CURRENT ASSETS AND CURRENT LIABILITIES:

WORKING CAPITAL

A Thesis

by

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August 1948

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INTRODUCTION

It is unfortunate that there has been such a lack of uniformity in dealing with current assets and current liabilities. The condition has been considerably improved by the excellent, though not always timely, work of the American Institute of Accountants, the American Accounting Association, the Securities and Exchange Commission, credit grantors, and others.

This paper discusses some of the differences of opinion that have existed concerning the current classifications and the extent these differences have been reconciled. It is hoped that this discussion of the theory and concepts underlying the current classifications will be helpful to all who have occasion to prepare or read financial statements.

CHAPTER I

WORKING CAPITAL

In economics, capital means wealth or resources available at a given time. As used in accounting, capital is generally understood to mean equity of the stockholders, owners, or proprietors in the resources of a business. However, the economic meaning is also used in accounting, and this is the meaning intended here.

In general, capital can be divided into two classes: current and fixed. Fixed capital is the capital invested in permanent properties "with which" the concern operates, and current capital is the capital either invested or available for investment in assets "in which" the concern deals. The last mentioned type of capital is in a constant state of flux and transformation, and for this reason, is frequently referred to as "circulating" or "working" capital.[1]

The term working capital is frequently used in the vocabulary of investment and business. Unfortunately, the term does not carry the same connotation for all of its users. Businessmen frequently speak of short-term borrowing as a means of increasing working capital. Although this represents an increase in total current capital, the investor and the accountant would not consider it an increase of working capital because it is entirely offset by an increase in current

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[1]Herrick, What Should Be Included In Current Assets, The Journal of Accountancy, Vol. LIII, p. 52.

obligations. In the first use the term refers to total current capital. In the second use it refers to the excess of total current capital over the claims on this capital. It has been said that the total current capital concept stresses the continuing nature of business, while net current capital emphasizes the banker's attempt to evaluate liquidity, but each use of the term seems to have significance in the analysis of financial statements.[1]

Because of the confusion resulting from a double meaning for a single term, one author suggests omitting all use of the term working capital, and substituting in its place a term such as "net current assets," "net quick assets," "net liquid assets," or even "net working capital."[2] For entirely different reasons another writer suggests complete abandonment of the current classifications, contending that they are of benefit only to the credit grantor and justifiable only from the creditor grantor's peculiar short-term-liquidation viewpoint. In his opinion, working capital is not homogeneous because it is built up of unlike elements and unlike values. He points out that current resources consist of cash and deferred claims to cash, while on the other hand, current obligations frequently contain claims against future operations rather than against current resources. The valuation of current resources is based upon realizable amounts at the date of the statement, while current obligations are often

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[1]Hoagland, Corporation Finance, p. 336.
[2]Dewing, Financial Policy of Corporations, p. 711.

expressed at an amount which will not be due until a future date.[1]

Despite such criticism, working capital can and does play an important role. It is a term frequently used in preferred stock agreements and bond indentures. It is considered important by credit grantors, investors, and others because insufficient working capital for operations is a common cause of business failure.[2] Important business decisions are based upon the amount of capital which is readily available for current operations, and this is the information which is presented under the heading of working capital.

It was once common practice to exhibit in balance sheets the fixed classifications ahead of the current groups. The emphasis, which this order placed on the fixed classifications, has now been shifted to the current classifications by placing the current groups first, except where current resources are insignificant as compared with fixed properties. As further testimony to the importance of working capital many corporations make it a regular practice to present a statement of working capital with the other statements in the annual report. In 1946 the Caterpillar Tractor Company introduced a new form of balance sheet for the purpose of making the information more understandable and meaningful. It is significant that this statement begins with current assets from which current liabilities are deducted, and the difference is labeled net current assets. Since

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[1]Gilman, Accounting Principles and the Current Classification, The Accounting Review, Vol. XIX, pp. 109 ff.
[2]Prime, Analysis of Industrial Securities, p. 209.

its introduction, several other corporations have adopted this form of balance sheet.

In the accountant's vocabulary, current capital is called current assets, and claims against current capital are called current liabilities. The excess of the former group over the latter is generally termed working capital. Recently, the Committee on Accounting Procedure of the American Institute of Accountants said:

> Working capital . . . is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations to be incurred and liquidated within the ordinary operating cycle of the business.[1]

Although a uniform understanding of the term working capital is important, an understanding of the groups of items from which it is determined is even more important, for it is a simple process to subtract one group from the other and call the difference working capital.

A form in which working capital information may be presented is as follows:

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[1]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 248.

Current Assets:		
Cash in banks and on hand . . .		$ 10,502.14
United States Government Securities - at cost and accrued interest (quoted market, $26,-675.19)		26,316.60
Accounts receivable		
Trade	$ 25,165.00	
United States Government .	18,170.50	
Officers and employees . .	2,505.00	
Other	1,615.12	
	$ 47,455.62	
Less reserve for doubtful accounts	8,500.00	38,955.62
Notes receivable		
Trade		7,000.00
Inventories - valued at the lower of cost (first-in, first-out) or market		
Finished goods	$ 25,214.00	
Goods in process	10,612.10	
Raw material	8,136.08	
Supplies	1,315.92	45,278.10
Prepaid insurance, taxes, and other operating expenses . .		2,516.84
Total Current Assets		$130,569.30

Current Liabilities:	
Trade accounts payable	$ 5,208.15
Trade notes payable	2,564.00
Bank loans payable	11,815.62
Accrued payroll	9,625.00
Reserve for Federal income taxes	11,562.85
Accident compensation claims payable	3,750.00
Dividends payable	10,000.00
Taxes withheld from employees .	3,765.48
Customers' deposits	2,500.00
Advance collections on sales contracts	4,600.00
Total Current Liabilities	$ 65,391.10

A presentation of the current classifications, similar to the one in this illustration, generally heads the asset and liability sides of the balance sheet. It should be emphasized that the amount of detail given varies considerably with the purpose of the statement. Those prepared for publication for the benefit of stockholders and the public are generally abbreviated, while statements prepared for credit purposes must be in considerable detail. The writer believes that it is possible to give sufficient detail to be adequate for most purposes, and still not divulge information to competitors which might give them an advantage. This illustration is offered as that type of presentation.

Working capital is supposedly significant as representing the margin of relatively liquid resources which are available for meeting obligations arising in the operating cycle. Because working capital is expressed as a dollar amount and not in relation to other factors, its value may be limited. To illustrate this point, let us assume that the current financial positions of two concerns are as follows:

	Company A	Company B
Current assets	$10,000.00	$55,000.00
Current liabilities	5,000.00	50,000.00
Working capital	$ 5,000.00	$ 5,000.00

It is obvious that the two concerns are not equally strong, although they possess the same amount of working capital. As illustrated here, the relative amounts of current assets and current liabilities must be considered in conjunction with working capital. The ratio of current assets to current liabilities (working capital ratio) is fre-

quently used to fill this need. This ratio is usually expressed as the number of times current assets cover current liabilities. Referring to the previous illustration, Company A's working capital ratio is 2.0 to 1 whereas Company B's is only 1.1 to 1. Used as a supplement to working capital, this ratio obviously meets the limitations of the working capital figure.

