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THE INFLUENCE OF ACCOUNTING ON THE DEVELOPMENT OF AN ECONOMY

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The subject of this paper was suggested by a distinguished economist, and my only regret is that he was unable to accept the invitation of the Committee to prepare the paper himself. My regret is not on my account, nor solely on yours; but largely on his, because I am sure he would have found the preparation of the paper, had he been able to undertake it, as interesting and delightful a task as I myself have found it. The subject is one which calls for more extended consideration than is possible in the course of a short paper, and I can not hope today to do more than make some suggestions as to the way in which accounting may have influenced economic development in the past or may do so in the future.

Growing recognition of the importance of accounting is bound to result in closer examination of the relation between accounting and economics, a subject that has not as yet received very extended consideration. Professor John B. Canning, in his *The Economics of Accountancy*, suggests that the accountant's approach to problems is similar to that of the economist, but there is little to suggest that the course of accounting has been consciously influenced to any considerable extent by economic thought. The fact is, rather, I think, that accounting is a tool of business, and that the development of accounting, like the development of business law, has been determined by the practices of business men.* Where accounting and economic thought are found to run along parallel lines, it is probable that both will be found to be running parallel to good business practice. Where accounting treatment diverges from economic theory, a similar divergence is likely to be found between economic theory and business practice.

To many persons, even in the business and financial world, the first question which the title of the paper would suggest is—how can accounting affect the development of a national economy? "Is not accounting," they would ask, "the application to particular facts of certain definite rules which can produce only

* This being so, the subject of this paper is, I recognize, merely one phase of the broader question of the effect of business practice on economic development.

one result?" Such a misconception of the nature of accounting is, I believe, less general today than it was a few years ago. During the last five years much has been done to secure recognition of the fact that accounting is not exact and rigid, but is based very largely on convention and judgment. In the necessary work of education on this point the Institute may no doubt claim to have had a large part; but I would rather emphasize here the contribution that has been made by other bodies, such as the New York Stock Exchange and the Securities and Exchange Commission. For the welcome recognition of the fact that accounting must necessarily be flexible, and for the resulting freedom of choice conceded to registrants by the regulations of the Commission, we are greatly indebted to the influence of Professor Sanders of the Harvard Business School, and we should all be grateful to him for the very important and helpful part he played in the formulation of those regulations.

I gather that in his efforts to secure adoption of the principle that registrants should be free to follow their own methods of accounting provided that those methods were not obviously unacceptable and were clearly disclosed, one of Professor Sanders' main difficulties was the dearth of support for the proposal obtainable from accounting textbooks. The objection was raised that the idea, while attractive, was a novel one; and it was with particular interest that I read an editorial brought to my notice by Dr. B. C. Hunt, in which the principle to which I have been referring, and which was stressed in the correspondence between the New York Stock Exchange and the American Institute and has since been embodied in the regulations of the Commission, was referred to many years ago, almost as a truism. The editorial appeared in the *Morning Chronicle* of London in 1849, when the question of railway accounts was being widely agitated and was under consideration by a select committee of the House of Lords:

"What are the precise criteria which distinguish revenue from construction charges it is no easy matter to determine. . . . At present there is great room for controversy, but this, at least, will be generally agreed to, that the principle adopted by any company in the distribution of its expenditure between the two accounts is of comparatively minor importance, provided that the system pursued be distinctly avowed and understood by the shareholders."

The English courts, in decisions under the income-tax law, have repeatedly taken the view that what is profit is to be determined

by the practices of business men. Moreover, as I have pointed out on other occasions, our own tax law has since 1918 laid down the rule that taxable income is normally to be determined "in accordance with the method of accounting regularly employed by the taxpayer in keeping his accounts" and this language remains on the statute book, although it must be admitted that the Bureau of Internal Revenue has done its best to make it nugatory.

So today it is, I think, clear that upon both principle and authority, accounting must be regarded as a process involving the recognition of custom and convention and the use of judgment, rather than as the application of rigid and unvarying rules.

