

THE REALIZATION CONCEPT: THE NEED FOR OBJECTIVE EVIDENCE

by *CSG*

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CHAPTER I

INTRODUCTION

A need was never more urgent than the need for a serious examination of the state of financial reporting due to the fact that current financial statements do not supply needed information. Accountants have realized that the accounting profession has not been successful in providing useful financial statements. One of the areas where there has been much confusion and unrest has been the realization concept, a concept which has been used extensively in modern accounting theory. There has been much disagreement as to what the concept means and what the criteria for realization should be.

It was the purpose of this report to examine the realization concept in relation to holding gains and in sales transaction. Prior evaluations have not resulted in generally accepted conclusions. It was the hope of this writer to further investigate this important concept and to effect some conclusions as to the changes which will be necessary.

The realization principle plays an important role in accounting today. The historical influence of a conservative realization concept has plagued the modern theorist. Many accountants resorted to the time-honored principles of conservatism and objectivity to support their realization concept.

In order to complete this study, several problems must be clarified;

the realization concept has been introduced and defined. It has been prepared to focus on the two types of economic events that apply to the realization principle.

The goals of accounting are presented in Chapter II. It was a premise of this report that the goals of accounting must first be determined before any rules may be applied to measure accounting data.

In Chapter III a historical summary has been presented to explain the development of the realization concept, followed by a review of the current writings on this subject.

A consideration of the problems of realization is presented in Chapter IV. Critical evaluations of present practices and proposed changes have been analyzed. Since the influence of the principle of objectivity has been deeply embedded in accounting theory, a separate section has been devoted to it.

The final chapter makes recommendations regarding solutions to the problems related to a better understanding of the principles of realization.

The Realization Concept

Probably the ones who have been most confused about the concept of realization have been the accountants themselves. Various definitions of realization have differed greatly in regard to what was realized and what was unrealized.

One of the most narrow definitions of realization was written by Stephen Gilman. He required that the receipt of cash or some asset close to cash was necessary for realization.¹

¹Stephen Gilman, Accounting Concepts of Profit (New York: The Ronald Press Co., 1939), p. 102.

A somewhat contrasting opinion has been expressed by W. A. Paton and A. C. Littleton, two of the leading accounting authorities. In speaking of revenue realization they said, "Revenue is realized by conversion or product into cash or some other valid asset."² These definitions dealt with the sale of the product only. During the 1940's this concept continued to deal only with the sale. However, in 1952, thirteen years after Gilman's definition was published, H. A. Finney and H. E. Miller defined realization as "the process of converting assets into cash. It is loose terminology to speak of liquidating assets. Assets are realized; liabilities are liquidated."³ This opinion prevailed in their later writings. Finney and Miller's definitions appears to be merely a reflection of Gilman.

In 1957 the American Accounting Association defined realization. This definition was substantially different from previous ones. It stated:

The essential meaning of realization is that a change in an asset or liability has become sufficiently definite and objective to warrant recognition in the accounts. This recognition may rest on an exchange transaction between independent parties, or on established trade practices, or on the terms of the contract performances which is considered to be virtually certain.⁴

²W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Madison: American Accounting Association, 1949), p. 46.

³H. A. Finney and H. E. Miller, Principles of Accounting: Advanced (New York: Prentice-Hall Inc., 1952), p. 46.

⁴American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus: American Accounting Association, 1957), p. 3.

Also in 1957 the AAA committee report raised several questions before the accounting profession:

1. How was the statement to be interpreted?
2. What was sufficiently definite and objective?
3. How certain was virtually certain?

Its definition eliminated the need of a transaction between the entity and an outside independent party. There was no requirement of a sales transaction nor was there mention that cash or some asset close to cash had to be received. Due to the great differences of interpretation between the AAA definition and prior definitions much confusion resulted.

Many accountants today tend to follow Gilman's interpretation. This is best exemplified by a quote from J. E. Sands.

The essence of the realization concept is that no increase in wealth takes place, either in the form of business operating income or in the form of capital gains, without the sale of an asset for cash or for a legally enforceable claim for cash.⁵

Generally speaking, the AAA definition has not been accepted by accounting practitioners. However, in this report the realization concept has been expanded to include two types of economic events---the traditional concept which referred to only revenue transactions, and those which include holding gains. These two types of events have led to most of the problems that have arisen in regard to the concept.

The terms "revenue" and "holding gains" have been defined by the 1964 AAA committee on the realization concept. They defined revenue transaction as "Transaction associated with the exchange of goods and services between the accounting entity and some external group."⁶

⁵J. E. Sands, Wealth, Income and Intangibles (Toronto: University of Toronto Press, 1963), p. 41.

⁶1964 Concepts and Standards Research Study Committee, "The Realization Concept", The Accounting Review, April, 1965, p. 313.

They defined holding gains and losses as "changes in the value of resources during the time they are held by the firm."⁷

The AAA definition was different from those previously described because they segregated realization from income. Formerly authors included realization as part of income. Russell Bowers said, "Income which is not realized is generally not considered income at all."⁸ Floyd Windal pointed this out in describing the difference between the 1957 definition and previous concepts when he said:

In effect these authors are making realization a part of the definition of income. The AAA committee definition, on the other hand, views realization as a concept entirely separate from income or revenue. The test of realization is used to determine when to recognize a particular item rather than to determine if a particular item falls in a certain category.⁹

In addition to the terms which have been described a few others should be defined. The commonly used definition of revenue is "a net asset increase resulting from the disposition of the product or service of the enterprise."¹⁰ A more appropriate definition was given by Robert Sprouse and Maurice Moonitz who defined revenue as "The increase in net assets of an enterprise as a result of the production or delivery of goods and rendering of services."¹¹

⁷ Ibid.

⁸ Russell Bowers, "Test of Income Realization," The Accounting Review (June, 1941), p. 139.

⁹ Floyd Windal, The Accounting Concept of Realization. (East Lansing: Bureau of Business Research, Michigan State University, 1961), p. 37.

¹⁰ Floyd Windal, "The Accounting Concept of Realization," The Accounting Review (April, 1961), p. 251.

¹¹ Robert T. Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises (Accounting Research Study No. 3 New York: AICPA, 1962), p. 9.

In defining income the 1957 AAA committee said:

The realized net income of an enterprise...is the change in the net assets arising out of (a) the excess or deficiency of revenue compared with related expired costs and (b) other gains or losses to the enterprise from sales, exchanges, or other conversion of assets.¹³

Sprouse and Moonitz defined net income as:

Net profit (earnings, income) or net loss for an accounting period is the increase (decrease) in owner's equity, assuming no changes in the amount of invested capital either from price-level changes or from additional investments and no distribution to the owners.¹⁴

¹³American Accounting Association, op. cit., p. 4.

¹⁴Sprouse and Moonitz, loc, cit.

CHAPTER II

THE GOALS OF ACCOUNTING

Several authors of accounting literature have proposed one or more goals of accounting. J. E. Sands suggested that the measure of wealth was the primary goal. Kenneth MacNeal was vehement in arguing that usefulness was the goal of accounting.

Kenneth MacNeal suggested four goals of accounting. They include: (1) fairness, (2) truthfulness, (3) usefulness, (4) objectivity. The justification for choosing these postulates as goals lies that users of financial data expect these postulates to be present in financial statements.

Fairness

The following is a definition of fairness as presented by Arthur Anderson and Co. They stated:

The one basic postulate underlying accounting principles may be stated as that of fairness---fairness to all segments of the business community (management, labor, stock holders, creditors, customers and the public), determined and measured in the light of economic and political environment and the modes of thought and the customs of all segments---to the end that the accounting principles based upon this postulate shall produce financial accounting for the lawfully established economic rights and interest that is fair to all segments.¹

The goal of fairness should be present in all accounting data. Fairness had connoted different things to different people. It has been difficult to compromise an outcome that is fair to all people at the same time. After Anderson's definition there has arisen the problem of applying a seemingly ambiguous term into accounting literature. Namely fairness has

¹Arthur Anderson and Co. The Postulate of Accounting---What It Is, How It Is Determined, How It Should Be Used (Chicago, 1960), p. 31.

been labeled an idealistic term. C. S. Stanley defended this idea in the following quote;

For management accounting fairness is clearly inappropriate as the goal. The implications of compromise between opposing interest which surround the goal of fairness are irrelevant when accounting is carried from the standpoint of one such interest---management.²

Later the author qualified himself and said:

He should deal in an unbiased manner with information which might be unobjective. In terms of fairness, this could be interpreted to mean that the management accountant must be "fair" as between the alternatives with which he deals.³

In summary, the accountant should seek to be fair to all in recording financial data. This goal may be impossible by putting the interests of all parties in one set of financial statements. Conventional practice has not dictated that statements be fair as long as they have followed generally accepted principles. Unrealistic conventions have not resulted in fair statements.