CHAPTER II

CURRENT ASSETS

Many different definitions have been advanced for current assets and current liabilities. In most instances, these definitions are nothing more than a rule of thumb for determining what is to be included in the current classifications of a statement of financial condition. It is to be expected that such informal rules would lack uniformity.

A part of the differences in definitions can be attributed to the trend of practice at the time. These trends are caused by changing ideas and requirements of the credit grantor, the investment analyst, and more recently, the governmental agencies charged with protecting the investor and fixing the rates for public service companies. If there has been a trend in definitions, however, it has not followed a definite time pattern. It is not unusual to find different ideas expressed by different writers whose works bear approximately the same dates. In general, the changes have been aimed at greater uniformity in the presentation of like information in the statements of companies engaged in similar functions.

The typical definitions of current assets until recent months were based upon a fixed period of time. An example of this type of definition is the one by R. H. Montgomery which states:

> Current assets are unrestricted cash and other assets which in the regular course of business will normally be converted into cash within one year.[1]

Although he says there are certain exceptions, this definition still implies a positiveness for current asset classification which the profession never enjoyed. It must be granted, however, that there are many border-line items between the current and fixed classifications, and no rule of thumb can be laid down for the precise separation between the two.[2]

The "regular course of business" implies the usual or ordinary functions performed by a business. Such functions vary considerably from one business to another. Thus a retail grocer buys and sells food products in the regular course of business, yet these same functions are entirely foreign to the regular operations of an automobile dealer. This part of the definition normally excludes from current assets such items as real estate and other fixed properties, even though the intention is to convert them into cash within a year.

Conversion may take place either as a direct result of the expenditure, or indirectly through other conversions. Expenditures acquiring products, services for sale, or materials and services with which to produce a product for sale are examples of direct conversions. Indirect conversions are called expenses in the language of the accountant. Theoretically, it is not necessary that an expend-

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[1]Montgomery, Auditing Theory and Practice, p. 83.
[2]Sanders, Hatfield, and Moore, A Statement of Accounting Principles, p. 70.

iture acquire a tangible benefit to justify carrying it as an asset, perhaps even as a current asset. An extensive advertising campaign may be expected to benefit several future periods. For this reason it should be deferred and charged against the periods it will benefit. However, accounting practice sanctions this procedure only when the advertising contract will be performed in a period subsequent to the balance sheet. This practice is conservative, and it avoids the difficulty involved in determining the amount to be carried forward and the number of periods over which it should be amortized.[1]

The selling price of products and services must be great enough to cover all costs and expenses if the business is to continue. In this sense most expenditures, if not all, result in a direct or indirect conversion, but this definition of current assets is usually interpreted as referring only to direct conversions for the reasons already mentioned.

If this definition of current assets were literally applied, it would mean, in many instances, that part of the accounts and notes receivable, and perhaps a major portion of the inventories, would be excluded from current assets. In heavy industries where current assets do not turn over during a one year period, it has long been an established trade custom to include in current assets installment notes maturing subsequent to a year from the balance sheet date.[2]

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[1] Finney, Principles of Accounting, Intermediate, p. 207 f.
[2] Robinson, Accountants' Reports and Audited Accounts, The Journal of Accountancy, Vol. LXVII, p. 82.

This is illustrated by a remark in the Annual Report of the International Harvester Company for 1934 which explains that the company wrote off a large amount of notes during the year following its established practice of charging off all notes outstanding five years or longer. None of the company's reports from 1929 to 1934 show any notes outside the current asset classification, although the statement above clearly shows that all of the notes shown were not collectible within a year.

Strict compliance with the one year rule would necessitate dividing the inventory into two portions: the portion to be converted into cash within a year being shown as a current asset, and the portion not to be so converted being excluded from this classification. This procedure is not followed because of the difficulty in determining the amount to be converted and also because it is assumed that persons interested in the balance sheet should understand the nature of the company's operations and be aware of the slow turnover of the inventory.[1]

The confusion which resulted from customarily including in current assets certain items which did not meet the requirements of the one year rule is partially eliminated by most authors by providing for such items in an explanation of their definition. Noble says, "Current assets most commonly include Cash, Notes Receivable, Accounts Receivable, and Merchandise Inventory."[2] It is impossible to say

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[1]Finney, op. cit., p. 278.
[2]Noble, Accounting Principles, p. 24.

whether such statements as the one mentioned were intended to modify the definition or merely to explain what was said. Since this is left to the imagination of the reader, he must assume it was intended as a modification to make the definition compatible with practice.

Another typical definition of current assets which generally follows the one year rule, yet is considerably more inclusive than the one which says, "will be converted," was given by the Committee on Terminology of the American Institute of Accountants in 1931. This definition states:

> Cash, accounts and notes receivable from outsiders and inventories of stock-in-trade, which in the regular course of business will be readily and quickly realized, together with such additional assets as may readily be converted into cash without impairing the business or enterprise, . . .[1] [Underscoring has been added]

The permissive phrase underlined above would permit the inclusion of such items as cash surrender value of life insurance policies and marketable securities where there is no intention of converting them within a year. Both of these items would be excluded by the more restricted "will be converted" definition.

In 1947 the American Institute of Accountants' Committee on Accounting Procedure departed from the one year concept of current assets. As has been shown, previous definitions were not uniform. Considerable variation and inconsistency were found in practice. The one year definitions were overly concerned with immediate or

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[1]American Institute of Accountants, Accounting Terminology, p. 12.

forced liquidation, and a more realistic interpretation was needed which placed emphasis upon the going concern.[1] Although this is the first formal recognition by a recognized body of the profession of the operating cycle rule for determining current assets, it was proposed as early as 1932 by Anson Herrick.[2] It is interesting to note that Mr. Herrick was a member of the committee adopting the rule, and it was through his leadership that this important change was made.

The trading or operating cycle of a business begins and ends with money. Money is exchanged for finished products, for materials, supplies, labor, and other factory services, or for labor to produce a service. The accumulated costs of the products so attained, or the costs of labor to produce a service, are converted into a receivable when the product or services to which such costs attach are sold. The resulting receivable is ultimately converted into money, thus completing the trading or operating cycle of the enterprise. "The average time intervening between the acquisition of materials or services entering this process, and the final cash realization constitutes an operating cycle."[3] In those enterprises where there are several operating cycles within a year, the one year time period should continue to be the basis for the segregation of current assets. Thus the change in basis for segregation is only in those enterprises where more than twelve months are required for a complete cycle, the

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[1]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 247.
[2]Herrick, op. cit., p. 51.
[3]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 248 f.

length of the cycle being the determining factor.[1]

It should be understood by the reader of a balance sheet that the time period for determination of current assets, using the test of the operating cycle, will vary among industries and perhaps will vary slightly among companies within a given industry. One year will continue to be the test in many short cycle industries, while the operating cycle will be used in those industries such as lumber, heavy machinery, tobacco, distillery, and others requiring more than a year to complete an operating cycle. This may appear inconsistent and perhaps arbitrary, but when it is remembered that trade practices have long been accepted as necessary modifications of the one year rule, this new rule will be accepted not as an innovation, but as recognition of present day practice.

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[1] Ibid.

