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Comments

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Introduction

I welcome the opportunity to comment on your Complexity Bulletin. Previously I would have felt uncomfortable in commenting simply because the ideas supporting my contribution had not yet been published, but today I received advice that my paper “Financial accounting reform: the need for a ‘back to basics’ approach for profit measurement and wealth measurement” is being published in the *International Journal of Economics and Accounting*, Vol.5 No.1, pp.1-50. This paper had been accepted for publication by the editor late 2012 and only now is it going to appear.

The ‘general purpose approach’ underpinning conceptual frameworks introduces unnecessary complexity into financial statements by effectively blocking, or standing in the way of establishing, a clear relationship between the measurements disclosed and the basic financial information needs of equity shareholders. Identification and acceptance of the important information needs confers the immediate benefit of enabling the selection from those needs of the relevant concepts of capital and profit to be applied in accounts, with the derived measurements being reported in financial statements. In other words, the measurements employed in financial statements are relevant to the recognised information needs because they reflect relevant concepts derived from them. This specific purpose approach ensures consistency in the measurements of an integrated set of financial statements. Furthermore, where warranted, important information needs which cannot be met by a particular interpretation due to the measurement base being inappropriate, may require an alternative interpretation of the accounting system. It is stressed that each interpretation should be internally consistent by faithfully representing the property being measured.

I demonstrate that monetary profit measurement (based on realisation) should be distinguished from wealth measurement as each related set of measurements requires a different measurement base. The qualitative, empirical property being measured in both cases is property rights, but in each case different aspects of property rights can be relevant.

The presentation in this submission has been condensed by omitting many of the references included in my paper mentioned above, and on which it is based.

The remainder of my comments are organised as follows. The monetary profit measurement system is next outlined, and then that for wealth measurement. Responses to your two questions are then offered. In concluding, I wish to emphasise the damage done by the general purpose approach in restricting a much more user friendly system or systems that would facilitate the employment of measurement systems able to procure relevant financial information.

Monetary profit measurement (incorporating realisation and cost allocation)

Writing after the enactment into UK company law of the recommendations of the 1945 Cohen Committee, de Paula (1948b: 422), summarised the purposes of annual accounts in this classic statement:

> …it is clear that the annual accounts of companies are purely domestic documents and represent the rendering by directors of an account of their stewardship. There are two main purposes, firstly to give to the proprietors a true and fair view of the company's revenue transactions and thus to show what profits (if any) are available for distribution, and secondly to give a true and fair view of the financial position of the company at the end of its financial year.

Developments since appear to have obscured this simple and clear objective which retains its relevance today.

Following this approach, the users assumed are the ordinary shareholders of a company. The first information need recognised is for financial information enabling assessment of whether the paid in money capital has been maintained, and the related question of whether monetary profit is a genuine surplus over the money capital (plus any retained monetary profits at the beginning of the current period). The purpose of the legal rule limiting dividends to profits is to ensure that creditors are not defrauded through the return to shareholders of their paid in money capital under the guise of a dividend. The claims of creditors are debts expressed as a sum of money, and settlement of their debts takes precedence over payments to the shareholders. Assuming that monetary profit is a genuine increase over money capital, and that dividends do not exceed monetary profit, then the amount of the money capital will not be distributed as a dividend, and hence creditors will receive the protection intended by the law.

The second information need recognised in the monetary interpretation is for the directors to provide a report of stewardship to the shareholders for the actual use they have made of the money capital invested in the firm, and the actual results achieved from using that money capital. Both of these purposes are rooted in ownership - there is no profit without an increase in assets arising from executed contracts. Further, profit also implies an excess of money revenue inflows over money cost outflows, a complementary measurement ensuring that profit represents an increase over the money amount of the invested capital. The more detailed explanation which follows explains the accounting principles in terms of the transactions arising from executed contracts which change property rights. Measurement of monetary profit applies the accounting principles of realisation and cost allocation, the latter including the recoverable cost rule.

The term 'monetary profit', apparently first used by the Institute of Chartered Accountants in England and Wales (ICAEW) in 1952 in Recommendation N15 *Accounting in Relation to Changes in the Purchasing Power of Money* captures the essence of profits computed under historical cost. Paragraph 1 includes the following statements:

> Similarly a profit and loss account is an historical record. It shows as the profit or loss the difference between the revenue for the period covered by the account and the expenditure chargeable in that period, including charges for the amortisation of capital expenditure. Revenue and expenditure are brought into account at their recorded monetary amounts. This basis is frequently described as the historical cost basis and in this statement the expression "monetary profits" is used to denote profits so computed.