Truthfulness

Kenneth MacNeal has been a strong supporter of the goal of truthfulness. He said:

Financial statements are undoubtedly the principle means by which investors are informed. They are undoubtedly relied on by millions of investors. But they can never become the key to the solution of the basic problem of protecting the small investor until the faulty accounting principles are changed to permit a presentation of simple truth as its instinctively understood by laymen everywhere.⁴

²C. S. Stanley, Objectivity in Accounting (Ann Arbor: Bureau of Business Research, The University of Michigan, 1965), p. 87.

³Ibid.

⁴Kenneth MacNeal, Truth in Accounting (Philadelphia, University of Pennsylvania Press, 1939), p. 57.

Elsewhere he stated that, "It becomes obvious that if assets are not correctly stated, both balance sheets and profit and loss statements must of necessity be contrary to the truth."⁵ Three fables illustrating this point written by him have been presented in Appendix A of this report. Each fable shows the result of assets being misstated. They also show how present financial statements are lacking in truthfulness.

Usefulness

Accountants should keep in mind the goal of usefulness in preparing financial statements; this goal has been placed second to truthfulness. When statements become more truthful, they will become more useful. J. E. Sands considered usefulness a prime goal when he said, "It must be acknowledged that the chief purpose is to produce accurate estimates of income and wealth."⁶

Stanley hypothesized that:

From the standpoint of the firm whose goal has been assumed to be profit maximization, it might be possible to identify usefulness with profit by proposing this hypothesis; the provision of useful information permits a firm to earn a larger profit.⁷

The main reason for the existence of management accounting has been to provide useful information for management. MacNeal has shown that this was not always the case. His fable of the investment trust produced worthless information that allowed dishonest persons to profit at the expense of

⁵Ibid., pp. 41-42.

⁶J. E. Sands, Wealth, Income and Intangibles (Toronto: University of Toronto Press, 1963), p. 7.

⁷Stanley, loc. cit.

others. Because of uncertainty, it has been impossible to present statements that were absolutely accurate. If holding gains were recognized, statements would be more useful and more truthful.

Objectivity

Objectivity has been a key argument in support of the cost principle which is an important factor in the balance sheet and has been discussed in a later section.

CHAPTER III

DEVELOPMENT OF THE REALIZATION CONCEPT

Development Prior to World War I

The accounting profession has grown rapidly in the past sixty years. In order to understand the current thought in accounting theory this writer has examined the history of the realization concept. This chapter deals with the origin of the concept and traces it to the present day.

Prior to World War I the realization concept was not generally accepted, but it was gaining support. One of the early accounting pioneers gave it strength by deleting unrealized appreciation as an element in the determination of operating income. The AAA summarized the theories of A. L. Dickinson. The report emphasized that:

Unrealized appreciation was not an element in the income from operations which was becoming more important as interests in the business became more widely distributed. Upon this point a report on profits of a corporation prepared by him (Dickinson) in 1909 is of special interest. There are shown first the profits from operations for a series of years. To the total there is added figure described as "appreciation of investment during the eight years"; thus a total is reached which is described as total profits. In his book, Accounting Practice and Procedure (Pages 80-81) Dickinson said, "It would be unfair, especially in a young and growing country, to exclude appreciation of capital assets from the accounts."¹

It is interesting to note that Dickinson proposed sixty years ago what many progressive writers have proposed in the last few years.

Some of the effects of the writings of L. R. Dicksee have been carried into today's practices. His theory was based mainly on the existing

¹American Accounting Association, Changing Concepts of Business Income, (New York: Report of Study Group on Business Income), 1952, p. 19.

practices of his time. He introduced the going-concern concept in his book, Auditing, published in 1893. In this concept he was influential in blocking the way of those who wished to depart from the cost basis of recording fixed assets. Reed Storey has commented on Dicksee's writings. He said: "A fluctuation in value caused by external circumstances was to be considered only when the business changed hands."² Later Storey said that "fluctuations in value due to external factors must not be allowed to affect the profit and loss account."³ This was opposed to the theory that many theorists have advocated today that holding gains should be entered into the accounts to arrive at the final net income figure. Other of Dicksee's ideas that prevail today were summarized by Storey in the following quote:

Profit must not, however, be anticipated, profit on manufacture being earned only when manufacture was completed, and profit on trading being earned only when the sale is completed.⁴

Dicksee justified his position in his book, Advanced Accounting, published in 1903. He stated:

The justification for thus ignoring fluctuations in the value of capital assets is that these assets have been acquired, and are permanently retained, not with the view of their being eventually realized at a profit in the ordinary course of business, but with a view of their being used for the purpose of enabling trading profits to be made in other ways...For practical purposes, therefore, these fluctuations may fairly be said to be of no account, and in any event it is quite an open question whether, pending a realization (which is not contemplated), any more reliable basis of value could be adopted than the actual cost in the first instance... Per contra appreciation in the value of floating assets might be with equal

²Reed Storey, "Revenue Realization, Going Concern and Measurement of Income," The Accounting Review (April, 1959) p. 234.

³Ibid.

⁴Ibid.

propriety be credited to Revenue, but as, pending actual realization, there must always be a doubt as to whether any such appreciation has actually occurred; it is only prudent to postpone taking credit for the assumed profit until such time as it has been actually earned."⁵

In summary, Dicksee advocated that permanent assets be valued at cost while unrealized appreciation should not be recognized and should not be included in net income. By today's standards, Dicksee was very conservative. According to Storey a problem arose as to the proper valuation of inventories. The valuation of inventories at cost was inconsistent with the going-concern concept. The realization concept answered this problem and provided the theoretical justification of valuing inventories at cost which was inconsistent with the going-concern concept.⁶

Influence of Other Accounting Theorists

Paton and Littleton. W. A. Paton and A. C. Littleton, outstanding accounting theorists, express their views on the problem of realization in the following:

Revenue...does not appear full-fledged until the product is completed and the selling price determined by actual sale. Yet it may be reasoned that, in a certain sense, revenue is "earned" during the entire process of operation reflected in the accumulation of cost assignable to product. This view is in accord with the basic assumption that all necessary activities, including distribution as well as technical production in all its phases, contribute to the final result, and hence to revenue, in proportion to the respective costs of such activities. Objective verification of the assumption is lacking, but it seems to possess inherent reasonableness, especially when compared to other possibilities.⁷

⁵Ibid., pp. 234-235.

⁶Ibid., pp. 236-237.

⁷W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Ann Arbor: American Accounting Association, 1940), p. 48.

The following shows how Paton and Littleton defined earnings and realization:

Revenue is realized according to the dominant view, when it is evidenced by cash receipts or receivables, or other new liquid assets. Implicit here are two tests: (1) conversion through legal sale or similar process; (2) validation through the acquisition of liquid asset.

Realization is in general more important than the process of earning. It is one thing to say that revenue is earned as the result of the entire process of production; it is quite another to hold that revenue can be measured and recognized prior to completion and disposition of the product.⁸

They also discussed holding gains but used the term appreciation, since the term realization was not used in accounting literature until a few years later. They rejected the notion that holding gains were realized gains or unrealized income. They confirmed this view by introducing the following study:

Does appreciation represent recognizable income? A negative answer to this query is fully justified...Appreciation in general does not reflect or measure the progress of operating activity; appreciation is not the result of any transaction or any act of conversion; appreciation makes available no additional liquid resources which may be used to meet obligations or make disbursements to investors; appreciation has little or no legal standing as income.

Appreciation is sometimes described as a form of unrealized income. This is not appropriate, if it is assumed that gains arising through the sale of appreciated property are to reported as realized income.⁹

Stephen Gilman. Approximately the same time that Paton and Littleton were writing. another authority wrote about the realization criteria in a similar but more stringent way. Gilman viewed that realization was only appropriate at the time of sale. Paton and Littleton said it may occur prior to sale, but it was not realized until the sale was completed.

⁸ Ibid., p. 49.