CHAPTER III

CASH, RECEIVABLES, AND ACCRUED ASSETS

Cash

Accounting Research Bulletin No. 30 states that cash shown under the current asset classification should be "cash available for current operations and items which are the equivalent of cash."[1] In view of the adoption of the operating cycle as the basis for the determination of current items, availability for current operations is undoubtedly implied in the phrase "items which are the equivalent of cash." In general, this includes such items as currency, coins, checks, bank drafts, money orders, and demand deposits in banks. Although banks have a legal right to demand a certain notice before withdrawals can be made from savings accounts, they rarely exercise this right, and there is no objection to including such balances in cash. According to the terms of a loan agreement, a company may be obligated to maintain a designated amount on deposit in banks. Even though these agreements are in effect, it is customary to include these balances in cash. However, the facts should be explained in a footnote to the balance sheet if substantial amounts are involved.

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[1] Ibid.

Cash should not include such items as advances for traveling expenses, I. O. U.'s, or postage stamps. Such amounts should be accounted for as prepayments or receivables.

If a company maintains only one bank account which shows an overdraft, the overdraft must be shown as a current liability. Where there are deposits in several banks, and one of the accounts shows an overdraft but the overdraft is less than the balances in the other accounts, the net of the accounts is sometimes shown as cash. A better procedure is to show the accounts with balances available for withdrawal as cash, and to show the overdraft as a current liability, because the deficiency must be made good by deposit, and there is a liability to the bank until this is done.

Special-purpose funds, such as those for the payment of bond interest, may be included among the current assets if the purpose of the fund is to pay a current liability. However, they should be shown separate from general cash with a statement of the purpose for which they are available.[1] This includes sinking funds for maturing long-term debts, provided the maturing debt has been properly set up as a current liability.[2] If special-purpose funds are not available for the payment of properly classified current liabilities or for current operating purposes, they should be excluded from current assets. An illustration of this is contained in the annual report of the Sun Oil Company for 1946 where a sizeable cash fund for replace-

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[1]Finney, op. cit., p. 222.
[2]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 249.

ment of sunken vessels is shown below the current classification. Even though not actually set aside in special accounts, funds required for construction, sinking fund payments, liquidation of long term debts, or other purposes which are not a part of the regular trading cycle should be excluded from current assets.[1]

Accounts Receivable

The use of the term "accounts receivable" as an account shown in the balance sheet is sometimes criticised as too inclusive. In the absence of qualifying words, a reader has the right to assume that all of the receivables originated through the sale of merchandise on the company's regular terms. Because non-trade receivables have frequently been included as accounts receivable, it has been suggested that a more descriptive term such as "customers' accounts" or "trade debtors" be used.[2] The objective should be to give sufficient information to the reader to make it possible for him to form his own opinion as to the liquidity and collectibility of the accounts.

Advances to subsidiaries are generally of a semi-permanent or permanent nature, and for this reason should not be classed as current assets. If goods are sold to a subsidiary on the regular credit terms, the receivable may be included in the accounts receivable as a separate item.[3]

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[1] Ibid.
[2] Rosenkampff and Wider, Theory of Accounts, p. 205.
[3] American Institute of Accountants, Examination of Financial Statements, p. 15.

Amounts receivable from officers, directors, employees, and stockholders are frequently not as current as other receivables, and there is a question as to the proper presentation. The answer, of course, depends upon the individual circumstances. If these receivables arose through sales on regular terms, or represent advances against wages or salaries which will be repaid on the following payday, there can be no objection to including them as current items. They should, however, be separated from trade accounts.

During and immediately following World War II, many companies had claims against the government which represented a substantial part of their assets. In most instances, these claims were shown as a separate item because of their size. A receivable from an individual or a concern which is material in amount should also be shown separately because failure to collect one of these accounts might seriously affect the financial condition of the concern.

If accounts are secured or have been hypothecated or pledged as security for loans, this fact should be disclosed in the balance sheet. The amount borrowed should be shown as a liability, and the pledged receivable shown as an asset since there is only a lien rather than passing of title. The details of the security on a receivable, or the lien on pledged receivables are sometimes shown in a footnote explanation in published statements. Credit grantors generally prefer this information shown by cross reference in the

body of the statement if it is prepared for credit purposes.[1]

Assignment of accounts requires a different handling because legal title passes under a contract of assignment.[2] The usual assignment is for not more than 80 per cent of the value which means that the assigning company retains an equity in the assigned accounts, and generally is guarantor of the amount it has received. This precludes the possibility of closing out the assigned accounts as sold and carrying only the equity therein.

The facts concerning the assignment may be shown in the balance sheet as follows:

Customers' accounts:			
Unassigned		$30,000.00	
Assigned under guaranty	$12,000.00		
Less Advances and charges	9,900.00		
Equity in assigned accounts		2,100.00	$32,100.00

As collections are made, the assigned accounts and the advances and charges will be reduced by the amount of the collections.

Another presentation, which gives less detail but is equally acceptable, is:

Customers' accounts:		
Unassigned	$30,000.00	
Equity in $12,000.00 of accounts assigned under guaranty	2,100.00	$32,100.00

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[1]The Texas Society of Public Accountants, Audit Reports for Credit Purposes, p. 10.
[2]McKinney, Texas Jurisprudence, Vol. 5, p. 4.

If shown as a footnote to the balance sheet, the following style is appropriate:

> This company is contingently liable on December 31, 1947, in the amount of $9,900.00 on accounts receivable which have been assigned under guaranty.

The contingent liability is reduced when collections are made, and is computed as the original amount of assigned accounts less collections and the company's equity.[1]

Some firms sell merchandise on long terms of credit, the receivable to be collected in installments extending over several months or perhaps years. Whether or not long-term installment accounts should be included in current assets is a question of long standing. This question may have lost some of its significance in recent years, however, due to governmental restrictions on credit terms.

The American Institute's Committee on Accounting Procedure in Accounting Research Bulletin No. 30, says that installment or deferred accounts may be included in current assets, "if they conform to normal trade practices and terms within the business."[2] Receivables arising from unusual transactions, such as the sale of capital assets or advances to affiliates, officers, and employees, should not be included unless it is expected that they will be collected within twelve months.[3]

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[1] Finney, op. cit., p. 243.
[2] American Institute of Accountants, Accounting Research Bulletin No. 30, p. 248 f.
[3] Ibid.

Credit balances in customers' accounts arise from overpayments or returns and allowances after accounts have been paid. A credit balance should not be deducted from the other customers' accounts, but should be shown as a liability since the company must pay the balance in cash or other liquid assets. If there is the relationship of both debtor and creditor to one person or concern, the legal right of offset may be reflected in the accounts by showing only the net balance owed or receivable.

Other receivables which may be classified as current assets, but which should be separated from customer accounts, are debit balances in suppliers' accounts, claims against carriers for damages to goods in transit, insurance claims receivable, and advances on purchases.[1] If these receivables are collectible within the period of the operating cycle, or within twelve months in industries having more than one trading cycle per year, they should be classed as current. Under other circumstances, they should be excluded from the current classification.

As already pointed out, the current classifications are the basis for determining the short-run financial position of a concern. If the current position is to be fairly shown, the values given current assets must not be more than the amounts realizable.