It follows that rules may, and sometimes must be changed as conditions change. You no doubt realize that this is true of law, but it may serve to bring out the point more clearly if I refer here to two legal decisions dealing with the question of depreciation, which I expect to discuss at some length in the course of this paper.

In 1876, the Supreme Court said that the public "rarely ever took into account the depreciation of the buildings in which the business is carried on," and in 1878 it supported the Government in its claim that a railroad company should not be allowed to include a depreciation charge in operating expenses, holding that "only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings." In 1909, however, we find the Court saying: "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.*

Need I add that accounting is not essentially a process of valuation, as some writers on accounting and some economists conceive it to be. Professor C. R. Rorem's book, *Accounting Method*, seems to me to suffer from this misconception, and it is hardly too much to say that Professor Canning's book (to which I have already referred) is built upon it. Primarily, accounting is historical in its approach, with valuation entering into it at times as a safeguard. The emphasis is on cost, though where an asset is intended for sale and its selling value is known to be less than cost, the lower figure may be substituted for cost. The outstand-

* *Eyster v. Centennial Board of Finance*, 94 U. S. (1876); *U. S. v. Kansas Pacific Ry. Co.*, 99 U. S. 459 (1878); *City of Knoxville v. Knoxville Water Company*, 212 U. S. 13 (1909).

ing illustration of this practice is the almost universal custom of valuing goods on hand at cost or market, whichever is lower.*

Capital assets, in particular, have traditionally been recorded by the accountant at cost or at cost less deduction for depreciation. It has seemed to the accountant to be neither a practicable nor a useful undertaking to attempt to determine the value of assets not intended to be sold and for which there is no ready market, especially bearing in mind the different concepts of value—and it has been said that in one English act the word “value” is used in twenty-seven different senses.† If the accountant accepts the economic measure of value as being the discounted value of a prospective income stream, it seems to him futile to attempt to reflect fluctuations of the income prospects and the discount rate on the books of a corporation which has no thought of attempting to realize its capital or of doing anything except receive and deal with the income stream as it comes in. He would rather concentrate on the more useful task of measuring—with what accuracy is attainable—the income stream as it flows.

True, during the 1920's, accountants fell from grace and took to readjusting capital values on the books of companies to an extent never before attempted. In extenuation they might plead that unsound laws, unpractical economics, and a widespread if unfounded belief in a new order of things combined to recommend such a course, but the wiser policy is to admit the error and to determine not to be misled into committing it again.

Now, once it is recognized that accounting is largely a matter of convention, it is easy to perceive that the nature of the conventions adopted may greatly influence the development of an economy. This is particularly apparent under a system of free enterprise, under which the hope of profit is the main reliance for the upbuilding of the industry of the community; for what is profit in the commercial sense here involved is not only an accounting question but is, indeed, the central question of modern accounting.

In the simplest forms of organized life, accounting problems arise, and the way in which they are decided influences action. The administrators of even a non-profit institution, such as a

* Incidentally, the growing emphasis of the income account as an index of earning capacity, and hence of capital value, may make desirable some modification of the treatment commonly adopted in this matter.

† See *Proceedings of the International Congress on Accounting*, London, 1933, p. 135.

club, let us say, are called upon to account to its members. Shall they limit the accounts to actual receipts and disbursements? Must they not at least exclude or deal separately with borrowings and repayments; and if they ignore unpaid bills, may there not be a temptation to delay payments that ought to be made in order to present a more favorable showing? If bills owing by the club but unpaid are to be brought into account, should amounts owing to the club also be taken into consideration? In technical language, should not the account be one of income and expenditure rather than one of receipts and disbursements? Taking a further step—in order to reduce the cost thereof, insurance has been written for three years; should the whole cost be charged against the one year and the next two years be relieved of any corresponding charge? Or, an automobile has been bought—should the cost be charged against the year or distributed over the probable useful life of the car? Speaking technically again, should not some accrual basis of accounting be employed?