⁹ Ibid., p. 62.

Gilman argued that as a practical expediency realization usually occurred when the shipment or delivery was made with the intent to pass title. If collection of the sales price were in doubt, no income would be realized.

Gilman listed several illustrations which reflected whether income was realized or was not realized. The following is a summary of his illustrations:

1. A car dealer sold two identical Fords for \$250.00. He sold one to a customer and received in exchange a ten year interest bearing note for \$250.00. Income has been realized because the sale resulted in a claim to cash. He sold the other car in exchange for five shares of General Motors stock with a ready market value. No income was realized because there was no legal claim to cash.
2. When one asset was exchanged for another, no income was realized unless the new asset was a claim to cash.
3. Trading merchandise for fixed assets did not result in realization, but selling merchandise and investing the receipts in fixed assets resulted in realization.
4. If a dividend were declared and paid in merchandise, no income was realized by the recipient. If a cash dividend were declared and the stockholder later accepted merchandise in lieu of cash, income to the stockholder was realized because they were two separate transactions.
5. Accretion did not represent realized income.
6. No income was realized when a company received property as a donation.¹⁰

Illustrations 3 and 4 have shown that Gilman lost sight of the goals of accounting as presented in a previous chapter. He had to have a rule for every situation; to him rules determined income. There was no basis for saying that trading merchandise for fixed assets did not result in realization when selling merchandise and investing the receipts did result in realization. Apparently he believed that the two transactions were necessa

¹⁰ Stephen Gilman, Accounting Concepts of Profit (New York: The Ronald Press Co., 1939), pp. 102-114.

for the realization of income. Both transactions should have produced the same effect. Also the degree of objectivity was the same in both situations; however, Gilman ruled that they were not the same. Unfortunately, this situation has continued to exist.

Legal Development

U. S. Supreme Court. Accountants were not the only ones trying to establish criteria for realization; legal developments affected it also. The U. S. Supreme Court was faced with the problems of realization in court cases involving income determination. On occasion, the court was forced to determine income. Also, it was faced with interpreting the realization concept in order to determine income. In 1911, the court held that the net-worth approach to income was proper and that decision was in line with the current prevailing concepts. Shortly, the tide changed from the value approach to a cash receipts approach and became necessary before income was recognized that there had to be a high degree of certainty that cash would be received. The advent of the income tax led to the requirement that realization must take place in the form of cash receipts.

The Supreme Court defined income in the case of *Eisner vs. Macomber*, 252 U. S. 189. It stated:

Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets.¹¹

Also in explaining income from a stock dividend, the court stated:

"Far from being a realization of profit, it (stock dividend) tends rather

¹¹ *Eisner vs. Macomber*, 252 U. S. 189 (1920), cited by Floyd Windal, Accounting Concepts of Realization (East Lansing: Michigan State University, 1961), p. 27.

to postpone such realization, in that, the fund...is no longer available for actual distribution."¹² Further developments in the case of *Eisner vs. Macomber* resolved that:

Income necessarily implies separation and realization. The increase in the value of the forest is not income until it is cut. The increase in the value of the land due to growth and prosperity of the community is not income until it is realized. Where investments are concerned, there is not income until there has been a separate realized gain.¹³

It was apparent that the case described above set a precedent for many later cases, since few cases involving income or realization failed to refer to the *Eisner vs. Macomber* case. Not until 1934 did the Supreme Court rule that the accrual basis of recording income was acceptable. In 1934 a question arose as to when interest received on negotiable bonds was realized to the owner who was on a cash basis accounting system. The court held that there was a realization of income in the amount of the payment received in the year of the interest payments. In its opinion the court said:

From the beginning the revenue laws have been interpreted as defining "realization" of income as the taxable event, rather than the acquisition of the right to receive it. And "realization" is not deemed to occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.¹⁴

Influence of the Securities and Exchange Commission. The SEC's influence on accounting theory has been indirect. It has the power to prescribe accounting methods of companies within its jurisdiction and it has

¹² Ibid.

¹³ Ibid.

¹⁴ Windal, op. Cit., pp. 29-30.

been willing to permit the accounting bodies to formulate practices. It has not placed impractical controls on presentation of financial statements. The SEC has long been opposed to any write-up of assets. It clearly stated that it would adhere to historical cost in statements which were filed.¹⁵ The commission has not been receptive to proposals that would show holding gains in financial statements.

Rulings of tax authorities. Income for tax purposes differs from accounting income because each has different objectives. The Internal Revenue Service has not allowed unrealized appreciation of property to be included in income and recognized income only when the property was sold; therefore, income was realized. The tax law has allowed a cash-basis taxpayer, who sold property at a gain, to report the gain at the time he received cash. For accrual-basis taxpayers, income was realized when they received the right to cash.

The Board of Tax Appeals touched upon the realization concept in the case of the Kansas City Structural Steel Company. The Board said:

Each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income.¹⁶

Review of Current Literature

The American Institute of Certified Public Accountants and the American Accounting Association have had strong influence in the accounting profession. However, the two organizations have differed in their opinions on

¹⁵Rappaport, Louis H. SEC Accounting Practice and Procedures (New York: The Ronald Press Co., 1966), Ch. 3: pp. 9-11.

¹⁶Ross, G. Walker. "Income Accounting and the Base Stock Inventory," Credit and Financial Management, June 1938, p. 14, cited by Gilman, op. cit

accounting theory and practice. The AAA has updated the accounting theory while the AICPA has dealt with more practical problems. Many practitioners have agreed with much of the new theory which will be presented in the following pages, but they have rejected it as being impossible to put into practice.

Edwards and Bell, two outstanding authors, have introduced the holding gain concept.¹⁷ Norton Bedford has done similar work on realizable income.¹⁸ Charles Horngren advocated a "liberal recognition, strict realization" concept.¹⁹ John Myers was noted for the "Critical event" theory.²⁰ Robert Sprouse and Maurice Moonitz²¹ have rejected the realization concept while Sybil Mobley considered it a useful device.²² Many theorists have disagreed on what changes should be made, but most of them agree that there has long been a need for change. The writer will present a summary description of the above-mentioned theories in this chapter.

¹⁷Edgar O. Edwards and Philip W. Bell, The Theory and Measurement of Business Income (Berkeley: The University of California Press, 1961), pp. 73-74.

¹⁸Norton Bedford, Income Determination Theory: An Accounting Framework (Reading, Massachusetts: Addison-Wesley, 1965), p. 65.

¹⁹Charles Horngren, "How Should We Interpret the Realization Concept," The Accounting Review, April, 1965, pp. 323-333.

²⁰John Myers. "The Critical Event and Recognition of Net Profit," The Accounting Review, October, 1959, pp. 528-532.

²¹Robert Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises, Accounting Research Study No. 3, (New York: AICPA, 1962), p. 15.

²²Sybil Mobley, "The Concept of Realization: A Useful Device," The Accounting Review, April, 1966, p. 294.

AICPA Position. An AICPA approval has been required for all significant changes in accounting practice. Their position on unrealized profit was stated in Accounting Research Bulletin, No. 43, which said:

Unrealized profits should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected.²³

The AICPA held to the theory that no revenue has been earned until the point of sale and only in rare circumstances has a departure been justified. They have allowed income to be recognized at the time the product has been completed under special circumstances such as a ready market, and known selling costs. ARB No. 43 explained such departures in this way:

Only in exceptional cases may inventories be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such market value; and other exceptions must be justified by inability to determine appropriate costs, immediate market-ability at quoted market price, and the characteristic of unit interchangeability.²⁴

The AICPA has allowed firms to use the percentage of completion method of realizing income and this was done for the following reasons:

The principle advantages of the percentage of completion methods are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimate of costs to complete or of progress toward completion.²⁵

²³American Institute of Certified Public Accountants, Accounting Research Bulletin, No. 43 (New York, AICPA, 1957), p. 3.

²⁴Ibid., chapter 4, paragraph 9.

²⁵Paul Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises, Accounting Research Study No. 7 (New York: AICPA, 1965), p. 97.