Similar terms were used by the ICAEW in evidence to the Jenkins Committee (1962) and quoted with approval by that committee, as shown later. The term ‘monetary profit’ is preferred to historical cost as a more accurate description of the object of measurement, particularly as historical cost accounting has incorporated measurements not supported by transactions and changes in property rights; income tax allocation, for example.

Fisher’s (1906) concept of property rights is adopted as the underlying qualitative, empirical property of the accounting elements, the objects of measurement. Transactions are accepted as the fundamental measurements. Derived from executed contracts, transactions are the primary means by which changes in property rights are measured, the contract consideration stipulating the amount of the relevant transaction. Whether it is the first contract entered into by a company, perhaps with its shareholders, or a later one when the company proceeds to trade, each contract executed by the company changes its stock of property rights.

Hence the money amounts stipulated in transactions derived from contracts provide the basis for measurement of changes in property rights. Money and contracts are intimately related, as, in addition to its significance for settlement of debts and contracts, money assumes the function of “money-of-account” (Keynes, 1930: 3) for use in profit measurement. This function is important as it gives businesses some certainty in respect of the cost to be recovered in order to return a profit. The money-of-account function would be lost if money (the domestic currency) was no longer accepted for the settlement of debts, and other currencies were used for that purpose.

Third, Mattessich’s (1964, 1972) general structure, based on the relationship between the general accounting system (uninterpreted calculus) and rules of interpretation by which specific meaning is conferred on the whole system, is central to my explanation. The rules of interpretation enable specific meaning to be conferred on the general accounting elements from financial information needs of shareholders. This process commences with the identification of the common financial information needs of ordinary shareholders, and proceeds by selecting compatible needs that can be met in a single interpretation of the general accounting system. Needs so met are described as ‘recognised’. ‘Common’ refers to financial information needs that apply to a class of shareholders. It is argued that these ideas underlie the theories or explanations of external financial reporting advanced by professional bodies in the 1930s and 1940s.

The Executive Committee of the American Accounting Association published the *Tentative Statement of Accounting Principles Affecting Corporate Reports* (AAA, 1936), a notable statement for several reasons. It was the first statement on accounting principles issued by a professional body. Extensive discussion, fuelled by the Executive Committee’s determination to make a positive contribution, “eventually produced agreement on every major point” (Zeff, 1966: 44-45), a truly remarkable achievement. The main motivation for its preparation was to provide authoritative guidance to the recently established SEC. C.G. Blough, first Chief Accountant at the SEC, praised it as “a real contribution to the accounting profession” (Zeff, 1966: 46). Apparently, the SEC’s “accounting staff frequently cited the Tentative Statement with favour as well as the revisions thereof issued in 1941 and 1948 and the eight supplementary statements issued between 1950 and 1954” (Zeff, 1999: 90). In a further accolade, Zeff (1999: 90) described the Tentative Statement (AAA, 1936) as a “paean” to historical cost accounting.

Paton and Littleton (1940), building on the Tentative Statement, produced their classic book described by Zeff (1999: 90) as "perhaps the most influential monograph in the U.S. accounting literature … Above all, it was an elegant explication and rationalization of the historical cost accounting model that was already widely accepted in the U.S. It met with general acclaim and was used for many years in accounting courses throughout the country". In a remarkable act of endorsement, the monograph was distributed jointly by the AAA and the American Institute of Accountants as a dividend to their respective members (Zeff, 1966: 49).

Across the Atlantic, credit for fashioning the common law rule that dividends were to be paid only from profits, and that capital was to be maintained at the money amount contributed by shareholders was given to Jessel, Master of the Rolls in his interpretation of the Companies Act 1862 (French, 1977: 307). In Flitcroft's case decided in 1882 Jessel enunciated the concept "of an implied contract with creditors ... [who] give credit to the company on the faith ... that the corporation shall keep its capital and not return it to shareholders" (Yamey, 1962b: 429-430). The economist, John Stuart Mill (1909), emphasised the need for financial statements to provide information relevant for capital maintenance, and stewardship. Andrews (1949: 71), another economist, explained the capital maintenance rule as a consequence of the privilege of limited liability.

Yet this important principle with respect to dividends was destined to be overturned by Lord Justice Lindley, who, in a series of decisions from 1889 in effect redefined the rules for capital maintenance, in the process overturning emerging accounting principles much to the consternation of accountants (Dicksee, 1892: 135-137). But these legal decisions did not link coherent definitions of capital and profits. Following the precedent from partnership law, the courts regarded the determination of profits, provided there was no evidence of fraud, as a matter of internal management to be decided by majority decision of members, or directors, in accordance with the articles (Johnston et al, 1983: 127).