From this example, it is easy to see how considerations of policy may influence accounting, or the form of accounting may influence the course of events. One form of accounting may show a balance for the year in favor of the club, with the result that the dues may be left unchanged or even reduced; another might show a balance against the club and lead to an increase of dues. Reluctance to put an increase in force may lead the administrators to choose the method which gives the seemingly more favorable result. Indeed, to leave bills unpaid at the end of an administration, thus unfairly relieving the accounts of the outgoing and unfairly burdening those of the incoming administration is a well-known device of dishonest politicians.

The most important group of problems which the accountant has to consider relates to the distinction between capital and income. In some cases, the question is whether amounts receivable or payable shall be carried once and for all to the income account or the capital account. In other cases, the issue is how and when amounts which have been carried in the first instance to the capital account shall be transferred to the income account. The second group is larger and presents more difficulty, and it is from this field that I propose to take the first case.

I am going to ask you to consider in some detail the historical and economic aspects of the problem of accounting by railroads

and public utilities for exhaustion of property, the cost of which is in the first instance charged to capital account. This question has in the period since the war assumed a new importance because of the changing attitude of regulatory bodies towards what is called "depreciation."

In a paper which I presented to the Institute in 1932,* I pointed out that the extent to which costs are today represented by expenditures made in the expectation that the benefits thereof will be received over a considerable period in the future was one of the outstanding problems of modern industry and modern accounting, and drew attention to economic authority for the view that it was also a factor tending to intensify and prolong industrial depressions.

Every accountant realizes both the difficulty of these problems and the widely varying results that follow from the adoption of varying courses of procedure. It is clear, therefore, that here we have a case in which accounting treatment may influence economic development, and that the effects may be of great importance.

Before proceeding with the discussion, I should like to remind you that the distinction between charges to capital and charges to revenue, which forms so large a part of the problem of modern accounting, depends almost entirely on the relation between the probable length of the useful life of the property acquired or created and the length of the accounting period. The cost of an electric light bulb would be a capital expenditure subject to depreciation if the accounting period were a day; an automobile would become a direct revenue charge if the accounting period were a decade.

Those familiar with the history of railroads and public utilities will, I believe, agree that until the present century little recognition was given to the element of depreciation, as such, and that property was often acquired or created, completed its useful life and was discarded, without any charge being made against income as to the cost of the property or the cost of replacing it. Such charges as were made in respect of abandoned property were usually made against accumulated surplus. No doubt substantial charges for replacements and (particularly after the reorganizations of the nineties) for improvements were made against income, and it may be argued also that in the early

* *The Influence of the Depression on the Practice of Accounting.*

days of the enterprises values were created (such as the adaptation, solidification and going value which figure so largely in railway rate cases) in respect of which no charges to capital account were made. But making every allowance for offsets of this kind, the charges against income fell far short of the cost or replacement value of the property which had passed out of existence; and if regard were had, also, to the extent to which the useful life of the property still existing had been exhausted, the aggregate exhaustion of value not charged to income would be far larger.*

The question whether railroads should provide for depreciation (or the exhaustion of property that was in progress) does not appear to have been extensively considered in our country at least until the railroad system was largely built up. The word "depreciation" does not appear in the index of Hadley's *Railroad Transportation* (1885), nor in the decision of the Supreme Court in *Smyth v. Ames* (1898). Our practice, however, was undoubtedly greatly influenced by English practice, and in that country the issue was hotly discussed as early as the middle of the last century, following the collapse of the great railroad boom of the forties. The select committee of the House of Lords in 1849 to which I have already referred, took testimony on the subject (including, incidentally, that of an accountant who stated that he had been carrying on his profession in London for more than twenty years) and in its report favored the creation of depreciation reserves:

