened and closed for each voyage or trading journey of a merchant mariner. He might sail from New Bedford, Massachusetts, loaded with a cargo of dried and salt fish, flour, bread, and barrel staves, and bound for the West Indies. The cargo would gradually be sold and the good ship loaded with West Indian products. When the mariner had returned home and sold his cargo the books of that voyage would be closed. The cash on hand would be disposed to the shareholders in the voyage. That technique of accounting went back to the Middle Ages in Europe. Only in the past one hundred years or so has the continuous system of accounting evolved to the point where a yearly closing based on modern "accounting conventions" has become essential. Production processes today often involve long periods of time, and expenses must be cut off at a fixed date. Heavy expenses for advertising are often made in one period to show increased profits in another period. The valuation of inventory at the end of one period plays a great part in the size of accounting profit, not only for the accounting period being closed, but also in the following accounting period.

The effect of judicial interpretation of man-made laws on profits is evident by a decision rendered by the Supreme Court as far back as 1876. That decision stated that the public "rarely ever took into account the depreciation of the buildings in which the business is carried on."² In 1878 the Supreme Court supported the government in a claim that a railroad company should not be allowed to include a depreciation charge in operating expenses, claiming that "only such expenditures as are actually made can, with any propriety, be claimed as a deduction from earnings."³ In 1909 the Court reversed its earlier opinion: "Before coming to the question of profit at all, the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life."⁴ It is easy to see that accounting conventions based on any of these Supreme Court decisions would influence the practice of accountancy and greatly affect what we call accounting "profit."

In other words, over the years, accounting has been evolved more and more to provide a figure of profit in accordance with man-made legislation, but consistent with recorded facts, established but constantly chang-

² *Eyster v. Centennial Board of Finance*, 94 U. S. (1876).

³ *U. S. v. Kansas Pacific Railway Co.*, 99 U. S. 459 (1878).

⁴ *Mayor and Alderman of City of Knoxville v. Knoxville Water Co.*, 212 U. S. 13 (1909).

ing accounting conventions, and personal judgments. That means one rate of depletion may be used for oil wells and natural gas wells, so that the total accumulated depletion may well exceed 100 per cent, but on machinery and equipment of the general run of business concerns, the accumulated depreciation may never exceed 100 per cent. That is a man-made law and accounting must take every implication of man-made law into consideration. That is your responsibility and the profession has and is living up to its responsibility in the highest possible manner.

In the nineteenth century and the early years of the twentieth century greater emphasis was placed on the balance sheet and less on income statements. Times have changed. As a result of the necessity of arriving at a figure for profit in agreement with man-made laws, greater emphasis is now placed on the income statement. The income statement is concerned with the current accounting period while the balance sheet is said to exhibit the costs incurred which are reasonably applicable to the years to come. Under this theory the balance sheet serves as a means of carrying forward unamortized acquisition costs, the not yet deducted costs. As Paton and Littleton wrote, it "serves as a connecting link joining successive income statements into a composite picture of the income stream."

Because an accounting profit is a man-made concept it is a very relative figure. Accountants know, but many business men do not know, that when one reads that profits of a particular corporation amount to a certain definite sum carried out to two decimal places, the figure should be accepted with a grain of salt, as under the current practices of accounting that very figure could be appreciably smaller or greater depending upon the detailed accounting assumptions used in a particular case.

Accounting profit is like the ship which appears on the horizon. Not until the ship comes appreciably closer and its lines and structure can be examined, is it seen to be an ocean liner, a tramp steamer, a warship, or a private yacht. And not until one knows first, the accounting assumptions which are applied in each case; second, the effect of rising or falling prices upon inventory valuations, and third the imputed depreciation based on replacement costs of capital assets, can a fairly accurate picture of accounting profit be determined under existing assumptions.

Finally, there is a great basic confusion between accountancy and economics, first, because economics knows only one value, economic value, and second, because "profit" as the word is used and practiced by accountancy, today often represents a combination of economic rent on the value of land in its natural state, and economic profit on invested capital. Money

is a medium of exchange, not an absolute measure of economic value. Yet accountancy as a mathematical science uses money as a unit of measure, and it uses the money of this year, of last year, of the year before that, and of ten years ago, all in the same schedule of assets and the same schedule of expenses. As Samuel J. Broad has pointed out, oranges and grapefruit are being added together in the same schedules. It's really adding oranges, grapefruit, apples, pears, peaches, and grapes together! Solomon Fabricant calls this combination of dollar figures arising in different price levels "heterotemporal" prices.

Accounting and Natural Laws in Economics

LET US LEAVE THIS LINE of reasoning for a few moments now and get back again to the area of economics to notice, if we may, the effect accounting has had while fulfilling its obligations to the business world, the public, and the government, in deterring the creation of a science of economics.

