Accounting, Economics, and Law

A Convivium

Volume 1, Issue 2

2011

Article 2

Economists and Accountants

A. Charles Littleton, *University of Illinois*

Recommended Citation:

Littleton, A. Charles (2011) "Economists and Accountants," *Accounting, Economics, and Law*: Vol. 1: Iss. 2, Article 2.

DOI: 10.2202/2152-2820.1038

©2011 Convivium. All rights reserved.

Economists and Accountants

A. Charles Littleton

Abstract

Economists and accountants work within differing disciplines. And ideas suitable to one probably will seldom be directly suitable to the other without change in connotation. Nevertheless, debate about concepts of income, as one example, is a healthy development since discussion can lead to better mutual understanding between fields that are inescapably in constant contact.

KEYWORDS: accounting and economics, accounting theory, economic theory, business income, corporate income, capital and income, price level change, social accounting

JEL Classification Codes: A12, M41, B10

Acknowledgements: A.C. Littleton [1886-1974], Ph.D. [1932, University of Illinois], C.P.A. [1919, Illinois], is Professor of Accountancy [1915-1952], Emeritus, University of Illinois. Former editor of "The Accounting Review" [1944-1947], he has served as president [1943] and director of research of the American Accounting Association and is a member of the Accounting Hall of Fame [since 1956]. This article is adapted from one of a series of graduate lectures presented at Michigan State University in 1955. Originally published in The Illinois Certified Public Accountant, 1956, p. 18-24. Chicago (IL): Illinois CPA Society (ICPAS). Reprinted courtesy of INSIGHT Magazine, The Magazine of the Illinois CPA Society. For the latest issue, visit www.icpas.org/insight.htm.

Accounting and economics have been closely interrelated longer than most people may realize.

Double entry bookkeeping – the continuing backbone of accounting – was fully developed in its essential features by the end of the fifteenth century. Its procedure made a systematic record of enterprise capital employed productively under the guidance of management, and a record of income generated by management's use of the invested assets. Clearly double entry, a very long time ago, was the record side of economic action – records of investing, of buying, selling, judging, risking, records related to servicing the economic wants of customers.

Businessmen in those early days knew that capital, productively employed, could reproduce itself and generate income. They knew, too, that income saved became new capital. Through long trial and error men converted mere memoranda of debts into a recording methodology which translated these naturally related economic phenomena into integrated, quantitative measurements of capital and income.

This integration was accomplished in the record by means of interrelated accounts for assets and accounts for expense-income. These two major classes of accounts were called about a century ago by a German writer “accounts of remainders” and “accounts of results”. We call them by the much less informative terms of “real and nominal accounts”.

The early literature dealt only with methodology. Textbooks included nothing we could call theory. It fell to eighteenth century economists, apparently without conscious intentions to supply a theory framework for double entry bookkeeping by their writings about capital and income. Capital they considered a stock of goods productively employed; income as wealth created over a period of time by the employment of this capital. Hence, capital is like a fruit tree; income is like the tree's fruit. The income (fruit) may be consumed or as seed invested to replenish or expand the orchard.

With twentieth century perspective we can see that fifteenth century businessmen were reacting in very practical ways to the inherent nature of the economic factors we call capital and income. We can see that eighteenth century economists were describing in words the inherent economic nature of capital and income. Centuries apart both businessmen and economists were dealing with the same social phenomena – particularly with the productivity of capital under independent enterprise management, and with the profit motive as an incentive to capital risk and managerial efficiency. The world is still benefiting from this wedding of economic practice and economic explanation.

From this background it would seem that the ideas of economists and accountants should be in close agreement. Yet such is not the case in some important particulars. Because this is so, it would be in the public interest if these

two parties came to understand each other more fully. The need for this mutual understanding has been given some attention on the side of accounting instruction. Accounting majors in these days study economics as well as accountancy. And the higher they go in academic work, the more economics they take.

This curricula requirement is a natural result because educators perceived two things about accountancy: (1) that accounting translates economic actions, particularly actions affecting business enterprises, into quantitative terms suitable for classifying relevant enterprise events into interpretative categories; (2) that the recording methodology compresses the economic decisions and experiences of enterprise management in a manner which makes the data particularly useful for back reference and guidance toward the future decisions.

This useful service began come 500 years ago with the appearance of double entry bookkeeping. While that methodology may seem to a casual observer to be little more than clerical work, the fact is the practical procedures there introduced were so basic that they could be satisfactorily continued in use for centuries and in modern times could prove surprisingly adaptable to highly complicated new situations.