"It must be obvious," it said, "that for the maintenance of railways in a due state of efficiency, as relating to the way, the buildings, the rolling stock and other property, an adequate provision ought to be made, as a matter of necessary precaution and prudence. The creation of a Reserve or Depreciation Fund for such purposes as created by Parliament (Companies Clauses Act of 1845, 8 Vict. c.16 s.122)†, seems now to be generally admitted as necessary, in some instances. The Committee rejoices to observe, it is practically adopted. Without such fund there is a constant temptation to misapply capital. Where capital still exists; and where capital is exhausted, the progressive deterioration of the line can hardly be avoided, greatly to the risk of the Public, and so the inevitable sacrifice of the ultimate interest of the company itself. It would be

* A factor contributing to this result, other than the common accounting practice of continuing companies, was the frequent transfer of properties from one company to another as a result of sale, refinancing, or reorganization. Upon any such transfer, much that might have been a revenue charge to the predecessor company, had it been continued, became a capital charge on the books of the successor. The importance of this factor, which is, I think, often overlooked, was brought home to me in studying the accounts of railroad companies which were reorganized after the depression of 1893.

† The provision seems to have been permissive rather than mandatory. Section 122, the section cited, provides that:

"Before apportioning the profits to be divided among the shareholders the directors may, if they think best, set aside thereout such sum as they may think proper to meet contingencies, or for enlarging, repairing, or improving the works connected with the undertaking, or any part thereof, and may divide the balance only among the shareholders."

difficult to prescribe by law the exact amount to be carried annually to this fund; but the fact of the creation or the non-existence of a Reserve or Depreciation Fund, together with its amount, where it exists, should always appear upon the face of the accounts. The receipts and expenditures of such fund, should in all cases be kept and exhibited, separate and distinct, should be examined and certified by auditors, and should be annually submitted, as well as left open to the inspection of the shareholders."

The controversy continued for many years until the passage of the Regulation of Railways Act of 1868. That act provided a special form of accounting for railways, which came to be known as the double account system. Under that system, all capital outlays were carried in an account entitled "Receipts and expenditures on account of capital"; only the balance of this account appeared in the general balance-sheet of the company. Rejecting the pleas that depreciation reserves should be made mandatory, Parliament contented itself with requiring certificates that the properties had been adequately maintained and that the dividends proposed to be declared were, in the opinion of the auditors, properly payable after making all charges against revenue which in their opinion ought to be made thereagainst.

Thus, while directors were free to make provisions for depreciation if they saw fit to do so, the question whether such provisions had to be made turned ultimately on whether auditors regarded such depreciation as one of the expenses which ought to be provided out of revenue, and leading accountants both here and in England took the view that this was not a necessary expense.*

In 1907, the Interstate Commerce Commission took the first halting steps towards the establishment of depreciation charges, by requiring at least lip service to the principle in the case of equipment. In recent times, however, the Interstate Commerce Commission has taken a position in favor of depreciation provisions on a basis which is extremely broad if not entirely practical, and in doing so has insisted that the depreciation which, upon its present view, is deemed to have accrued in the past, represents a failure on the part of the railroads to make provisions which they ought to have made. Its new rules came into force on January 1, 1933. State commissions have followed the example of the Interstate Commerce Commission and prescribed depreciation schedules for other public utilities.

It has been suggested, and the suggestion is at least plausible, that the attitude of the Commission on the subject of depreciation

* Cf. Hatfield's *Accounting*, p. 142.

charges against revenue is but a part of a determined attempt to make its own views—that depreciation on a straight-line basis should be deducted from gross investment in determining the rate base—prevail over those of the Supreme Court, which has hitherto limited the deduction to observed depreciation.