American Accounting Association. In 1957 and 1964 the American Accounting issued statements on the realization concept that were of significant importance. Their position was much more flexible and more liberal than the AICPA position. The 1957 committee report stated:

The essential meaning of realization is that a change in an asset or liability has become sufficiently definite and objective to warrant recognition in the accounts. This recognition may rest on an exchange transaction between independent parties, or on the terms of the contract performance of which is considered to be virtually certain.²⁶

This definition was significantly different from previous definitions of realization. Prior to 1957 the realization of revenue meant that cash or some asset close to cash had been received. By this the concept has been broadened to include events "sufficiently definite and objective to warrant recognition." Before this time, no mention was made that cash or some asset close to cash had to be received.

The 1964 Concepts and Standards Research Committee on the realization concept faced two problems: (1) Which economic events should be recorded in the accounts and (2) How are the recorded events to be reported in the financial statements? The committee report stated:

On the first decision, the committee unanimously recommends that the effect of changes in the value of all assets, other than good will, that can be supported by adequate evidence be recorded in the accounts. For the second question, a majority of the committee recommended that "unrealized" changes in the value of assets should not be included in the computation of reported net income, but should be shown on the income statement below the net income line; on the position statement, the cumulative unrealized changes in value would be shown as a separate item in the retained earnings section.²⁷

²⁶ American Accounting Association Committee on Accounting Concepts and Standards, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, (Columbus, Ohio: American Accounting Association, 1957), p. 3.

²⁷ 1964 Concepts and Standards Research Study Committee, "The Realization Concept," The Accounting Review, April 1965, p. 312.

The Committee recommended that unrealized changes in value should be shown, but a majority of the committee felt that a market transaction involving the firm was required for realization.

The 1964 AAA committee on the realization concept discussed the problems of holding gains and losses. They concluded unanimously that holding gains and losses should be recognized and recorded in the accounts but that the unrealized holding gains and losses should not be included in the net income figure. As a result, the figure would be labelled net income plus holding gains and losses. The committee justified their position by saying that the method provided "full disclosure of relevant information but at the same time retained a net income test that gives a meaningful distinction between significantly different economic events."²⁸

It would seem that Sidney Davidson, who was chairman of the above-named committee later offered a better solution. He recommended that the sum of realized gains and income from unrealized holdings be designated as total net income. The entire amount would be carried to the retained earnings account. However, the opinion of the majority of the committee ruled that the retained earnings statement would be divided into two parts: (1) realized retained earnings; (2) retained earnings from holding gains and losses. Another AAA committee on Long-lived Assets agreed with Davidson and stated that; "the income statement would show net income as the sum of income from ordinary operation, catastrophic losses, discovery of assets, and holding gains and losses."²⁹

²⁸ Ibid., p. 322.

²⁹ American Accounting Association, "Accounting For Land, Building and Equipment," Accounting Review (July, 1964), pp. 697-698.

The Inventory Measurement Committee of AAA was split on the question whether holding gains and losses were to be included as realized income. The committee felt that holding gains and losses should be shown in the period that they occurred. The supporters who claimed the holding gains were realized contended that the definitional requirement of "objective verifiable evidence" had been met. The dissenters, while agreeing to show the holding gains and losses, believed the point of sale was the best practical measurement of "objective verifiable evidence." Charles Horngren was one of the dissenters on this committee. His alternate proposal will be explained later.

Edwards and Bell. Edwards and Bell introduced many new ideas in their book, The Theory and Measurement of Business Income. They used the realization idea with their concept of business profit and rejected it in their realizable profit method of measuring income. However, they selected business profit as the best measure and defined it as current operating profit plus realizable cost savings. Current operating profit was defined as the gain related to the production and sale of output resulting from the matching of current costs with current values.³⁰ Realizable cost savings was the increase in the current cost of assets held.³¹

In connection with business profit, Edwards and Bell presented the realization concept in the following way:

Business profit is based upon the application of the realization criterion on a production basis and on the use of the realizable principle over time. Entry values are used as a basis for valuation of assets on hand, but these entry values carry current dates; all assets are carried at current costs but not gains from production are not recognized until final sale.³²

³⁰ Edwards and Bell, op. cit., pp. 92-93.

³¹ Ibid., p. 93.

³² Ibid., p. 90.

In the summary chapter they explained their concept of realization much more clearly. They said:

We [Edward and Bell] have argued that the activities of a firm have two dimensions, time and production. The realization principle may be thought of as having two dimensions. In its time dimension, the realization principle instructs the accountant to assign values to assets on the date of acquisition and not to change them until date of sale. If the realization principle is not recognized, assets will be valued on the basis of prices prevailing at the time of valuation.

The production dimension of the realization principle, on the other hand, is based upon the form of assets upon entry to and exit from the firm. If the principle is followed entry values must dominate the accounts until final sale.³³

They were, in effect, saying that the realization concept was used differently when they spoke of current operations and the holding of assets. In current operations, the production basis was used, meaning no gains from production were recognized until final sale. A different standard was applied to assets held by the firm. In that instance, they used the realizable principle over time.

If the realization principle were abandoned in both of its dimensions, a new concept of profit would arise and would be termed realizable. This would show the change in the market value of assets from the beginning to the end of the period. However, Edwards and Bell diminished the value of the realizable profit method in favor of the business-profit method.

Norton Bedford. To Bedford the realization concept was not as important as it was to others. He did not consider that the point of revenue recognition was important in determining what was income. He defined current operating income as "the difference between regularly recurring operating revenues during a period and the current replacement cost of the

³³ Ibid., p. 274.

services used to provide the revenue."³⁴ He also said that it may be either realized or unrealized, depending on the point selected for recognition and that the time revenue was recognized was a decision the accountant had to make.

He said that part of the problem was due to the fact that there was no clear concept of what was meant by the word "realized." He felt the concept was lacking in two points:

1. There is no principle of what has to be realized, whether it is knowledge that cash will be received or knowledge that a resource is worth more than it previously was.
2. There is no statement as to whose realization, that of the accountant, the manager, or the public is the proper realization to be used.³⁵

He criticized the concept because losses were recognized at the time management decided they existed and that gains were not recognized until the resource was sold. Another criticism was the degree of realization necessary before it was considered to exist, and whose realization was to be accepted; management realization, market realization or accounting realization.

Charles Horngren. Mr. Horngren's approach has been referred to as "liberal recognition, strict realization." It allowed for recording the changes in the value of an asset, but labeling it as unrealized. At the time of the disposal of the asset, the gain was realized.

He considered recognition as one aspect of realization. He said that "recognition is primarily a problem of what constitutes reasonable verifiable evidence."³⁶ He also stated that the answer to the problem depended

³⁴Norton Bedford, op. cit., p. 325.

³⁵Ibid., p. 94.

³⁶Horngren, op. cit., p. 325.

on the practical usefulness of the suggested changes. He concluded that a liberal recognition test and a strict realization test served the interest of both economic income and accounting income. Horngren's sample balance sheet and income statement effecting a compromise has been included in Appendix B.

John Myers and the "Critical Event Theory." This theory was developed as one solution to the realization problem. Myers proposed that there was a critical event that determined when income was realized. His discussion was based on one important assumption, i.e., that profit was recognized at one moment in time and that accountants had to select that moment.

When has a profit been earned in a merchandising business? In response to this question, Myers said that a business performs three steps: (1) wise buying, (2) effective selling, and (3) efficient collecting.³⁷ When there is wise buying, a profit will be earned. If the major event is selling, a profit is earned. Where collection is critical event, it is not uncommon to defer profit until that time.

A manufacturer is faced with those three steps plus that of producing a product. He is faced with four possible critical events.

Myers' arguments did have some validity since it would be more useful if profit could be measured earlier in time. When the first stage has passed and profit can be reasonably determined, then it should be recorded but if not, then it should be recorded as soon as possible after the critical event has passed.

The "critical event" theory was exemplified by a situation where a

³⁷Myers, op. cit., p. 530.

magazine subscription was sold and cash was collected in advance. What was the critical event that the seller did to earn the revenue? Was it selling? Was it when the advertising was sold? Was it when the manufacturing costs were incurred? Is the current practice of recognizing revenue when the magazine was distributed, the correct time to record income?

When the costs of filling a subscription could be estimated with a degree of accuracy, there could be no reason why a major portion of the profit could not be recognized when the subscription was sold if selling were the critical event. It does not necessarily follow that each dollar of cost has earned an equal amount of profit.