Although economic action has always been taking place, economics as we understand the term is a newer discipline. During most of its development as a field of knowledge, economics has been philosophical in approach—that is, it leaned towards reasoning along historical and theoretical lines concerning the way people make a living and react to their economic surroundings. It is only in relatively recent years that refinements and broadening have made statistical methodology into an instrument for producing quantitative measurements suitable for economic reasoning.

Students who major in economics usually include some study of statistical methodology. But that other quantitative discipline, accountancy, is seldom a part of the program. I have often wondered why, since accounting is very significantly related to the firm and its management, and that section of theory, micro-economics, is closely concerned with studying “the firm”.

Accounting shows some of the aspects of statistical methodology, but does not go so far as to include time series. Accounting classifies data about economic acts, but only for those transactions which directly involve a given enterprise. Perhaps this subject is not often accepted by students of economics because accounting instruction is still organized strongly along time-consuming lines and with continued emphasis on technical procedures as such. Or perhaps it is because accounting data, being created for individual business enterprises, do not suitably express economic data for the nation as a whole. This last would seem a not unreasonable surmise since economists from the time of Adam Smith’s “Wealth of Nations” have been accustomed to concern themselves with a society as a body of individuals.

For example, considerable interest is now developing in what is called “social accounting”. This is a statistical approach to an extensive organizing of data dealing with nationwide economic activities. These statistics are desired so that governmental policies may be formed which may help prevent imbalance between segments of the economy.

This ideology is compactly expressed by a recent writer in these words:

“An essential preliminary to the formation of consistent (governmental) policies is a catalogue of information about receipts and payments throughout the national economy... The most appropriate way to set out this information is in the form of a system of accounts.”¹

It may be noted in passing that enterprise accounting has progressed a long way beyond reporting on receipts and payments. Perhaps it is not too much to say that this change is one of the major refinements of accounting technology, and thus makes of accounting a more effective aid to the decisions of managers and investors.

In contrast to the interest economists have in society and the individual people who make up society, accounting has seldom sought to serve individuals separate from a business enterprise and has never aspired to attempt to classify economic action for the whole of a nation. These are inherent differences and both parties would do well always to bear them in mind.

Differences in the thinking by economists and accountants about account data have become clearer in recent years in connection with a still continuing discussion of the statistics of national income as part of “social accounts”. It is understandable that new clarity now should be appearing; the viewpoints of the two groups are being more clearly brought out by discussion.

Economists have become increasingly concerned about events which affect the nation’s well-being. This interest seems to have been associated with a marked increase in conditions which conspired to give emphasis to the power of central government to become a factor in the national economy.

When decisions of vast economic importance are to be taken within central government, they should of course rest as much as possible on dependable economic statistics. In no other way can men’s minds comprehend the complex issues and screen out emotional reactions. Economic statisticians, eager to improve nationwide statistics, have become dissatisfied with those data which derive from enterprise accounts.

The essence of their corrective proposal lies in the idea that statistics of national income would be improved if the cost figures used by business in

¹ Gilbert Walker in Chapter 9 of *The Accounting Field*, Donald Cousins, ed. London, 1954.

computing enterprise income were modified. The modifier would be a series of index numbers representing the fluctuations registered by changing wholesale price levels. The index would be used to multiply invested dollars into so-called current equivalent dollars.

The theory back of the proposal is that such an adjustment would eliminate from the accounting figure of profit the effect of rising price levels. Accounting net income without such an adjustment has been called “unrealistic”. It is said that this kind of modification would convert accounting net income into a “realistic” figure.

Most accountants, however, are still unconvinced by this asserted distinction between realistic and unrealistic. But it may be of interest, therefore, to take a brief look at some of the ideas which keep economists and accountants from more ready agreement in the matter of calculated net income.

For example, economists and accountants have quite different basic ideas of income. As long as this situation exists, the parties will be likely to differ as to the realism of accounting calculations that use dollars of invested cost. Yet this fact need not stand in the way of increased mutual understanding.

Economists view income as a complex of several ideas of which three are mentioned here:

(1) Income is wealth which the owner can disburse over a period of time and be as well off at the end as at the beginning. Here is a strong leaning toward analogy to personal well-being. Presumably, by this concept, a business enterprise—a social institution—could have no “earnings” unless it were as well off in value of assets at the end as at the beginning of a period. The influence of price level changes and of the price of asset replacements would under these ideas seem inescapably involved in the calculation of current well-being.

Such reasoning seems to be appropriate in regard to the well-being of a person. But is it equally suitable to reasoning about an impersonal, economic institution such as a business enterprise?

(2) A second idea of interest here is that economists consider the current value of a business enterprise to be measurable by capitalizing the expected earnings of that company.