By Section 20 (5) of the Interstate Commerce Act as amended in 1920, the Commission was required to prescribe the classes of property for which depreciation charges may properly be included under operating expenses and the percentages of depreciation which shall be charged with respect to the use of such classes of property. The Court would, therefore, presumably be powerless to prevent the Commission from requiring depreciation charges against operations on any basis not obviously capricious or arbitrary which it might prescribe. There is, as the Commission has stressed in its decisions, a natural relation between the depreciation charges which for the purposes of rate regulation form a part of the cost, and the depreciation which should be deducted from gross investment to determine the rate base on which the return on capital to be included in the rate shall be computed. If, then, the Commission prescribes that depreciation shall be charged against income on what is known as the straight-line method, then, logically, it may be argued that depreciation on a straight-line basis should be deducted from the capital investment, as the Commission has deducted it in the valuation which it has made under the Act of 1913. A head-on collision between the Commission and the Supreme Court seemed inevitable until motor vehicles and the depression combined to make the rate base of the railways an academic question. The irony of the situation lies in the fact that in commercial practice, while the straight-line basis is generally used in measuring operating charges, it is practically never used in measuring remaining value—indeed, for this purpose it is demonstrably inappropriate. For, if capital value is the discounted value of a future annual yield, the fall therein from year to year is measured not by the fraction of the total life which one year represents but by the decline in the value of an annuity resulting from shortening its term by one year.*

I turn, now, to consider what the effect on the development of

* The unwelcome fact that from the standpoint of valuation the annuity method of computing depreciation rather than the straight-line method is appropriate, is passed over by the Commission, which blandly but quite unconvincingly states that the two methods do not produce very different results in practice. Professor Sharfman also ignores the point in his defence of the Commission's procedure "on the merits," (see *The Interstate Commerce Commission*, Vol. III-A., p. 197).

our country would have been if the methods of accounting for depreciation now favored by the Commission had been put into effect in the early days of railroad enterprise. I raised this question in a memorandum which was submitted to the Interstate Commerce Commission and in an article which appeared in the *Quarterly Journal of Economics* of February, 1929, and from which I may, perhaps, quote:

"The result of a depreciation plan is obviously to throw an added charge for use and exhaustion of property upon the earliest years of operation, years in which the traffic development would be in progress and in which consequently the charge would be more burdensome than in later years. Such a condition would seem to be exactly the reverse of that which would be economically desirable from the standpoint of the community. Its interests would be served by keeping the charges in the early years down to the minimum consistent with maintaining the efficiency of the property, thus enlarging the volume of the commodities that could profitably be transported, and building up both the traffic and the community more rapidly than would otherwise be possible. The best interests of the community in such a situation would be served, it would seem, by a mutual agreement to ignore the depreciation on the property in so far as it could never be made good while the property was being operated; the owners of the railroad agreeing that this depreciation should not be treated as a part of cost of operation, and the community agreeing on the other hand that in computing return no deduction should be made from the original investment therefor."

From a financial standpoint, with depreciation charges treated as a part of operating cost, only a small proportion of the enterprises proposed could have been claimed to present the prospect of being able to earn their fixed charges within a reasonable period after being open for traffic. The published results of the ventures of those who had been bold enough to proceed would have discouraged others from attempting similar enterprises. On the basis of the accounting methods then employed, which ignored accruing depreciations, Hadley estimated in 1885 that the railroads as a whole were earning not more than five per cent. on the actual capital invested. To my mind, it is incontestable that the effect of the application of such depreciation accounting would have been that the construction of a large part of our railway mileage would at least have been greatly delayed—if, indeed, some part would even have been constructed at all. Such a result would have been exactly the opposite of that sought at the time by legislatures and the public. Hadley begins his chapter on railroad legislation with the statement:*

* Hadley *Railroad Transportation*, (1885), p. 125.

"The early railroad legislation in the United States was devised for the object of securing railroad construction. The only fear was that railroads would not be built as fast as they were needed."

And as late as 1907 the Interstate Commerce Commission was complaining in its report:*

"It may conservatively be stated that the inadequacy of transportation facilities is little less than alarming."