The face amounts of accounts receivable are frequently greater than the realizable values for several reasons.

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[1]Finney, op. cit., p. 234 f.

First: It is customary to offer discounts to customers for prompt payment, and if discounts are taken, collections will be less than the face of the accounts collected.

Second: Merchandise may be returned or allowances made which will reduce the collectible amount.

Third: Customers sometimes pay freight charges which are the seller's obligation, and deduct the amount when paying their accounts.

Fourth: It would be very unusual if all customers to whom credit has been extended paid their accounts in full.

Unless appropriate reductions of accounts receivable are made for all of these items, working capital is overstated. While this is true in theory, practical considerations often outweigh theoretical arguments. For example, returns, allowances, and cash discounts can be deducted for income tax purposes only after they have occurred. The misstatement of working capital, in most instances, is not large enough to justify the work involved in estimating the provisions. Since the same arguments cannot be advanced for freight and bad debts, specific valuation provisions are almost invariably made for these items.

Notes Receivable

The unqualified term "notes receivable," as used in financial statements, should include at their face value only collectible, unmatured notes received from customers in the regular trading transac-

tions of a business.[1] Because of the similarity of an accepted bill of exchange to a note, acceptances are frequently carried with notes receivable. One author points out that this may not be desirable because, instead of representing a current transaction, an acceptance may be in settlement of a past due account.[2] Inasmuch as the same may be said for a note, there seems to be no good basis for this objection. On the other hand, certain types of acceptances are considered better assets than notes. Trade acceptances are more readily discounted because they arise from the sale of merchandise and are self-liquidating.

The legal difference between notes and acceptances does not seem to constitute a good reason for differentiating between the two in the accounts and statements. In fact, post-dated checks received from customers are often carried as notes receivable although they are bills of exchange which have not been accepted. The fact that a customer gives a post-dated check usually indicates that it cannot immediately be presented for payment. The same circumstances may exist at the presentment date.

Although there seems to be no good reason for distinguishing between notes and acceptances in the usual type all-purpose balance sheet, it may be desirable to make this distinction in special purpose statements. Thus credit grantors generally require that trade acceptances be separated from notes receivable, probably because of

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[1]Rosenkampff and Wider, op. cit., p. 195.
[2]Kennedy, Financial Statements, p. 31.

the self-liquidating nature of trade acceptances.

Notes receivable in the balance sheet should be subdivided into notes from customers, directors, officers, employees, affiliates, and others by name. All of these may not be current, consequently further subdivision under a non-current classification may be required.

Trade notes and acceptances receivable generally arise in and conform to the operating cycle, hence are current assets. Installment notes receivable are also current "if they conform to normal trade practices and terms within the business."[1]

Notes arising from sale of capital assets, advances to affiliates, directors, officers, and employees, and other unusual transactions are current only "if collectible in the ordinary course of business within a year."[2]

What has already been said in the section dealing with accounts receivable concerning full disclosure, either in the body of the statement or in a footnote when accounts have been hypothecated or pledged, holds equally true for notes receivable. If security is held on notes, it may be desirable to indicate the value of the security. Since collateral is usually required only from debtors of doubtful standing, the notes may be worth no more than the security held.[3]

Funds are sometimes obtained from notes before their maturity by a procedure known as discounting. The amount of the advance is the

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[1]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 248.
[2]Ibid.
[3]American Institute of Accountants, Examination of Financial Statements, p. 13.

maturity value of the note less interest charged by the discounting agency. Although title passes when the instrument is endorsed to the discounting agency, an offset account (notes receivable discounted) is credited rather than the notes receivable account because of the contingent liability on the endorsement. This liability remains until the note is settled at maturity by the maker or the discounter.

Information concerning the contingent liability on discounted notes can be adequately presented in a footnote, the notes receivable being shown net of the discounted notes. The contingent liability is generally shown at the face value of the discounted notes even though the actual liability, in the event of dishonor by the maker, includes interest. Although this understates the contingent liability, this procedure is widely followed, and no great amount of harm is likely to result because interest is usually nominal in amount.

Asset Accruals

Business was once regarded as a series of successive yet separate ventures. When one venture terminated, and before another began, most of the assets were liquid and obligations were at their lowest ebb. This was the logical time for measuring results. Assets were inventoried or appraised, obligations determined, and the remaining net assets compared with the net assets at the beginning of the venture. The increase or decrease was regarded as the profit or loss. Determining profits or losses in this manner emphasized the importance

of the balance sheet as a financial statement.[1]

As business progressed and became more standardized, it was no longer possible to distinguish one venture from another. There was no longer a definite or logical time when results could be measured, and as a matter of convenience, one year came to be regarded as the accounting period. One year remains the accounting period, although it is frequently criticized as being too short to give a fair indication of results.[2]

The convention of preparing statements each year brings about the problem of accounting for benefits which have not, and in most instances cannot be realized by collection until some future time. These benefits are usually referred to as accruals of income.

Webster says the legal meaning of accrue is, "to come into existence as an enforceable claim."[3] Then from the legal viewpoint, income is said to accrue on the date it can be collected. In accounting, income accrues minute by minute, day by day, and month by month, and the amount accrued in this manner at a statement date is recognized as income. The accountant's concept of accrue has modified the legal meaning, evidence of which is found in the Internal Revenue Code.[4]

According to the operating cycle rule, cash and other assets which are reasonably expected to be realized in cash, or sold, or

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[1]Gilman, Accounting Concept of Profit, p. 74 f.
[2]Leland, Contemporary Accounting, Chap. 2, p. 25.
[3]Webster's New International Dictionary, p. 17.
[4]American Institute of Accountants, Papers on Accounting Principles and Procedures, pp. 69 ff.

consumed during the operating cycle are current assets.[1] If this rule were followed, it would be necessary to recognize as assets and income amounts which would accrue and be collected during the ensuing operating cycle. In practice this is never done for several reasons.

In the first place, taking items into income which have not accrued at the statement date would be anticipation of profits. Accruals are recognized to the date of the statement to give a more useful reporting of income, and in this respect accruals are more important from the point of view of the income statement than the balance sheet.

In the second place, it would be unconservative to recognize an asset on which a future act or service is necessary before the benefit is owned. The benefit would never be realized if the asset on which it accrues is disposed of before the right to the benefit begins.

Accrued assets are normally small as compared to total assets, and under such circumstances there is no objection to combining them into one figure and presenting it as "Accrued receivables." In the case of investments where the discounted value is purchased and interest is realized by the maturity value being greater than the purchase price, the accrued interest should be added to the investment.

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[1] American Institute of Accountants, Accounting Research Bulletin No. 30, p. 248.

CHAPTER IV

MARKETABLE SECURITIES AND PREPAYMENTS

Marketable Securities

Certain types of investments must be considered for inclusion in the current asset section. These are the temporary investments in marketable securities representing as asset available for current operations. In general these encompass government notes and bonds, readily marketable bonds and stocks, and early maturing commercial paper.