Sybil Mobley. Sybil Mobley held that the realization concept was a useful device, but she claimed that the concept as it is known today is incomplete. Mrs. Mobley professed that there was no one point of realization applicable to all cases and therefore, there could be no universal realization concept. One should accept a realization point that would provide the most meaningful information. The problem was to select the point in time when the financial information was most meaningful. She considered that the earlier in the operating cycle realization has occurred, the less objective and definite was the resulting measure.³⁸ But what was more important: early realization and less objective data or point of sale realization and objective? Mrs. Mobley analyzed this dilemma in the following way: Less objective data could be more meaningful and could be adjusted as more data is obtained.

³⁸ Mobley, op. cit., p. 294.

Not only did she suggest several realization points, she also suggested several measures of income. For each measure of income the appropriate realization point would be selected; i.e., validated income was described as income defined by the general public. Validated income equalled actual revenues less associated costs. In this case, the point of realization was the final sale. Also, estimated earned income equalled anticipated and actual revenues less the sum of actual cost, prior productive gains and prior price gains. In that case the appropriate point of realization was the change in value.³⁹

Sprouse and Moonitz. They rejected the realization concept because it lacked analytical precision. Instead they concentrated on what they considered the real issues, the changes in assets and the related effect on profit.⁴⁰

³⁹Sybil Mobley, "Measures of Income," The Accounting Review, April, 1968, p. 340.

⁴⁰Sprouse and Moonitz, op. cit., p. 15.

CHAPTER IV

ANALYSIS OF THE PROBLEMS

In the preceding chapter the literature on the subject of realization was reviewed and examined in a historical perspective. At this time the concept must be analyzed. As was stated previously, Davidson considered the realization concept as the most important convention in income determination, while other accountants rejected it as not being an essential accounting procedure.

First, it is advisable to state the questions which serve as a basis for this analysis. They are: Has the realization concept been the hero or the villain in accounting practice? Has the realization concept been used to measure income or has it been considered a definition of income? More questions of this type will evolve as the study progresses.

In the opinion of many, as the concept has been upheld today it has been a villain. The current view of realization could still be upheld if modified to include unrealized appreciation of assets, both in the balance sheet and income statement.

It has been assumed that no truly accurate measure of income to a firm could be known until it has ceased operations and all assets have been converted to cash. It has been unrealistic to expect the firm to wait until it has gone out of business in order to know how much profit has been earned. Therefore, a method of measuring profit and losses had to be devised while the firm was still operating. Accountants had to assume unlimited life in measuring income; they had to measure the firm's successes

or failures at periodic intervals of time, usually one year. Many accountants have developed a concept of income and have proceeded to measure income as nearly as possible, while they have used the realization concept and determined what should be considered as realized.

Realization Criteria

Sprouse and Moonitz summarized several conditions that have been used as a test for realization. They included:

1. It had to be earned.
2. It had to be the result of a conversion brought about in a transaction between the enterprise and someone external to it.
3. It had to be the result of sale or similar process.
4. It had to be severed from capital.
5. It had to be in distributable form.
6. It had to be evidenced by liquid assets.
7. Its effects on the enterprise had to be the subject or accurate measurements or of estimates with a high degree or reliability.¹

In considering Sprouse and Moonitz statement, it seems that the criteria appeared orientated toward the income statement and it has also made income independent on the realization concept.

The present concept has been derived from the above-mentioned tests of realization. Naturally, before realization could occur, revenue and income had to be earned. As a result arguments have arisen concerning what was earned. The second criteria led to the exclusion of holding gains from earned income. The logic was that more objective and accurate verifiable evidence was gathered when only dealings with business firms were concerned; little attention was given to fixed asset appreciation. It

¹Robert Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises, (New York: AICPA, 1962), pp. 14-15.

was not an uncommon belief, as Dicksee said, that the value of fixed assets was irrelevant to income determination.² This caused little concern about the earning capacity of assets, just net income.

The third criterion made the concept more income-statement orientated. If a sale were required, several other items were automatically excluded; i.e., trade of inventory for a fixed asset or similar transactions. Gilman also claimed a trade of any kind was to be excluded.

The seventh criterion was of significant interest in that it presents an illusion that accountants had to supply accurate measurements on the balance sheet and the profit and loss statements. This is true, but over the past decades a certain inaccuracy has prevailed. This is due to the fact that many amounts stated on the ledger, have been determined through purely subjective methods; i.e., the different depreciation methods would naturally affect the income statement.

In addition to the above-mentioned inaccuracy, there are several accounts that are not absolutely correct. Unless the future were known with certainty, no accurate measure of the allowance for bad debts could be made. If that were the case, there would be not need for the allowance for bad debts, since the firm would know which accounts were too great a risk and would not sell to them. The same criterion also said that estimates with a high degree of reliability could be accepted. A better description would be one of a high degree of usefulness and this would be accomplished by the determination of what information was needed. As stated previously, Sybil

²Lawrence Dicksee, Advanced Accounting as cited by Reed Storey, "Revenue Realization, Going Concern and Measurement of Income," The Accounting Review, April, 1959, pp. 234-235.

Mobley said that usefulness was its own justification and also said that "the earlier in the operating cycle the point of realization is, the less objective and definite are the resulting measures."³ Naturally, this concept leads to the idea of reliability. It has been more useful to have realization recognized at an early point in the operating cycle, and therefore less reliable measures have had to be accepted. Therefore, the usefulness of the desired data should have played a more important role than reliability.

For too many years the time of sale has been the general point for the recognition of revenue. It was at that time that revenue was said to be realized. Hendriksen listed several reasons why this rule has been supported:

1. The price of the product is not established rather definitely.
2. The product has left the firm and a new asset has taken its place---an exchange has occurred.
3. For most concerns, the sale is assumed to be the most significant financial event in the economic activity of the firm.
4. Most of the costs relating to the manufacture or acquisition of the product and the costs of disposal have now been incurred or are readily determinable.⁴

With the realization criteria, exceptions were not uncommon. In the case of rare metals such as gold, while realization occurred prior to the time of sale profit on long-term contracts had been realized as the work was completed.

Realization at the time of sale allowed for minimal uncertainty and in many cases it did not offer the best measure of income. The following

³ Sybil Mobley, "The Concept of Realization: A Useful Device," The Accounting Review (April, 1966) p. 294.

⁴ Eldon Hendriksen, Accounting Theory (Homewood, Ill.: Richard D. Irwin, Inc., 1965), p. 138.

illustration has shown this: Assume that Company A was formed in period 1. It manufactured its product only after having received an order from a customer. Company B ordered the product and the selling price was \$500,000. The estimated cost to manufacture and distribute was \$400,000, resulting in an estimated profit of \$100,000. On December 31, of year 1 the product was completely manufactured and was awaiting shipment. Under both the percentage of completion and accretion method the profit was earned and recognized but under the sales method the profit was earned, but it was not recognized. Under the conditions of the sale the point of profit realization had occurred by December 31 and Myers "critical event" theory would apply to this situation. Most of the revenue had been earned when the contract was signed for the manufacture of the goods. Shipment and delivery were irrelevant in the case since the probability that the goods would be destroyed in shipment or rejected by the buyer would be so negligible that it could be ignored. Delaying recognition in the above case could not be easily justified.

The 1964 AAA committee mentioned that there were three factors necessary for realization. They were:

1. The nature of the asset received.
2. The presence of a market transaction.
3. The extent to which services have been performed.⁵

The first factor was affected by two attributes, liquidity and measurability. It was presumed that for realization to occur there had to be some evidence of receiving liquid assets; cash and receivables ranked high

⁵ 1966 Standards and Research Study Committee, "The Realization Concept," The Accounting Review, April, 1965, p. 314.

on the list. The less liquid the assets received, the more skeptical accountants became. It was an absurd practice to deny recognition of profit when payment for a sale was made with a fixed asset in lieu of cash since a normal sales price for the product sold could be determined. An approximate evaluation could be made of the fixed asset received as payment. Management had an approximate estimate of the fixed assets when it accepted the asset as payment. If objective valuations for fixed assets traded for inventoriable goods can be determined, then it would be only just to recognize a profit or a loss. The AAA committee made a good decision when they stated that measurability and not liquidity was the essential attribute required for revenue realization.

There has been a general acceptance of the view that a market transaction has been necessary for revenue to be realized and the accounting profession has followed this very closely. If revenue could be referred to as the probability of receiving an increase in value of assets held by the firm, the rule of a market transaction could be eliminated.