Since the development of other public utilities and commercial enterprises followed naturally on the development of railroads, this portion of the growth of our capital equipment would also have been greatly retarded. It has been said that we owe our great railroad facilities and the developments which they made possible, in a large measure, to unsound finance; but if it be held that depreciation provisions are an essential element of sound railroad accounting, then unsound accounting must share with unsound finance in the responsibility for the tremendous economic development that has taken place since railroad enterprises were first begun.

It is no doubt true that as a result of the accounting methods followed, large amounts of capital have been lost by investors. How large such losses in the aggregate must have been is brought home to us when we consider enterprises such as street railways, in respect of which capital has been furnished by investors—first, for the cost of an original installation of horse-cars, and then for the cost of equipping the lines for electrical operation (with, in some cases, an intermediate cable development); and, finally, as we have recently seen in New York and elsewhere, the electrically operated street-cars have been displaced by buses. This, however, merely emphasizes the truth too often ignored by unfriendly critics of the existing economic order—who see only the large fortunes made by a relatively small number of fortunate individuals from the development of the capital equipment of the nation—that in the aggregate, the community pays only a small return to capital for the amount invested, and that it is the community that is the only sure gainer therefrom. However legitimate the project, however honest the finance, however conservative and scrupulous the accounting, and however competent the management may be, the losses in industry are bound to be enormous, and the community can well afford to allow the few

* *Twenty-first Annual Report of the Interstate Commerce Commission (1907) p. 9.*

who meet with unusual success to receive and retain substantial rewards as a part of the price it pays for *all* the capital invested.*

It may be worth while to refer briefly to another consequence which would have followed from the adoption of the depreciation principle in railroad accounting, and would follow from its adoption today. The accumulation of provision for the exhaustion of property, however long-lived, would have meant the creation of huge depreciation funds, a large part of which could never have been spent so long as the railroads were being operated. It is obvious that the investment of these funds might well have constituted a problem with important social consequences. A similar problem will arise under the provisions of the Social Securities Law recently enacted.

Before leaving this question I should perhaps anticipate an objection that the methods of accounting adopted may have been an effect rather than a cause; the objection that this may be a case in which methods of accounting have been influenced by other than accounting considerations, rather than one in which accounting judgment has influenced the economic development. True, the methods followed here and in Great Britain might represent the giving of effect to an opinion deliberately reached as to what was economically desirable, or they might be the reflection of the views (born, perhaps, of the wishes) of those who were interested in the creation of such enterprises. There is, however, nothing to suggest that the theoretical desirability of depreciation was recognized by those responsible for the enabling legislation, either here or in England, but deliberately ignored because it was believed that the development and welfare of the country would be aided by ignoring it. Nor do I believe that those who were responsible for finding the capital for railroad enterprises in England or here, or those auditors in England who were required under the Act of 1868 to certify that dividends were *bona fide* due after providing for the charges which ought to be made against revenue, believed that sound finance or good accounting called for depreciation provisions which would ultimately provide for the amortization of outlays on all property except that which was indestructible and could never become obsolete, and deliberately refrained from requiring such provisions.

The policy that omitted any provisions for depreciation was, in

*Failure to recognize frankly these simple truths seems to me to be a major ground for criticism of measures for control of security issues and tax proposals which have been put forward in the last year or two.

England, entirely consistent with the policy which omitted any provision for amortization of obviously wasting assets such as mines, ships, or annuities. It was consistent with the whole theory of the determination of income under the English income-tax laws (which had been revived before the railroad development in England had proceeded very far). American practice in the early days was undoubtedly determined largely by English precedents, which was natural in view of the fact that the capital for our railroad enterprises came largely from abroad, and particularly from England.

I believe that in dealing, or omitting to deal, with depreciation the railroads merely followed the general accounting practice of the times. I have already referred to the change of attitude on the question on the part of the Supreme Court between 1878 and 1909. It was not until the present century that depreciation charges became general even in industrial accounting practice in our country—in fact, full recognition of the necessity therefor might almost be said to date from the enactment of the first corporation income-tax law in 1909, under which depreciation was an allowable deduction which corporations generally were anxious to secure, and which was allowed only if taken up on the books.