Note that such a valuation as of two dates could be considered as providing one kind of measurement of improved financial condition. Note also that “valuation” under this concept would need to make use of *expected* earnings—this because “value” is a future-looking word, whereas “cost” is a backward-

looking word. Accountants find expected earnings unacceptable for most accounting uses. The reason is found in an unwillingness to cut loose their thinking and their service from the provable objectivity of accounts kept and financial statements made in terms of costs actually incurred by this enterprise before the current date.

This position has been given recent support by two prominent accountants, G. O. May and J. L. Dohr, in these words:

“Since 1941 it has been more and more widely recognized that books of account and balance sheets disclose the amounts that have been invested—not the value of what exists. The most natural substitute for book value would therefore seem to be book investment.”²

A more extended analysis of reasons in favor of adherence to invested cost has been made by Professor W. A. Terrill under the title “Cost Basis—Accounting’s Samson’s Tresses.”³

(3) Economists believe that the real income of an enterprise is made visible only after corrections of accounting net income have been made to eliminate the effect of “changed value of money;” that is, the effect of changing price levels. The idea inherent in the first phrase also prompts an assertion that accountants assume that money has a stable value although fluctuating price levels show how unstable the money unit really is.

It is too large a problem to undertake here to analyze the question whether the value of goods or the value of money is the unstable factor. Perhaps the dollar sign that is shown or implied before each item in financial statements is responsible for some confusion of thought. Some people may think it symbolizes value; others think of cost.

Does the symbol of a crossed S (\$) in this country or a crossed L (£) in England mean that the accompanying digits speak of a quantity of value, or of an agreed-upon price? The symbol alone does not differentiate. At the moment of exchange of an item the digits may express both value and cost. Later the same digits for the same item can only express cost. A transaction of today is an accomplished fact. The price agreed may seem to measure value as of that moment, but that “value” may soon change—for example, if customers show no interest in the merchant’s new purchase. But the merchant’s cost price does not change for that reason. If the merchandise is unsalable, his loss is measured by the invested cost, not by the customer’s current valuation of the item. If this is true for

² *Journal of Accountancy*, April, 1955.

³ NACA Bulletin, April, 1955. [Reprinted in Terrill (2011)].

a loss, can the calculation of profit from sale be logically rested on any other figure than invested cost?

Accountants are quite aware that the primary goal of their technology is measurement of enterprise income. They realize that any person's judgment of the value of an enterprise is conditioned by his knowledge of at least two matters of quantitative fact which present different problems of measurement:

1. Profits earned by the enterprise under management.
2. Possible unearned value-increments behind the enterprise.

Accountants believe that only fact number one can be measured by use of accounting. As to the second factor, they consider measurement of such increments to be beyond the reach of accounting techniques. The reason for this view is the belief that unearned increments are largely the result of the effect of general economic conditions upon personal opinions as to value in general. Hence, non-accountants using non-accounting methods would be the best people to attempt such an appraisal of subjective opinion.

We have been viewing economists' concept of income and now should look more closely at the concept held by accountants. It starts from the idea that enterprise assets may derive from three sources:

1. From lenders, in exchange for debt pledges.
2. From proprietors, in exchange for ownership certificates.
3. From customers, in exchange for services rendered by this enterprise.

Only such assets as are derived from customers can normally qualify as being associated with enterprise net income or earnings, and then only if the asset newly received from a customer shall consist of these two measurable parts:

- a. One part that reimburses the enterprise for the cost it has invested in the items sold and in service expenses;
- b. One part that affords compensation for enterprise risk, for use of capital, for management skill exercised on behalf of the enterprise.

It is an important function of accounting to measure these two parts. In case the excess of sales price over purchase cost (goods and expense) is zero, the accounting evidence shows that customers have been unwilling to pay a price sufficient to include any compensation for the enterprise factors mentioned. The message to management is plain: somewhere policies and decisions and actions have been out of line with conditions that prevail. If sales price fails even to reimburse purchase cost, the message is the same with additional emphasis.

In further analysis of accounting ideology, we may take note of two other underlying beliefs:

(1). Belief that enterprise compensation is not directly separable into distinct rewards for risk, for use of capital, for managerial skill, and for a residual amount due to the effect of external economic movements, such as price level changes.

The reason for this view? It is that economic causes are too intermingled to be untangled for separate measurement by accounting technology.

(2). Belief that income cannot arise directly from new investments or borrowings, or by action of owners in creating an item in their accounts called “goodwill”, or by owner action in re-pricing assets already possessed.

The reason for this view? It is that no service has been rendered by this enterprise in connection with these purely financial actions.