However, dividend distributions were still required, and a definition of capital implies a definition of profit. Yamey (1962a: 41) wrote: "It was the accounting conventions and not the legal requirements that in practice imposed the real restraints on the calculation of divisible profits". At a time when the profession was emerging, the legal decisions blunted its authority, not only throwing accountants into disarray, but also weakening their position with directors. The directors no doubt noted the freedom accorded them provided they acted honestly. Hence, the stage was set for men of business to create secret reserves for the purposes of dividend equalisation, and for these secret reserves to be lauded as the hallmark of a sound business (Edwards, 1976: 297).

Then came the 1931 Kylsant case. In de Paula's (1948a: 35) classic phrase "the profession had gone on happily and satisfied that all was well, when suddenly, out of a blue sky, an atom bomb fell that shattered our self-complacency and startled and shocked the public". This was a case in which a great company, the Royal Mail and Steam Packet Company, had raised funds from the public and had paid dividends throughout the 1920s but had failed to disclose that from 1921 to 1929 it had not recorded a trading profit. Large profits made during and after the war, hidden in secret reserves, were transferred to profit and loss as required. For this deception a Lord of the Realm was sent to prison, while the auditor was apparently acquitted on a technicality.

This resulted in an enormous change from the previous attitude of 'non-interference' of the ICAEW evident in their recommendations for extensive disclosure in accounts presented to the 1945 Cohen Committee. The commencement in 1942 of the issue of a series of recommendation on accounting principles by the Taxation and Financial Relations Committee of the ICAEW signalled the new, proactive approach. The sweeping changes recommended to the Cohen Committee were enacted in the Companies Act 1947, becoming on consolidation the Companies Act 1948. The use of secret reserves was outlawed; henceforth all movements in reserves were to be disclosed, and items appropriately classified. Both the balance sheet and the profit and loss account were required to give a "true and fair view", and to be audited. Consolidated accounts were introduced.

Although the Cohen Committee clearly favoured disclosure of fixed assets at their cost less accumulated depreciation, the description of the historical cost basis was incomplete in at least two respects. First, profit was not defined; and secondly, their recommendations, unwittingly it seems, included a general clause permitting the valuation of fixed assets, rather than valuation being restricted to the three exceptions referred to in the recommendations of the 1945 Cohen Committee (para. 100). Nevertheless, overall the amendments were welcomed.

In endorsing the historical cost basis of accounts outlined in the Cohen Committee Report, the 1962 Jenkins Committee noted that such accounts may need to be "accompanied by supplementary information in order to give shareholders the true and fair view required by the Act" (paragraph 334). The Committee endorsed the improved function of annual accounts from the evidence of the ICAEW, and, noting that the realisation concept had been virtually "universally applied", recommended that the same principle should be applied in determining capital profits (paragraph 337). Further, paragraph 350 recommended several amendments necessary to clarify the unsatisfactory case law initiated by L J Lindley in 1889 but it was to be several years before they were enacted. After summarising the effect of the Companies Acts of 1980 and 1981 on the legal rules for calculating distributable profits, Edwards (1989: 187) commented that the "overall effect is to give specific legal emphasis to the realisation and accrual concepts and general statutory support for the, more rigid, profit measurement procedures traditionally favoured by accountants". Thus, on both sides of the Atlantic, the system of historical cost accounting received strong support.

The above evidence is presented in support of the view that the main principles of historical cost accounting were supported by the professional bodies in the 1930s to the 1950s. Figure 1 summarises the logical steps by which the measurement of periodic monetary profit and money capital is derived from the two recognised financial information needs of ordinary shareholders.

Figure 1
The relationship between the two information needs recognised and measurement of monetary profit and money capital

Shareholders' common information needs
Measurement of monetary profits available for dividends,
and of money capital maintenance
Stewardship of the contributed money capital
↓
Qualitative, empirical property
Changes in property rights
Specific properties of property rights
Right(s) of use for profit
↓
Interpretation of the accounting elements
Owners' equity: money capital, retained monetary profits
Assets: money, rights to money, and money expenditure (net)
Liabilities: debts
Monetary profit = Revenue - Expenses
(related meanings for changes in A, L and OE elements)
↓
Accounting policies
Realisation, cost allocation including recoverable cost
Money (the domestic currency) as the unit of account
(plus detailed accounting policies, for example, depreciation)
↓
Circumstances
Opening balance sheet
Transactions for the period
Continuity condition, if applicable
↓
Measurements reported in financial statements
Profit Statement, showing monetary profit for the period
Retained profits statement for the period
Cash Flow Statement for the period
Balance sheet at period end

Wealth measurement

The case for measurement and disclosure of the wealth of a company is now explained from a specific information needs perspective. The two information needs recognised for wealth measurement are debt paying potential, and calculation of net exchangeable asset backing per ordinary share. Other needs may be equally relevant. If assets are to be used for paying debts they must be capable of being converted into cash. Liquidity is the name usually given to the funds available for payment of debts in the short term, while solvency refers to their long term counterpart. As this information need is now 'generally accepted' it is not discussed further here. The second information need is for calculation of net exchangeable asset backing per ordinary share. Basing the calculation of asset backing on the current market prices of the assets and liabilities enables comparison with the current share price. By showing the potential 'break-up' value of the company it can be particularly useful to shareholders in evaluating a takeover offer.