It may well be that the adoption of the theory of depreciation by railroads and public utilities was to some extent actually checked by accounting regulations framed by regulatory bodies which were undoubtedly influenced by other considerations than those of sound accounting, but the effect of regulation on accounting does not fall within the scope of the subject I have been asked to discuss today.

I have dealt with this question at such length that it will be, I fear, impossible to do more than touch briefly on other cases in which accounting practice has influenced or may influence economic development. I have felt it worth while to do so because, to my mind, not only is the problem an outstanding one in the field which we are exploring, but also the recent discussion of it by commissions has suffered from lack of a proper perspective. This seems to me particularly true of the suggestion by the Interstate Commerce Commission that the omission to provide depreciation charges in the past constituted a "failure" on the part of the railroads and that the burden of any adjustment to the new method ought to fall upon them.

The next broad question which I should like to touch on is the treatment of gains or losses on the sale of capital assets. Here we have regarded such items as finding a place in the income account; the contrary practice prevails in England.

It is not difficult to understand why such a difference of practice should exist. In England modern accounting developed in a community in which previously the predominant interest had been in land and which already thought in terms of annual produce, whereas here it developed in a new country in which the greatest opportunities for gain lay in sharing in the growth of the country rather than in securing a part of the current annual yield. The opening sentence of *The Wealth of Nations* (1776) reads:

"The annual labor of every nation is the fund which originally supplies it with all the necessities and conveniences of life which it annually consumes, and which consists always either in the immediate produce of that labor, or in what is purchased with that produce from other nations."

Cannan, in his edition of the work, comments in a foot-note as follows:

"This word [*i. e.*, 'annual'], with 'annually' just below, at once marks the transition from the older British economists' ordinary practice of regarding the wealth of a nation as an accumulated fund."

and in his introduction (page xxxiii), says:

"The conception of the wealth of nations as an annual produce, annually distributed . . . has been of immense value."

Anyone who has lived both here and in England will recognize the truth of the statement that here we think in terms of capital value and there they think in terms of annual income. Inquire whether a man is well-to-do here and you will be told he is probably worth so many dollars; ask a similar question in England and the answer (if you get one at all) will certainly be that he is probably worth so much a year. Local taxation in England is invariably placed on the annual value of property—not on capital value as with us.

It is a curious contradiction that we, who have gone further than any other country in refining double-entry bookkeeping and distributing charges over successive periods by elaborate systems of accrual, should in our thinking have, in effect, adhered to the old single-entry method of determining gain or income by deducting worth at the end of the period from worth at the beginning thereof. Some of our well known economists and statisticians have adopted the view, and have even undertaken to measure

"national" income by such methods. In doing so, they have exaggerated the growth of wealth in the boom period and the decline in the period of depression with, as I think, unfortunate results.

Whatever may be the cause of the difference in practice, it is undeniable that our system of treating capital gains as income has had important and, as I believe, injurious effects on our economic development. It has led to the taxation of capital gains as income (which is not done in England), and I think those who have studied the effects of this taxation in general agree that they have been undesirable. Such taxation undoubtedly prevented sales of securities taking place on a large scale, which would have had an important corrective effect during the boom which culminated in 1929.

It was probably, also, a factor (though doubtless a less important factor than considerations of political expedience) in preventing the framing of the income tax along lines that would provide a broader basis and a steadier annual yield.