The following example clarifies the concept: Suppose Company A purchases some securities as an investment at a cost of \$10,000 during the year. At the end of the year the securities had a market value of \$10,300. The probability of the company being able to receive \$10,300 was greater than the probability of receiving only \$10,000 at the end of the year. The \$300 increase in value should be shown as a realized gain, since the purpose was to hold the securities with the idea that they would appreciate in value. The presence of a market transaction had no relevance in the determination of the gain for the year. Suppose further, the market value had increased to \$10,700 by the end of year two. A realized gain of \$400 should be shown. Again the assumption that the gain must be realized by the sale

of the securities should be done away with. The appreciation of the securities in the amount of \$400 was the proper amount to be recorded as the realized gain during the year. If the gain were shown as a recognized gain, but unrealized, it would be a step in the right direction. The gain was made, not by selling the securities, but by holding them while the market value appreciated. In the opinion of the writer, the best method was therefore, to show the securities on the balance sheet at their market price and to show the holding gains in the income statement. As a result there would be more accurate financial statements. A positive effect of this would be that management could no longer regulate profit by selling or holding the securities. Since the market value of the securities are easily determined, the holding gain or loss is easily stated in the accounts

Opponents have argued that: (1) It is not objective, (2) It is not realized, and (3) There is no claim to cash. Obviously, they have been wrong on all three points: The market value was objectively determined and a gain has occurred whether it was realized in the form of cash or the securities held. Since the firm had no control over the market value there was a claim for cash of \$10,700 had the company wished to dispose of the assets.

The third factor mentioned by the AAA committee was the most complex: What amount of revenue was earned as the service was performed? Two problems arose in this area:

1. How to measure the extent of the service performed?
2. How much revenue was associated with each step?

If cash were received in advance and none of the service had been performed, no revenue had been earned. If part of the service had been performed, measuring the revenue associated with the completed part had to be esti-

mated since there were several steps in performing a service; such as, order taking, production of the ordered goods, delivery and collection. A separate analysis has to be made of these functions as completed; otherwise, more confusion would probably result from departure from the point-of-sale realization.

The AAA committee report examined the "critical event" theory of John Myers. With regard to the extent of the service performed, the committee stated:

Assume a situation where a magazine subscription is sold for cash. This is a crucial event from the point of view of the seller and he should recognize some of the subscription and cash collection. Additional revenues will be recognized when the magazines are published and mailed in the next accounting period. This is a situation where revenue is joint to several time periods and two economic functions (selling and filling subscriptions)."⁶

There were problems with this approach. If one company realized fifty per cent of the subscription revenue at the time cash was received, while another company recognized all of its revenue at the time of distribution, then the statements of neither company were meaningful. Because of the difference in timing, the income statement was not only affected, but the deferred revenue account affected the balance sheet as well.

As the committee report stated, there could be no correct answer of how much revenue was earned at each step. Because of uncertainty, the true measure was impossible. However, the closer the true measure was reached the more accurate were the financial statements.

The problem was more clear cut when all the service had been performed in one period and then cash was received in the next period. It was irrel-

⁶Ibid., p. 316.

evant when the cash was received. All the service had been performed and therefore all revenue had been earned. It was not necessary to postpone the realization of revenue because an allowance for bad debts was set up for the accounts that were determined to uncollectible.

Other Current Problems

The question of obsolescence enters into the realization concept. It had not been pure in form because there were always exceptions to the rule. An analysis of the exceptions have been already presented in Chapter II.

Has the realization concept outlived its usefulness? Certainly, a yes or no answer could not be given without qualification. If realization can only be realized by a sales transaction with an outside party, and losses can be realized without a transaction, the concept is obsolete. Not only is it obsolete, it is illogical. It clearly shows how deeply embedded the conservatism principle is established in accounting theory. The realization concept has been used to present distorted financial statements by recognizing losses and not recognizing gains. Secondly, the answer to the above stated question is "no" if the profession considers realization only to be validated by a sale, but recognizes unrealized holding gains in the income statement and market values in the asset accounts. Moreover, the problem is not so much that of realization, but that of recognition of gains and losses. In that case the concept should be expanded and holding gains and losses should be recognized.

There have been several points of recognition other than the point-of-sale recognition, i.e., accruals, long-term contracts, and agricultural products and services could be recognized at the completion of production. However, most items were recognized at the time of sale. Installment sales

were recognized at the time of cash collection. Table I on page 39 summarizes the several recognition periods and the conditions under which recognition is appropriate.

Advantages of Liberalizing the Realization Concept

The accounting profession has been faced with a tremendous burden to change the requirements for realization and recognition. In this way financial statements would be much more useful. Edwards and Bell had no kind words for accounting profit. They and many others had given up on the usefulness of the conventional financial statement. In 1966 the AAA said that:

Accounting information is the chief means of reducing uncertainty under which external users act as well as a primary means of reporting on stewardship.⁷

Therefore, it should be a goal of the accounting practitioners to provide the external users with data that has significance.

Since the present and future are more important than the past, it is evident that a change in the interpretation of the realization concept is necessary. Historical data has been important only in the sense that it has been used as a guide for predicting the future. The importance of future values is based on the new definitions of assets. For the writer's purposes "assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction."⁸ This definition of assets rules out historical cost as

⁷ A Statement of Basic Accounting Theory (Evanston, Illinois: American Accounting Association, 1966), p. 19.

⁸ Sprouse and Moonitz, op. cit., p. 7.

TABLE I

CONDITIONS FOR REALIZATION

Time of Recognition	Conditions for Recognition	Examples
During production	Establishment of a firm price based on contract or general business terms or existence of market prices at various stages of production.	Accruals; long-term contracts; accretion.
At completion of production	Existence of a determinable selling price or stable market price. No substantial cost of marketing.	Precious metal; agricultural products; services.
At time of sale	Established price for the product. Reasonable method for estimating amount collectible. Estimation of all material related expenses.	Most merchandise sales.
At time of cash collection	Impossible to value assets received with fair degree of accuracy. Additional material expenses are likely, and these cannot be estimated with a fair degree of accuracy at time of sale.	Installment sales; exchange for fixed assets without objectively determined value.

SOURCE: Eldon Hendriksen, Accounting Theory (Homewood, Ill.; 1965), p. 142.

the value of recording assets. All that historical cost tells anyone is what the asset cost figure has little meaning for the present. A depreciated value of the asset has little significance but the essential factor is the present value of the asset. The value of the asset at the present moment and the future earning power of the asset are the important criterion.

No matter how one has looked at accounting there has been no completely objective accounting data. In all accounts besides cash, there has been a degree of subjectivity; therefore, there has been a degree of uncertainty present in the accounts. The accounting profession in the face of uncertainty, has tried to be totally objective; this was impossible. They limited the degree of subjectivity and allowed no flexibility in the accounting rules. One argument against holding gains, besides the fact that the gains were not realized, is that it involved the measurement of the gains. Some claimed that the gains could not be objectively measured. However, these same accountants did not seem to realize that many of the assets were subjectively determined already. The depreciated value of a plant asset points out this fact very clearly. Two identical plant assets could have different depreciated values due to different methods of computing depreciation. There have been serious doubts that the depreciated value (net value) was more subjective than an estimated market value. Also a current estimate of the value of an asset would have more relevance than the arbitrarily depreciated net value.

CHAPTER V

THE ROLE OF OBJECTIVITY

Objectivity has been a key argument used to support the cost principle in accounting and accountants have resorted to the use of objectivity as a test of reliability. Also accountants have relied on objectivity because of the existence of uncertainty. Objectivity is related to data that can be independently verified and not influenced by the personal feelings or judgments of the accountant.

What has objectivity meant to the account? One writer said that financial statements were objective when:

1. It is free from personal opinion and bias, which further requires
 - a. That there actually be an exchange of something for something, both having "value," and
 1. this exchange be the result of an arm's length transaction between independent parties,
 2. this exchange be capable of being accurately measurable in dollars,
 3. that one of the negotiating parties in the exchange be the unit for which the accounting is being done.
2. It is substantiated or capable of being substantiated by an independent investigator.¹

Objectivity has always been regarded as a principle whereby only reliable data has been entered into the accounts. Furthermore, it has been spelled out clearly by accountants in rules and has been verified and substantiated. This has provided a means to trace the origin of a recorded transaction, so that it could be examined for dependability and verification.