A corollary to this reasoning is seen in this other belief: while economic change, present or prospective, may affect people’s opinion regarding the value of an enterprise or of some of its products or of its securities, yet such opinion is subjective and outside of the reviewable facts within the enterprise in question. For this reason, such opinion cannot logically change the existing ledger-account pattern of objective facts which will indicate the knowable structure of the enterprise.

Economists and accountants work within differing disciplines. And ideas suitable to one probably will seldom be directly suitable to the other without change in connotation. Nevertheless, debate about concepts of income, as one example, is a healthy development since discussion can lead to better mutual understanding between fields that are inescapably in constant contact.

Perhaps full identity of concepts and purposes is not necessary. It seems doubtful if extensive modification of such a serviceable technology as accounting would necessarily be in the public interest. Whatever corrective force might lie within accounting figures for income after adjustment by index numbers, that force would be powerless materially to counteract the ideological, financial, political, and emotional pressures which create and maintain so much dilution of the currency as to produce continuing rise of price levels—the same rising price levels which accountancy and business management are being admonished to change merely by modifying their accounting processes.

When they understand the concern which prompts economists to wish for different enterprise account data, accountants can take appropriate steps outside of

the customary boundaries of accounting theory and method as already proposed. Supplementary data will prove even more usable by economists than would altered financial statements. And the proven serviceability of usual financial statements to many other people will be left undisturbed.

The discussion that has lately been in progress about the impact of price level change upon accounting and the middle-ground result which seems to be emerging (supplementary statements) are examples of the kind of social service that can flow from better mutual understanding following upon careful analysis and friendly debate. Data supplementary to the use of financial statements no doubt would be acceptable to economists. And it would be clearly within the accountant's concept of full disclosure. "Full disclosure", in the view of accountants, "corresponds in economic affairs", as Professor Cannon puts it, "to the institutions of free press and free speech in political affairs."⁴

It probably is of minor importance who makes up the supplementary presentation. Accountants might well make the schedule as an adjunct to the usual financial statements—providing (1) they need not certify to it, and (2) that they will equip themselves with an adequate understanding of the needs and of methodology of economic statistics—an understanding that will carry beyond the arithmetical computations of applying a designated index series to certain key figures involved in the usual calculation of net income.

If accountants do not provide this collateral and interpretative information, economists will compute their own adjusted figures as well as may be. They probably would prefer not to undertake this task for they would readily see the need for extending their knowledge of accounting ideology, if not its methodology.

It would not be helpful if both parties avoid responsibility by taking an attitude of "let the other fellow do it." Professor John T. Wheeler has given us two sentences which seem particularly appropriate here. "Accountants have been too quick to label economics as impractical and of no use to them. Economists have been too apt to regard accounting as a useless business ritual which had no application to their field."⁵

It is not impossible that both parties are in error. Some economic theorizing—perhaps a good deal of it—is not very useful to accountants and businessmen. Perhaps economists could extend the area that could be useful, i.e., "economics of the firm." To these people, some brief acquaintance with accounting procedure may indeed leave an impression that it is ritual, i.e., strictly according to custom, convention or formulae. Could not accounting writers make other material available to students and economists? It would make good a present deficiency in accounting literature. Can we not see in the criticisms of economists

⁴ *Journal of Accountancy*, March, 1955.

⁵ Chapter 2, *Handbook of Modern Accounting Theory*, 1955. Morton Backer, editor.

a need for clear, logical, verbal explanations of and justifications for accounting concepts and ideology?

References

- Walker, Gilbert and A.A. Walters (1954), "The Social Accounts," chapter nine in Donald Cousins ed., *The Accounting Field*, London: English Universities Press.
- May, George O. and James L. Dohr (1955), "Book Value: A Brief Comment on the Stans-Goedert Article," *Journal of Accountancy*, 99 (4), April, pp. 42-44.
- Cannon, Arthur M. (1955), "Accounting as a Social Force," *Journal of Accountancy*, 99 (3), March, pp. 60-66.
- Terrill, William A. (2011) "Cost Basis: Accounting's 'Samson's Tresses'," *Accounting, Economics, and Law – A Convivium*, 1 (1), Article 9. URL:
- Wheeler, John T. (1955), "Economics and Accounting," chapter two, in Morton Backer ed., *Handbook of Modern Accounting Theory*, New York: Prentice-Hall Inc.

Biographic Note

A.C. Littleton [1886-1974], Ph.D. [1932, University of Illinois], C.P.A. [1919, Illinois], is Professor of Accountancy [1915-1952], Emeritus, University of Illinois. Former editor of "The Accounting Review" [1944-1947], he has served as president [1943] and director of research of the American Accounting Association and is a member of the Accounting Hall of Fame [since 1956]. This article is adapted from one of a series of graduate lectures presented at Michigan State University in 1955.