In seasonal businesses where peak seasons are not financed by borrowing, cash balances will usually exceed requirements in slack periods. Rather than allow surplus funds to remain idle, wise management will place them where they will produce revenue. Since these are funds which will soon be required for operations, due consideration must be given to safety, freedom from wide fluctuations, and ready marketability. This leaves little or no room for speculation and due to this fact short-term government obligations are popular for this type of investment.[1]

It is sometimes contended that a small portion of a company's reacquired stock may be included in marketable securities if it is

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[1]Kester, Advanced Accounting, p. 116.

intended for sale or issue to employees. This treatment is supposedly justified by the amount not being material, which is the equivalent of saying an error is not an error if it is a small one. There seems to be as much justification for including the company's unissued stock for it too may be intended for sale or for issue to employees.

In recent years a new type of temporary investment was made available by the government to make it easier for taxpayers to meet the heavy tax burden imposed by the National Defense Program. These securities, United States Treasury Tax Notes, could be purchased by the taxpayer as income accrued to be later used as a medium for tax payment, or they would be redeemed if the purchaser so desired. The low interest yield which these securities carried, however, was lost unless they were used as tax payment media.[1]

Taxpayers considered the purchase of these notes virtually an advance payment of taxes, and thought it entirely proper to deduct them from the tax liability. The American Institute's Committee on Accounting Procedure issued this recommendation for their treatment in accounting statements:

> The usual procedure of showing the notes in the current asset section of the balance sheet is obviously proper, and especially should they be so shown if, at the date of the balance sheet, or at the date of the report of the independent auditor, there is evidence of intent to use the notes for other purposes or if such presentation is required under accounting definitions of applicable bond indentures or preferred stock agreements.

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[1]American Institute of Accountants, Accounting Research Bulletin No. 14, p. 119 f.

> Since the tax notes were presumably purchased with the intent that they be used for the payment of federal income and excess profits taxes, it is also good accounting practice that they be shown as a deduction from the accrued liability for such taxes in the current liability section of the balance sheet. The full amount of the accrued liability should be shown, and the tax notes should be deducted therefrom in an amount equal to their tax payment value at the balance-sheet date.[1]

The committee made it clear that offsetting assets against liabilities is generally unacceptable and is only justified by special circumstances.[2] Although working capital is not affected by offsetting, the working capital ratio is affected. In the following illustration showing tax notes as current assets, the working capital ratio is 2 to 1.

U. S. Treasury Tax Notes	$ 5,000.00
Other current assets	15,000.00
	$20,000.00
Federal income taxes payable	$ 6,000.00
Other current liabilities	4,000.00
	$10,000.00

Using the same figures but deducting the tax notes from the tax liability, the ratio jumps to 3 to 1.

Current assets		$15,000.00
Federal income taxes payable	$ 6,000.00	
Less U. S. Treasury Tax Notes	5,000.00	$ 1,000.00
Other current liabilities		4,000.00
		$ 5,000.00

Investments in securities of subsidiaries or affiliates are usually held for purposes of trade relations and under these conditions

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[1] Ibid.
[2] Ibid.

are not current assets. If, however, such securities represent investments of cash available for current operations, they should be included in the current section.

When marketable securities are purchased, an investment account should be charged with the cost of the security, brokerage fees, taxes, and any other expenditure incident to acquisition.

As a general rule, the cost of acquisition is the proper basis for carrying assets. Deviations are considered proper in the case of current assets, however, on grounds of conservatism and also on the theory that a decline in value should be recognized as a loss in the period in which the decline occurred. This is done in dealing with marketable securities by applying the rule, cost-or-market, the lower.

Marketable securities are merchandise, so far as security dealers are concerned, and the lower of cost-or-market is generally applied to each security. The same procedure may be followed on securities representing temporary investments of surplus cash, although the rule is usually applied differently. On these, the market value of all such securities is determined, and if lower than cost, a valuation reserve is provided for the difference between cost and market. This method offsets advances in market against declines in arriving at the market value.[1] The application of this method presents no problem if all the securities in the portfolio are disposed of in a block. If, however, individual securities are sold, problems do

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[1]Finney, op. cit., p. 401.

arise.

Assume the following facts:

Securities	Cost	Market
A	$ 10,000	$ 15,000
B	80,000	65,000
C	60,000	65,000
D	25,000	15,000
	$175,000	$160,000

The entry required to write the securities down to total market value would be:

Market loss on securities	$15,000	
Reserve for market decline of securities		$15,000

If security A, on which the market has advanced, is sold at the market value, the entry would be:

Cash	$15,000	
Marketable securities - A		$10,000
Reserve for market decline of securities		5,000

The cost of remaining securities is $165,000, the total market value is $145,000, and the balance of the valuation reserve is $20,000 which brings the book value down to market, market being lower than cost. If a gain of $5,000 had been recognized on the transaction, it would have been necessary, in order to restore the securities to the lower of cost-or-market, to increase the reserve by charging a loss account, thereby offsetting the gain.

Instead of security A being sold, let us assume that security B, on which the market has declined, is disposed of at the market value. The entry would be made as follows:

Cash	$65,000	
Reserve for market decline of securities	15,000	
Marketable securities - B		$80,000

Cost of the remaining securities is $95,000, market value is also $95,000, and the reserve account has no balance. Had a loss account been charged instead of the reserve, the securities would be valued below either cost or market.

In the event securities are sold at a price above or below the market price used in determining the required reserve, the difference between selling price and that market price would be gain or loss, as the case might be.

Prepayments

It is common practice to present such items as prepaid expenses, organization expenses, bond discounts, doubtful items, and sometimes losses not yet written off, under the heading of deferred charges. This is customarily shown as the last asset item on the balance sheet. This grouping, although illogical, no doubt found its origin in the banker's demand for highly liquid assets in the current classification. The view that prepayments do not produce realizable assets in liquidation is based upon the peculiar "dead concern" idea which is contrary to a fundamental assumption in accounting that business is a continuous chain of operations.[1]

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[1]Gilman, Accounting Principles and the Current Classification, The Accounting Review, Vol. XIX, p. 111.

At the outset, a distinction should be made between prepaid items and deferred charges. The one thing they have in common is that both are being held in suspense to be charged against a subsequent period or periods. Aside from this, they are totally unrelated. Prepaid expenses are usually of short duration and represent services or benefits yet to be received. On the other hand, deferred charges are generally of longer duration and the service or benefit has already been received but is expected to benefit subsequent periods.[1]

Manufacturing supplies are generally accepted as inventory items and are therefore worthy of the current classification. This type of supply is converted through the operating cycle, first into inventory, then into a receivable, and finally into cash. Operating supplies such as office supplies and selling supplies follow a similar conversion; the route is less direct but often shorter. Selling prices usually cover all costs and expenses (involving write-off of these prepaid items) and the same can be said for other types of prepayments such as insurance, taxes, unused royalties, and rents. It can therefore be said that they will be converted into cash through proceeds of sales of products or services.