The same practice, or the habit of mind which it reflects, is, I think, also in large measure responsible for the laws passed in recent years making the propriety of dividends dependent on there being an excess of assets over liabilities and capital, thus displacing the old rule under which the source of income to a stockholder was the earning of a profit by the corporation in which he held stock, and the declaration of a dividend merely fixed the time when it became income to him. This change, whether desirable or undesirable, may obviously have very important economic consequences, particularly in conjunction with the no par value stock laws. If generally adopted, it would rob the word "dividend" of its old significance, since under it the payment of a dividend does not imply the previous earning of a profit and a dividend may be, in every real sense, a distribution of capital. Though perhaps the new law represents only an attempt to escape from the difficulties with which we are familiar without adequate thought of the new difficulties which may be encountered, to me it seems to be fraught with great possibilities of evil.

I should like to draw attention to one danger against which some safeguards should be created. It arises from the existing custom of treating capital gains as income, and the alarming habit which seems to be developing of regarding every annual report as a new edition of a prospectus. Even those who contend

that realized capital gains are a form of income must concede that such gains and recurrent income have no common relationship to earning capacity, except to the small extent that capital gains may represent recurring income that has not been distributed. Apart from this item, which for practical purposes may be disregarded, the gain normally represents either (a) the capitalized value of a change in capacity to earn recurring income (demonstrated or assumed), or (b) a change in the rate of capitalization applied to an unchanged earning capacity; or (c) a combination of the two. This being so, it is obvious that such a capital gain can not properly be added to a recurring earning capacity (which has not already been capitalized) to form the basis from which, by multiplication, the capital value may be determined. To my mind, few points are of more importance in connection with the problem of presenting illuminating reports to investors than that of taking some steps which will tend to prevent investors from including capital gains with current income in one sum, from which they will compute capital value by a single multiplication.

The treatment of capital gains as income reached its most pernicious development during the boom period in the practice of regarding stock dividends as income in an amount equal to the market value of the stock, the evil being especially marked in the case of pyramided holding companies. To the extent that the amount included in income exceeded the amount of earnings which formed the basis of the distribution by the company declaring the dividend, the credit to income by the receiving company represented nothing except an unrealized capital appreciation. Fortunately, the accounting profession is not, I think, called upon to accept the blame for this unhealthy development except, perhaps, in so far as it might be argued that it could never have taken place but for the unsound accounting practice of treating capital gains as income.

If time permitted, I could discuss other cases of, I think, less importance, in which accounting practice has exercised an influence on the development of our economy. It would be interesting, for instance, to consider what the effects would have been if the United States and its subdivisions, and those corporations which pay pensions, had adopted the accounting practice of providing for future pensions in the years in which the service which gave rise to the right thereto was rendered.

It is by no means abnormal that the actuarial value of the pension benefits attaching to municipal employment should be equal to twenty per cent. of the nominal compensation of the employee. It is obvious, therefore, that if municipal budgets provided currently for the deferred compensation as well as for that immediately paid, and if the present value of the future liability were treated as a part of the indebtedness of the municipality, both the budgets and the borrowing capacity of the municipality might be very largely affected. In New York City, some of the funds are maintained on at least a quasi-actuarial basis, while in other cases no provision is made for future liabilities, the present value of which today run into several hundred millions of dollars. The same is true, on a much smaller scale, of commercial corporations which maintain pension benefits. As against the advantages which would be derived from a more accurate disclosure of the costs of government and of the financial position of a municipality from the inclusion of the provision for deferred pensions liabilities, there must be considered the possibilities of abuse that would be created if funds to meet such liabilities were currently set aside and entrusted to city officials for investment in order to provide for the obligations as they become due.

Our subject might be pursued indefinitely, but our time is limited—indeed, it may seem to you that the considerations I have been advancing are abstract and remote from the practical problems of the profession, and that our time might more usefully have been devoted to a consideration of those practical problems. The present time, when novel theories and untried methods are being advocated by persons who do not enjoy the practical experience that falls to the average accountant, seems to me particularly opportune for the consideration by our profession of some of the broader aspects of questions that come to our attention. We have had, during the past three days, a series of papers and discussions on eminently practical questions, and I think there is everything to be said for devoting our last session to a consideration of matters which possess an interest extending beyond our own profession.