Stock exchanges operate on the basis that the share market is an informed market; that is, that buyers and sellers are able to ascertain all relevant information so that no one buyer or seller can obtain an unfair advantage in trading. Accordingly, strict rules for disclosure of market sensitive information have been stipulated. In spite of these provisions, many shareholders have learnt, subsequent to the sale of their shares, that they have sold them for an amount significantly less than the asset backing calculated using the net realisable value of the company's assets. Sometimes this may be no more than bad luck or bad timing of the seller.

However, where shareholders were not informed of relevant information, like the current market selling prices of major assets, known to the company but not reported to the shareholders, they will have a justifiable sense of grievance. Numerous examples exist of takeovers where the acquirer subsequently disposed of the assets, pocketing a large profit. Small shareholders are the more likely to be disadvantaged by non-disclosure of the realisable value of the company's assets simply because the large shareholders and institutional investors are in a much stronger position to ascertain relevant information.

Current cash equivalents (CCEs) of the net exchangeable assets are not disclosed as a matter of course in financial statements, and presumably their non-disclosure has been one of the forces behind the pressure for periodic revaluations, and, more recently, for the extended use of fair values. However, disclosure of periodic revaluations of some assets from time to time is not an adequate response, especially as the revaluations are often arbitrary. What is needed is annual disclosure of the current market selling prices of all exchangeable assets in a separate statement as a matter of normal reporting practice. Intangible assets, which can be separately sold, such as patents and trademarks, should be included.

As this is not a valuation of the business, but a schedule listing all the exchangeable assets and liabilities at their individual market prices, it is not appropriate to include general business goodwill. Further, it is not suggested that sensitive competitive information should be disclosed; but rather that information which in many cases would be a matter of public record should be disclosed. For example, government valuations of land and buildings, and prices from second hand markets of motor vehicles. For completeness, including comparison with the monetary capital/profit balance sheet, specialised equipment, or assets for which there were no current prices, could be included at zero, or the fact simply reported that they had no separate market price.

It is clear that the satisfaction of the two information needs recognised requires disclosure of the current market prices of all assets and liabilities where these are available. The right of sale of assets is the specific property right relevant in respect of these two information needs. Unless the company actually owns the asset, and holds the right to sell it at the balance sheet date, it is not in a position to sell it and receive the proceeds of sale. Valuation and inclusion in a schedule of wealth assumes that the company holds the current right of sale. Leased property unavailable for sale or for which no rights to sub-lease are held, and future income tax benefits are examples of assets which should not be included as no right of sale is held in respect of them. Accepting that the term wealth denotes measurement in current market prices, wealth provides the qualitative, empirical property under this interpretation.

Similarly, liabilities involve the negative property right - the obligation to settle debts – in accordance with the contract for value received or the levy or charge imposed by a lawful authority. The entry in the wealth schedule will be the current market settling price plus any transaction costs. Deferred income tax is an example of a liability that does not constitute an actual obligation evidenced by property rights, and it should not be included. Thus the right of sale coupled with the obligation to settle derived from these information needs calls for measurement of assets and liabilities at their CCEs, and in total, the entity's net wealth. This sum, divided by the relevant number of ordinary shares, yields the amount of net asset backing per ordinary share. These relationships are shown in Figure 2.

Figure 2
The relationship between the two information needs recognised and the measurement of wealth

Shareholders' common information needs
Assessment of debt paying potential
Calculation of net exchangeable asset backing per ordinary share
↓
Qualitative, empirical property
Wealth
Specific property of property rights
Right of sale/Obligation to settle
↓
Interpretation of the accounting elements
CCEs of assets and liabilities
↓
Circumstances
Balance sheet at period end
Details of CCEs for all assets and liabilities
↓
Measurements reported in financial statements
Schedule of assets and liabilities
(a Schedule of Net Wealth owned by the company)

My answers to Questions to respondents

(i) Yes, subject to (ii).
(ii) The complexity introduced by the general purpose assumption should be discussed, with hopefully, a recommendation that there should be a trial of a 'specific purpose' approach as outlined in these comments.

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