Prepaid expenses represent investments of working capital in operating costs before these costs are absorbed in operations. Had these advance payments not been made, other current assets would be

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[1]Sanders, Hatfield, and Moore, op. cit., p. 75.

required in the operating cycle. It cannot be claimed that working capital should be reduced by the inclusion of a liability for 1949's expenses in the balance sheet of 1948, and neither can it be logically claimed that working capital should be reduced by the prepayment of these expenses.[1]

The General Motors Corporation showed prepaid expenses as current assets throughout the 1920's, but shifted them to deferred charges in their annual report for 1934 in order to conform to the report required by the Securities and Exchange Commission. Since that time the Commission has revised its requirements, and now allows prepayments for services to be received in one year to be shown as current assets.[2] This change was both logical and desirable, but it was not responsible for any great shift in accounting practice. A study of 525 corporate reports for 1946 and 1947 showed that only six of the number surveyed carried prepaid expenses in the current classification.[3]

Accounting Research Bulletin No. 30 adopted by the American Institute's Committee on Accounting Procedure in 1947 recommends that current assets include:

> . . . prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance,

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[1]Herrick, Current Assets and Liabilities, The Journal of Accountancy, Vol. LVI, p. 339.
[2]U. S. Securities and Exchange Commission, Regulation S-X, p. 13.
[3]American Institute of Accountants, Accounting Survey of 525 Corporate Reports, p. 12.

> would require the use of current assets during the operating cycle.[1]

Insufficient time has elapsed at the date of this writing to determine the final effect of this recommendation. A brief survey of current published reports indicates many accountants have eliminated the practice of excluding prepaid expenses from current assets.

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[1]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 248.

CHAPTER V

INVENTORIES

The following statement from Accounting Research Bulletin No. 29 summarizes the term "inventory" by saying:

> The term "inventory" is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in the process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.[1]

In the trading concern, inventory is the stock of merchandise held for sale. The fixed assets used to produce in one concern are often the stock-in-trade of another. Only assets held as stock-in-trade should be included in inventory. This applies with equal force to the manufacturing concern where inventories include completed goods held for sale (finished goods), goods in the process of production (work in process), and materials and supplies which will be directly or indirectly consumed in the production process (raw materials and supplies).[2]

Raw materials consist of all goods purchased by a manufacturer to which no work has been added, but must be before a product is in condition for sale. This includes raw products, such as crude oil for

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[1] American Institute of Accountants, Accounting Research Bulletin No. 29, p. 235.
[2] Ibid.

an oil refinery, and partially completed or completed products of other manufacturers such as paper used by a publisher. These materials become a part of the manufactured finished product.

Manufacturing supplies are also contributed to production but do not become a physical part of the finished product. These include such items as factory cleaning materials, machine oils, abrasives, and other maintenance materials and parts which are absorbed indirectly into production.[1] Supplies may be shown as a separate inventory, but practice indicates, at least with respect to published reports, that they are customarily included in raw materials.[2] In fact trade practice often condones inclusion of administrative and selling supplies in the material and supplies inventory if the amount is not significant.[3] The last mentioned types of supplies have been discussed under the heading of prepayments.

The work in process inventory is an accumulation of materials, labor, and manufacturing expenses incurred in producing goods which are unfinished. Before these goods are ready for final disposition (sales), further operations are required. When completed, they become a part of the finished stock termed "finished goods."

In a balance sheet, inventories should be separated into the major categories outlined above. Commercial and industrial company reports filed with the Securities and Exchange Commission must:

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[1]Neuner, Cost Accounting, p. 27.
[2]American Institute of Accountants, Accounting Survey of 525 Corporate Reports, p. 12.
[3]Kester, op. cit., p. 177.

> State separately in the balance sheet, or in a note therein referred to, major classes of inventory such as (1) finished goods; (2) work in process; (3) raw materials; and (4) supplies.[1]

This requirement of the Securities Exchange Commission is responsible for a more detailed showing of inventories than was customarily given in published reports.

Inasmuch as inventories are an essential link in the operating cycle of a concern, all of these types of inventories are usually considered current assets. But what of the inventories of the concern that has purchased considerably in excess of normal requirement for its operating cycle? Are all of its inventories to be considered current, or should the part in excess of normal operating cycle requirements be shown below the line? The theoretical problem is easily handled. Compliance with the operating cycle rule would require separation to avoid overstatement of working capital. Practically speaking, it is extremely doubtful that any of the inventory would be considered non-current, this being defended on the grounds of trade practice.

It is not necessary that goods actually be on hand to be counted as inventory so long as ownership exists. Thus goods may be in transit, out on consignment, in the hands of branch offices or agents, or in warehouses or storerooms, and still be included in inventory. Although title has not passed and an inventory inclusion is not pre-

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[1] U. S. Securities and Exchange Commission, op. cit., p. 12.

per, it may be appropriate to recognize as current assets expenditures which will lead to the acquisition of goods. The most common example of this is advances on purchases to be received and used in the operating cycle. Because an advance on goods not yet received is further from cash conversion than goods on hand, advances of this type would usually be listed after inventories in the balance sheet.

The legal test for incidence of ownership is sometimes quite complicated, and for reasons of expediency, it is a convention of accounting to assume title changes from the seller to the purchaser when delivery is made to the purchaser, or to the carrier if by the terms of the transaction the purchaser bears the freight charges. Instances undoubtedly occur where both the seller and the purchaser include the same goods as a part of their respective inventory. Of course this should be avoided if possible, but it is not particularly important if all data reflecting on financial position are shown in their balance sheets.

After full consideration is given to what is to be included in inventory, or for that matter any other asset or liability, there remains a need for further clarification. In preparing financial statements it is important that items included be determined in accordance with generally accepted procedures, but it is equally important that they be measured in terms of a common denominator understandable to all who have occasion to use statements. As implied in the term "financial statement," money is the measure used. In accounting it is an assumption, so fundamental and basic as not to be questioned,

that all items be expressed in units of money.

Still unanswered is, what is to be reflected in the measurement? Should it be liquidation value, current selling price, current cost, or initial cost? "The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset."[1] In general, the cost of purchased inventory includes, in addition to the invoice price, freight and hauling charges, insurance on goods in transit and storage, warehouse charges, duty, and costs of seasoning or aging. The cost of manufactured inventory includes the above mentioned costs on materials going into production, labor costs, and all other costs incurred in perduction. All costs incurred to place goods ready for sale should be charged to the inventory.[2]

Costs should be determined from objective data whenever possible. Some costs such as depreciation cannot be accurately determined, but this does not excuse the omission of reasonably assignable costs which can be estimated, nor does it permit the inclusion of theoretical and fictitious costs such as interest charges on fixed assets. In theory, part of administrative and selling expenses may be proper additions to inventory costs. However, this is seldom done because of the difficulties involved in apportioning these expenses, and also because such procedure is not considered conservative.

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[1]American Institute of Accountants, Accounting Research Bulletin No. 29, p. 236.
[2]Kester, op. cit., p. 158.

From the foregoing it might appear that the determination of the cost of inventory is a highly standardized procedure. This is not true in view of the fact that although the costs of purchases and the costs of manufacturing may be known, several different assumptions may be made as to the costs of goods remaining in the inventory. A different total cost will result from each of the assumptions, and any one of them may be regarded as correct.

In some instances, particularly where the inventory is composed of relatively few and bulky units, it may be possible to identify actual costs with specific items. This method, however, does not produce the most useful operating statements in a period of changing price level unless the same billing practice is consistently followed. It may be that in one period the earliest purchases are sold, leaving the latest purchases in inventory. In the following period the opposite may be true, thus producing widely varying profits and inventory valuations between the two periods. It is conceivable that this device could be employed to the detriment of non-cumulative preferred stockholders, but this possibility is often minimized by the necessity of selling the oldest goods first to prevent merchandise from becoming obsolete or shopworn.