In my early remarks I stated that "a science whether it be astronomy, chemistry, physics or biology is based on natural laws, on laws of nature which are the same yesterday, today, and tomorrow, and the same in the United States, Greenland, and South Africa." I also stated that in economics "there is little in which there is agreement; one economist will interpret one set of observations in one way and another economist in another." There is, however, one statement to which all economists from the time of Adam Smith to the very present agree and that is there are three and only three factors in the production of wealth, namely, land, labor, and capital. Consequently all production is divided into three streams, one in the form of rent to landowners, one in the form of wages to labor, and one in the form of profits to the suppliers of capital.

These terms, as used by Adam Smith, carry connotations which are somewhat different than their meaning in our present-day industrial life. The payment of rent represents the return to the landowner on the value of the land in its natural state and without improvement of any kind, and not the payment of a monthly or a yearly sum which today has generally come to include two distinct elements, economic rent on the value of land in its natural state, and a return on the use of improvements, that is, on capital. In wages to employees is included payments to officers of corporations, to proprietors, and to partners for their services, as well as to labor in its current narrow sense. And profit, that is, economic profit in accordance with natural laws and not man-made laws, according to Adam Smith—and this has been disputed by no economists to my knowledge since Smith

wrote it—is the sum remaining after the payment of all wages, and rent on land in its natural state, as the return to capital.

Then, Smith carefully observed 177 years ago, “When those three different sorts of revenue belong to different persons, they are readily distinguished; but when they belong to the same they are sometimes confounded with one another, at least in common language.” That sage observation is even more true today than in the early days of the industrial revolution. Many business corporations own title to land which is improved with factories, warehouses, premises, or stores, so that the final “accounting” profit includes two elements, (1) a return representing rent on the value of land, and (2) a return to capital.

From the viewpoint of a science of economics, here is a basic reason why we fail to ascertain the exact figure of economic profit in accordance with natural laws, under the mathematics of accountancy as practiced currently. This reason is tied up with the simple fact that part of “accounting” profits in accordance with man-made laws—that is, part of the “accounting” profit of corporations which own land on which some or all of their plants, warehouses, premises, or stores are located—is actually economic rent. Moreover, we lack even a faint idea as to what part of accounting profit represents rent earned on the value of land in its natural state, and what part represents the return on capital invested in a business including improvements to and on land. So, what we run up against today, is the confusing reality that “accounting” or the businessman’s profit in accordance with man-made laws, in addition to being a relative mathematical concept, is not economic profit in accordance with universal natural laws.

You are probably saying “So what!” I’m sure I would if I were in your place. What does all that logic mean, even if it is true?

Let me answer that question in this way. The step-by-step progress in science from the days of Aristotle to the present time has been made first in theory and then in practice. Each step is first advanced in pure theory and then that theory is later supported by facts. Urbian Leverrier in France and Professor J. C. Adams in England predicted the positive existence of the planet Neptune before it could be seen. Albert Einstein provided the formula indicating that matter and energy were different forms of the same reality years before the first atomic explosion was produced by man at Los Alamos, New Mexico, on July 16, 1945.

In economics there is complete agreement that there are three and only three factors in the production of wealth, namely, land, labor, and capital.

Accounting is the mathematical medium which some day must translate that theory into meaning. Accounting has not done so up to this time. The fact that accounting up to this time has followed along the path of adapting itself to business procedures, in accordance with man-made laws, is no reason why it should not simultaneously provide the facts to make a science out of economics in accordance with natural laws. What is needed today, as never before in our history—with maximum taxation staring us in the face for the first time since the colonists landed at Jamestown in 1607—is actual information showing what part of the income of every business flows as a return to land, labor and capital, and what part of the aggregate production of wealth in the United States flows as a return to land, labor, and capital. Then and only then, will the facts be available to make a science of economics, comparable with the science of astronomy, chemistry, physics and biology, a science based on the laws of nature and which are the same yesterday, today, and tomorrow, and the same in the United States, Greenland, and South Africa.

To be the instrument or the means of making a science out of economics in this troubled world might well be an objective worthy of a great and growing profession.

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Theory and Measurement in the Social Sciences

THE TWENTY-YEAR RESEARCH REPORT of the Cowles Commission for Research in Economics at the University of Chicago, entitled *Economic Theory and Measurement* and covering the period 1932–1952, has not received the attention it deserves. It is much more than an account of the commission's stewardship, although that part of it is quite a stirring story of scholarly pioneering and achievement. Its discussion of a central problem in social research, the role of theory in empirical investigations, particularly of integrated theory, deserves careful consideration, since the commission's viewpoint is based on its own experience.

When the Cowles Commission began its work, its approach was expressed in a nutshell by the motto on its seal, "Science is Measurement." This approach led to a concentration upon problems of measurement that, in the eyes of a few critics at least, threatened to divert the energies and interests of these promising research workers from the fields of economics where they were so much needed into by-ways of mathematics that seemed remote from economic applications.

With the growth of the staff, there was an infusion of new blood,