In spite of the merits of this principle, in reality it presented

¹Harold E. Arnett, "What Does 'Objectivity' Mean to Accountants?" Journal of Accountancy, (May, 1961), p. 66.

certain inadequacies in many areas, but particularly, in the relationship of realization to objectivity and visa versa. Did objectivity rule realization or did realization rule objectivity? A transaction was not considered realized until it could be objectively determined. Therefore, objectivity ruled realization and the objectivity principle was being used to justify the prevailing accounting practice. Likewise, realization was being used to justify the cost principle where the cost principle was inconsistent with the going-concern principle. A rule always can be conjured to justify anything.

The accounting profession set guidelines of what was objective; however, they were incomplete. Arnett tried to show what objectivity was in practice but his concept was too rigid; his description did not function. That was the key to the problem that a completely objective circumstance was rare. An element of subjectivity was present in almost all accounts, therefore, there could not be complete objectivity in the accounting practice.

This led to the problem of how much subjectivity should be allowed in the accounts. Since cash could be counted, there was no subjectivity in that account. Accounts receivable, the most liquid asset, contains a lesser degree of objectivity since the exact amount which will be collected is unknown.

In trying to make the inventory account more accurate, accountants have made the balance sheet less reliable. Conservatism has played the major role, and it was supported by objectivity, in that it required that data had to be verifiable. There have been doubts raised whether this was the preferred method. MacNeal's fable of the two flour mills exemplified it. Both companies showed the same dollar value for their inventory of

wheat. Or did it? One flour mill had twice as much wheat as the other. This showed that the cost basis was inappropriate. If market values had been used, it would have shown that one firm had twice as much wheat as the other. The income statement would have shown that one firm had an appreciated gain by buying wheat when the price was cheap.

In the following passage by Arthur Cannon it appears that the most objective value for the fixed asset is the market value, not cost or original cost adjusted for a change in the price level:

The other day we made a mortgage loan for the construction of a new shopping center. . . The land in question was the sole asset of the owner, and he had purchased it as a farm for \$8,000 about fifteen years ago. It was currently appraised at \$300,000, and we made a mortgage loan of \$350,000 for the new construction. The total value when completed to be \$650,000. The over-all price level in the period the farmer held the land approximately doubled. If we accountants prepared a statement for this farmer just before the indicated transaction, we would have shown the asset at \$8,000 and net worth at \$8,000 (other items excluded). If we took the price level change in account, we would show the asset at \$16,000 and the net worth at the same amount. The change in the price level is trivial in comparison with the over-all change in value. After the construction and the loan are completed, a traditional accountant's statement would show the land and buildings at \$358,000, the loan at \$350,000 and the net worth at \$8,000, and if the price-level change were recognized, then the asset would be \$366,000, the loan \$350,000, and the net worth \$16,000. This statement of financial condition is a long way from financial condition, whether based on cost or whether based on cost adjusted for the price-level change. What is needed, of course, is to show the land at its current value, \$300,000---in which case the total assets will be \$650,000, the loan \$350,000 and the net worth \$300,000. In that net worth should be reflected cost \$8,000, adjustment by reason of price-level change, another \$8,000 and appreciation by reason of holding in a rising market, \$284,000.²

This showed that historically objective data was not the most useful form of recording. Actually, the most objective data was the current value.

²Arthur Cannon, as included in comments of A Tentative Set of Broad Accounting Principles for Business Enterprises (New York: AICPA, 1962), p. 64.

Cost or cost adjusted for price-level change was grossly inaccurate and it would be unjust to show net worth understated by \$300,000.

CHAPTER VI
CONCLUSIONS

The traditional realization concept has outlived its usefulness and several changes have long been needed. The need for change has been advanced by a changing concept of revenue and income. Formerly revenue had regarded as "a net asset increase resulting from the disposition of the product or service of the enterprise."¹ Today's concept of revenue has been moving in the direction of the definition of Sprouse and Moonitz who said revenue was the "increase in net assets of an enterprise as a result of the production or delivery of goods and services."²

Because of the gradual change in the concept of revenue the concept of realization must also be changed. The criteria for realization have generally been fixed; it is imperative that it be changed, since the test for realization is primarily a timing device. The criteria should by no means be fixed and inflexible. In its application a point is determined at which time revenue or income is recognized. In the past, the primary concern in the determination of income was the point of sale of the product. It was recognized that income was earned during the entire production process, but it was not realized income until the time of sale because it lacked objective and verifiable evidence. Therefore, the realization con-

¹Floyd Windal, The Accounting Concept of Realization (East Lansing: Bureau of Business Research, Michigan State University, 1961), p. 37.

²Robert T. Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises (Accounting Research Study No. 3 New York: AICPA, 1962), p. 9.

cept was also a screening device. Only a sales transaction was considered to be objective; other items were excluded from recognition, since they did not achieve the degree of definiteness necessary for recognition. This writer concluded that other items are objective enough to warrant recognition, i.e., holding gains and trading an inventory commodity for a fixed asset.

Income has to exist before it can be realized. Since income considered a net increase in assets, excluding additional contributions to capital or distribution to the owners, the prior concept of income matched income as the excess of revenue over expired costs. The more modern approach has allowed the concept of holding gains to be included in the definition of income. Holding gains can be measured in most cases, and they should be included as realized income. MacNeal's fable of the two milling companies pointed out this need.¹ If two companies show inventory of wheat at cost of \$100,000 and one company has twice as much wheat as the other, something is wrong. The simple answer is to show the market value appreciation as a holding gain and showing the inventory value in the balance sheet at its current value.

The gain made by holding an asset should be recorded; it is an increase in net assets. This has been illustrated by Cannon's previous example of the appreciation of land. The amount that the assets could be sold for is the proper value to have on the financial records.

It has been concluded that holding gains should be considered part of realized income. Current practice should move toward this goal. Some writer argued that the gains should be shown as income, but they should be labeled

¹See Appendix A.

as unrealized gains. Even though this is an acceptable goal for the present, it should be considered flexible in the future. This was essentially Horngren's proposal. Also, it has been concluded that income is income and regardless whether it is labeled realized and unrealized gains. This study points out that Horngren's plan is more acceptable than the present practice.

Furthermore it has been concluded that it was not necessary for accountants to dispute over the question of whether a recognized gain was an unrealized or realized gain. The important point was that the gain be shown as a part of income.

This writer also was in agreement with Sybil Mobley that different measures of realization were needed for different measures of income. Income should not necessarily be realized at any one point in time. If measures of income can be made early in the operating cycle, they should be recorded at that time. In other cases if an accurate measure cannot be made until the time of sale, then income should not be recorded until then. It is not necessary to postpone recognition of income in all cases until the time of sale because some measures cannot be objectively determined until the time of sale.

An argument for holding gains stems from the principle of conservatism. If holding gains are not recognized in the period in which they occurred, net income is understated in that year. The net income is overstated in subsequent years by showing prior years holding gains in that year. The net income statement for the later year would certainly not be conservative.

It is the hope of this writer that some convincing arguments in support of a change have been adequately presented. It is also the hope of the writer that these changes will take place in the accounting profession without delay.

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APPENDIX A

The following fables were summarized from the writings of Kenneth MacNeal from his book Truth in Accounting, (The University of Pennsylvania Press: Philadelphia, 1939) pp. 2-15. These fables were first published thirty years ago, but they still have relevance today.

The Fable of the Two Factories.

There were two identical factories in all respects that were built by the same builder. There were two businessmen; John was a capable businessman, and William was a stupid businessman. The builder sold one factory to John for \$5,000 and the other to William for \$20,000. John formed a corporation so that he could raise money to operate his factory. He sold his factory to the corporation for the same price he paid for it, namely \$5,000 and accepted stock to a par of \$5,000 in payment thereof. John hired a public accountant to prepare a certified balance sheet. The accountant found that John's company had bought the factory for \$5,000 and prepared a certified balance sheet showing the factory to be worth \$5,000. William copied John and sold his factory for \$20,000 and accepted stock to a par of \$20,000. William hired the same accountant who prepared a certified balance sheet showing the company to be worth \$20,000.

Both men sold additional stock on the basis of their respective balances. A banker put \$5,000 cash into John's company and acquired one-half interest. A farmer invested \$5,000 in William's company and acquired a one-fifth interest.

Everyone in town except the farmer knew that the two factories were identical. William was soon arrested on a charge of defrauding the farmer. William placed the blame on the accountant, who was arrested and

brought to trial.