Because it is not always possible or desirable to specifically identify costs with units on hand, assumptions as to the flow of goods may be necessary. Inventories may be priced on the basis of average cost, the average being computed on the basis of a simple average, a weighted average, or a moving average. The use of an average method implies that the cost of any goods sold or on hand is composed in part

of all goods previously purchased or manufactured. In a rising market, average cost will be below market cost, while in a falling market, average cost will be greater than market cost. Although this tendency is less pronounced when a weighted or moving average is used, under any method of averaging, inventories do not reflect current costs.

Another assumption which may be made with respect to inventory flow is that the first goods purchased are the first goods sold, first-in, first-out. This method closely alines itself with actual merchandising procedures in the distributive industries. Pricing of inventory by this method is based upon approximate current market prices, and in this respect, the balance sheet portrays "current" financial position. If the balance sheet were the only consideration involved, it is clear that this method is highly satisfactory.

The income statement must not be overlooked since its importance is as great, if not greater, than that of the balance sheet. Pricing inventory at the latest costs of acquisition means that earlier costs are matched against current sales figures. In a period of rising prices, the effect of this is high profits. It is contended that a part of the profit shown is not realized because it must be reinvested in inventory through no choice of the management.

Another method of pricing inventory based upon the assumption that the latest goods purchased are the first to be sold has been recently recognized for income tax purposes. In this method, the latest costs are matched against the current sales prices, and of course, on

a rising market a lower profit is the result. Whether or not matching current costs against current revenues is desirable or realistic is debatable. The most effective argument, and the factor which is responsible for the increasing popularity of this method, is the saving it affords in income taxes during the present high tax period.

If the balance sheet reflection of financial position is to be meaningful, the last-in, first-out method should not be used. The earliest cost realized, which is the valuation assigned to the inventory, is a meaningless residual figure. In this respect, the inventory valuation is a departure from the cost basis and an understatement of working capital.

Another method of inventory valuation, which is frequently employed, is standard cost. This method involves the keeping of cost records on the basis of predetermined standards of quantity and price for materials, labor, and overhead.

The inventory valuation is usually based upon standard rather than actual cost. The assumption here is that deviations from standard result from avoidable waste, inefficiency, and idle production facilities, and these costs have no place in inventories. If standards are frequently adjusted, the inventory valuation should closely approximate average costs realized.[1] If standards are so tight as to be unattainable, or so loose that operations are normally more efficient than the standards set, inventories will be misstated show-

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[1]National Association of Cost Accountants, Research Series No. 11, N. A. C. A. Bulletin, Vol. XXIX, p. 711.

ing a fictitious working capital as well as an incorrect profit. Because of this, inventories should be adjusted to actual unless standards are revised frequently.[1]

With the exception of the last-in, first-out method, all of the methods of inventory pricing discussed generally follow the cost basis of accounting. It is important that the method selected be consistently followed so as to make the results of various periods comparable. In this connection, it is also important that the pricing method be disclosed in the financial statements, thus making it possible for the reader to form his own opinion regarding the success of operations.

After cost has been determined by one of the accepted methods, a revision of this value may be in order. Accounting Research Bulletin No. 29 states:

> A departure from the cost basis of pricing the inventory is required when the usefulness of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as "market."[2]

This conforms to the general rule that profits should not be anticipated and provision should be made for all losses.[3] The reduction

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[1]Ibid., p. 712.
[2]American Institute of Accountants, Accounting Research Bulletin No. 29, p. 238.
[3]American Institute of Accountants, Accounting Research Bulletin No. 1, p. 6.

to market is based on the assumption that a decline in market purchase price will be closely followed by a decline in selling price; therefore, carrying inventory into the following period at a price greater than market will not permit cost to be recovered in future periods.

CHAPTER VI

CURRENT LIABILITIES

There seems to have been greater acceptance of a single definition in the case of current liabilities than in the case of either current assets or working capital. No doubt, this is accounted for by the less complicated nature of problems relating to current liabilities. Valuation, always a major problem with current assets, is secondary in dealing with current liabilities.

The chief problem with respect to current liabilities is what liabilities belong in the current liability section? This question has generally been answered with a time test such as:

> A current liability is a legally enforceable debt or obligation that normally will be paid within one year of the balance sheet date.[1]

It will be noted that this definition squares with the time period test for current assets. Like current assets, however, trade practices and customs have had their influence in making this rule less certain of application than the wording indicates. As Kester aptly puts it:

> The term "current liabilities" cannot be standardized; it varies and will perhaps always vary according to custom and practice in any particular trade. In the main, all debts maturing within a period of a year from the date of

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[1]Kennedy, op. cit., p. 44.

> entry or of a balance sheet and for the settlement of which the current assets must provide the funds, will be classed as current liabilities.[1]

With the recommendation of the Committee on Accounting Procedure that the operating cycle be used as the basis for the segregation of current assets, it was logical that a similar recommendation should be made for current liabilities. A part of that committee's report is as follows:

> The term "current liabilities" is used principally to identify and designate debts or obligations, the liquidation or payment of which is reasonable expected to require the use of existing resources properly classifiable as current assets or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, . . .[2]

Certainly this gives the profession a much more comprehensive and workable rule than the one year test. Should exceptions to these recommendations be necessary, the committee emphasised that they should be dealt with according to the merits of the circumstances and under the general principles outlined.[3]

Accounts Payable

Preferably accounts payable should include only amounts owed for purchases of merchandise and materials required for operations. It is important that this type of obligation be separately stated,

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[1]Kester, op. cit., p. 378.
[2]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 249.
[3]Ibid.

so it will be possible for interested persons to determine the ratio between purchases and the outstanding obligations on purchases. This ratio indicates whether or not liabilities for merchandise are being liquidated within the usual credit terms of the industry, thus giving an indication of current financial standing.[1]

The incurring of an obligation for purchases increases current assets as well as current liabilities, and presumably the obligation will be liquidated with cash realized from sale of the merchandise or from other current resources. Normally accounts payable should be classified as current liabilities if it is reasonably expected that their liquidation will require current assets or the creation of another current liability.[2]

Special purpose statements such as those prepared for banks and other credit grantors are usually required to show separately accounts which are past due. This would be valuable information in an all purpose statement, but it is a refinement which is rarely followed.

Merchandise which is on consignment from another concern should not be included in inventory because title to the goods rests in the hands of the consignor. By the same token, a liability should not be shown. This exclusion of consigned goods should not be confused with merchandise purchased but not yet received. If title has passed, this merchandise should be included in inventory and the liability

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[1]Finney, op. cit., p. 451.
[2]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 249.

therefor recorded.

Returns and allowances or overpayments sometimes effect a shift in status of an account from that of debtor to creditor. If a significant amount is involved, the full amount of credit balances should be displayed as a current liability and the debit balances as a current asset with an appropriate title such as "debit balances in suppliers' accounts." As previously stated in the section dealing with accounts receivable, if there is a relationship of both debtor and creditor with the same individual or concern, the legal right of set-off may be exercised and the net amount shown as a current liability, or as a current asset if that is the condition.