The accountant defended himself in the following manner. He confessed that he did not know the value of either factory and did not know what the factories could be sold for, if they could be sold at all. He did not know what it would cost to build and equip them. Therefore, he used the original cost as the basis for valuation. He claimed that he did the best he could while admitting that the difference between the two factories was absurd. The jurors disagreed on a verdict. Some thought the accountant should have made inquiries as to its value. Others thought that the accountant should have a builder estimate its value. Still others agreed with the accountant's method of valuation. Since no verdict could be reached, the accountant was released.

Yet the farmer and the banker were not treated equitably because they relied on the accountant's statement. And accountants are still performing in the same way today.

The Fable of the Two Flour Mills

Once upon a time there were two corporations that had just been formed. Each had \$150,000 in cash and no liabilities. Thus the net worth was \$150,000. Henry, a competent businessman, owned one corporation, and Bill, an incompetent businessman, owned another.

Each started business on January 1 by leasing a small flour mill for \$1,000 annual rental. At that point each had \$149,000 in cash remaining. On that day wheat was selling for \$1.00 a bushel. Henry invested \$100,000 in wheat believing the price to be as low as it ever would be. Bill knew little about the market and waited for the price to go lower. Bill put \$100,000 out at 6% interest. Then the price began to rise. By December 31 the price had risen to \$2.00 a bushel. Bill feared it would go higher

and bought \$100,000 worth of wheat by calling in his money out on interest. Thus Bill and Henry each had \$100,000 invested in wheat, but Henry had an unrealized appreciation of \$100,000, whereas Bill had realized \$6,000 in interest.

At this point each man decided to sell one-half of their stock to the public. Each had an accountant to prepare a balance sheet and income statement. The accountant showed that Henry had cash of \$49,000. He showed that Henry's wheat at original cost of \$100,000. Net assets totaled \$149,000. The income statement showed a net loss of \$1,000 for the year.

The same accountant prepared statements for Bill. The statements showed cash of \$49,000 and the wheat at its original cost of \$2.00 a bushel or \$100,000. In addition it showed additional cash of \$6,000 for the interest earned. His assets were valued at \$155,000 and had an income of \$5,000.

Both men sent their certified financial statements to a wealthy farmer. They were both willing to sell one-half interest in their businesses to the farmer for \$75,000. The farmer went to his banker for advice. The banker pointed out that Bill's business was worth \$6,000 more than Henry's and Bill showed a profit whereas Henry showed a loss. The banker indicated that Bill was the more capable businessman.

The banker and farmer were both deceived. Henry's business was actually worth \$249,000 and Bill's only \$155,000. Henry had actually earned \$99,000 during the year. He earned \$100,000 by holding the wheat for the year.

Henry converted his wheat in flour in January of the following year and sold it for a \$100,000 profit. Bill also converted his wheat into flour and sold it, making no profit.

The accountant was later questioned and indicated that he had no right to anticipate the unrealized profit on Henry's wheat. The accountant described his method of valuing inventories as conservative and reputable accountants still value inventories in this manner today.

The Fable of the Two Investment Trusts

Once upon a time there was a small group of investment financiers who formed two investment trusts. One was named the American Trust and the other was named the National Trust. Each trust started with paid-in capital of one million dollars. Each had numerous small stockholders, but both were controlled by the same group of investors. Each trust proposed to operate by investing its capital in securities that were selling cheap and selling them when the market price had appreciated.

Each trust invested its capital in identical securities. These financiers understood accounting principles. By December 31 the dividends received by the trusts were negligible, but the market value had appreciated to 20% above cost of the securities. On December 31 the American Trust was ordered to sell all of its securities in order to realize a profit. On January 1 the financiers ordered a public accountant to prepare a balance sheet and income statement. The income statement of American Trust showed earnings from dividends of \$30,000 and \$200,000 from realized profits. Total profit was \$230,000 or 23% of capital stock. Net worth was \$1,230,000. National Trust showed earnings of 3% of capital stock and net worth was \$1,030,000. It was disclosed in a footnote that the securities were worth \$1,230,000. People disregarded that fact because it was paper profit. Once the certified reports were circulated, everybody knew that American Trust had earned 23% on its capital and National Trust had earned only 3%.

The group of financiers knew that both had earned 23%. A decline in the value of one would wipe out the gain in the other because the stock price of American Trust rose sharply as investors rushed to buy it. The price of stock in National Trust declined sharply as investors disposed of it. The financiers sold stock in American Trust at a huge profit and bought stock in the other trust while the price was cheap.

By December 31 on the next year both trusts had earned an additional \$30,000 in dividends and each had further earned an unrealized profit of \$200,000 in its securities. This time National Trust was ordered to sell all of its securities and reinvest the proceeds. This was done and a profit of \$200,000 for the current year was realized in addition to the \$200,000 of the previous year. On January 1 the public accountant prepared financial statements for American Trust. It showed dividends in the amount of \$30,000 and no other earnings.

The profit and loss statement for National Trust showed dividends earnings of \$30,000 and \$400,000 in realized profits or 43% of capital stock. As soon as the reports were published the value of American stock fell and the financiers bought it at a cheap price. In turn, they sold the stock in American Trust at a huge profit. The financiers knew that both were identical in value and were intelligent enough to know that a decline in the security market which would wipe out the 20% of unrealized gain on American Trust, would also wipe out the same amount of realized profit of the National Trust, because each trust owned exactly the same quantity of the same securities.

The financiers continued this operation for years realizing huge profits because they knew the accounting firm would always maintain that unrealized profits were not income. They became wealthy and respected

and no one ever criticized them because they knew that the accounting firm would never certify a fraudulent or deceptive balance sheet or income statement. Yet year after year the small group of stockholders were deceived and defrauded because of their confidence in the trusted firm of accountants. And down to this day this firm and other firms still maintain that realized profits are earnings and that unrealized profits are not earnings.

APPENDIX B

HORNGREN'S PROPOSED STATEMENTS

Balance Sheet Accounts

December 31

	19x1	19x2	19x3
Assets			
Marketable securities--at acquisition cost.	\$1,000	\$1,000	-----
Add: Unrealized appreciation.	100	350	-----
Marketable securities--at market quotations	\$1,100	\$1,350	-----
Stockholders' Equity			
I. Recognized but unrealized income.	\$ 100	\$ 350	-----
II. Recognized and realized income.	-----	-----	\$500

Income Accounts

For the Year

	19x1	19x2	19x3
a. Gain (Loss) recognized and realized during current year.	-----	-----	150
b. Gain (Loss) recognized in prior years and realized during current year--dr. I above.	-----	-----	350
Total effects on current realized net income (a+b)-- cr. II above.	-----	-----	500
c. Gain (Loss) recognized but unrealized during current year--cr. I above.	\$ 100	\$ 250	-----
Total effects on current recognized net income (a+b).	\$ 100	\$ 250	\$150

THE REALIZATION CONCEPT: A NEED FOR OBJECTIVE EVIDENCE

by

JOHN PATRICK STUART

B.S.B.A., Rockhurst College, 1967

AN ABSTRACT OF A MASTER'S REPORT

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Better financial statements are needed due to the fact that today's financial statements leave much to be desired to its users. The realization concept is one of the areas where much improvement is needed, since it plays an important role. It was the purpose of this report to examine the realization concept in an attempt to solve some of the problems of this concept.

Many of the problems today result from the 1957 American Accounting Association definition of realization, which was substantially different from previous definitions of realization. The interpretations of this definition are still being argued today.

There are two types of economic events to which the realization concept is concerned. They are sales transactions and holding gains. These two events account for almost all problems of realization.

This writer has studied the problems of realization and has attempted to effect some conclusions. The writer has relied primarily on accounting periodicals in his attempt to analyze the problems. In most cases the writer has been able to rely on primary sources for most of his information.

This writer has concluded that several changes in regard to realization are necessary. It is imperative that a rigid realization test is no longer applicable. Economic events must be measured when applicable and revenue realization need not wait until a sale has been made. The author believes that income must exist before it can be realized, but realization does occur and can be measured in many cases prior to a sale. Also it has been concluded that different measures of realization are needed for different measures of income.

Holding gains should be recorded in the accounts, since they can be measured in most cases. It is imperative that they be recorded if accountants are to supply useful and meaningful data. The writer believes that statements can be materially distorted if this is not done. The writer has further concluded that holding gains should be included as part of net income that is transferred to retained earnings. These changes in accounting practice should take place without further delay.