The Committee on Accounting Procedure recommended that short-term obligations not arising out of the normal trading cycle be classified as current liabilities if they are to be paid out of current resources within a short period of time, usually one year.[1] The committee was faced with the necessity of recognising that obligations for which specific retirement provisions have not been made eventually become claims against current resources. Because of the difficulty involved in establishing the time when this occurs, the committee arbitrarily set the test as one year from the statement date. The writer believes that the committee was influenced by the customary one year interval between statements in recommending the carry over of the time test in this instance.

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[1] Ibid.

Notes Payable

A notes payable is a written and signed promise to pay a definite sum of money on a fixed or determinable date. Notes may arise in connection with the purchase of merchandise, the borrowing of funds, or the purchase of capital assets. The circumstances giving existence to the obligation do not govern the propriety of its classification as a current liability. Again the test is whether liquidation is reasonably expected to require current assets or the creation of another current liability.[1]

Notes which are secured by a pledge of property should be separated from unsecured notes and a contra reference made to the pledged assets. If the total amount of notes is not material, it is usually satisfactory to indicate parenthetically the amount secured without making a separation.

Trade notes should be shown separate from other notes. This is important because an unusual volume of trade notes in a given industry may indicate financial weakness necessitating settlement of accounts with notes. In this connection, if it is a usual trade practice to accept drafts in payment of purchases, there is usually no objection to including these acceptances with the trade notes. There is no essential difference between notes and acceptances as they are both written promises to pay, and the accounting treatment is gener-

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[1] Ibid.

ally identical.

When funds are borrowed on notes, interest is frequently deducted from the face of the note; consequently, the actual liability is less than the face amount until the note matures. Theoretically it is proper in a balance sheet prepared in the interim to exhibit the liability at its face less the unexpired portion of the asset (prepaid interest). Despite theoretical considerations, however, accountants customarily display the face amount even though this will not be the amount due until some future date.[1]

The obligations represented by negotiable instruments issued to obtain funds should be presented in the balance sheet so that those to banks, affiliates, directors, stockholders, employees, and others will be separately shown. The sources from which a company obtains funds may have significance when funds cannot be obtained elsewhere and investors and creditors find it necessary to make additional advances to protect their investments. Although it is probable that the concern may not be able to pay such obligations when due, they should be included in the current section if their redemption will create another current liability.[2]

In a sense, obligations incurred in the purchase of capital assets are usually an incident of normal operations. The assets acquired do not enter directly into the trading cycle, however, and

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[1]Canning, The Economics of Accountancy, p. 34.
[2]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 249.

the obligation is not necessarily a claim against current resources. If the terms of such obligations provide for installment payments, there is an implication that payments are to be met from proceeds of future operations. There is little difference between maturing installments and future rental payments which would be required had the asset not been purchased. In one case, a liability must be recorded, while in the other, there is no present liability. They are both claims against future operations rather than against existing current resources.[1]

It becomes necessary to recognize liens on existing resources only when installments mature. This is accomplished by presenting the matured installments as current liabilities. Such presentation is necessary when their regular and ordinary liquidation is expected to occur within approximately twelve months.[2] Exceptions occur when a sinking fund has been provided for liquidating the debt, or the debt is to be refunded. There is no claim against current resources unless the sinking fund is considered a current resource. Since neither the fund nor the liability is a part of the operating cycle, it appears that both should be omitted from the current classifications with an appropriate explanation of the reason for the omission.[3]

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[1]Herrick, Current Assets and Liabilities, The Journal of Accountancy, Vol. LXXVII, p. 53.
[2]American Institute of Accountants, Accounting Research Bulletin No. 30, p. 250.
[3]Ibid.

The liability for funds borrowed on life insurance policies should be included in the current classification if by the terms of the obligation or by intent the obligation is to be repaid within twelve months. The cash surrender or cash loan values of life insurance policies are not current assets and pledging them as security for loans does not alter their noncurrent classification. If it is expected that the loan will not be repaid but will be liquidated by deduction from the proceeds of the policy at maturity or cancellation, the liability should not be included in the current classification.[1]

Accrued Liabilities

As previously pointed out in connection with accrued assets, accruals are seldom evidenced by legally enforceable claims. They are recognized primarily for a more useful and accurate reporting of income. In the case of accrued liabilities, the recording involves a charge against revenues offset by a credit to a liability. The importance of the liability so created must not be slighted and the nature and presentation of this type of liability is the topic of this discussion.

Common accruals are for wages, salaries, commissions, interest, taxes, rents, and royalties. It is not necessary that the party or parties to whom debts are owed be known or that the exact amount of

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[1] Ibid.

the claim be determinable.[1] It is important that the claim be established in the records by estimation, or objective data if obtainable, so working capital will not be overstated. Accruals determined by estimation are commonly designated as "reserves" or "estimates," but this does not in any way influence the classification.

Accrued debts which arose in operations directly related to the operating cycle are not matured in the sense of being payable immediately, but they are expenditures which have been made and will be payable in the near future. The time element does not come into play on such items, because they will be liquidated in the operating cycle and should therefore be included in current liabilities. Operating reserves which are expected to be required to cover expenditures within twelve months subsequent to the balance sheet date should also be included in the current classification. Examples are provisions for accruing bonus payments and estimated claims on guaranty of services or products. Income taxes are current even though the entire amount is not payable within twelve months.[2]

Deferred Credits

Deferred credit implies a dynamic or income statement point of view rather than a static or balance sheet position. The flow of revenues into the stream of future operations is suggested by the

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[1] Ibid.
[2] Ibid.

term. Future revenues are a mixture of liability and profit and must be considered for inclusion in the current liability classification. Although of a somewhat different nature, collections for the account of third parties will also be considered in this section.

The liability arising from collections in advance of the delivery of goods must usually be liquidated from current assets. Common examples are sale of merchandise coupons or tickets and advance subscriptions to publications. In such cases, the funds received are generally merged with the current resources, and there is a claim on the funds received in the event delivery of goods is not made or on the goods until they are delivered. In other words, current assets are increased by the advance collection and unless current liabilities are also increased, working capital is overstated. Transactions of this nature which arise as a part of normal operations and which are reasonably expected to be liquidated in the normal operating cycle are current liabilities.[1]

Along with the recording of a transaction by a concern, there is a reciprocal recording by the other party to the transaction. For example, let us assume a concern pays its monthly rent in advance of the use of the property. This concern accounts for an asset (prepaid rent) which will be absorbed into operations as an expense. As previously pointed out, this type of asset belongs in the

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[1] Ibid.

current classification. Examining the position of the other party, we find that the rent received is not an earned income. In fact, it is a liability to allow the use of property for a designated time. Now assuming that one concern has both prepayments for services and collections in advance of rendering services, it becomes obvious that they are contra items; one is a current asset, the other a current liability. Like current prepayments, collections in advance of rendering services should be judged by the operating cycle and included in a current classification if the services are to be rendered within the operating cycle.[1]

Amounts collected for the account of a third party, such as taxes withheld from the wages of employees, are liabilities which must usually be liquidated in cash. The claim is against a current asset and the amount which is expected to be settled within approximately one year of the balance sheet date should be displayed as a current liability.[2]

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[1] Ibid.
[2] Ibid.

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