

## COMMENTARY

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### Criteria for Choosing An Accounting Model

**SYNOPSIS:** Consciously or unconsciously, all choices are made by testing alternatives against a predetermined set of criteria. There has been little discussion in the accounting literature about the criteria to be used in choosing an accounting model, except to say that the resulting information should be relevant and reliable. This paper goes beyond that, by formulating seven criteria an accounting model should satisfy if it is to be preferred over competing models. The criteria are virtually axiomatic, and it is shown that our present body of generally accepted accounting principles fails to meet any of them. The criteria point, in fact, to the choice of an accounting model based, not on historical cost, but on "value to the business," i.e. deprival value.

The paper also discusses the debate, which has been going on for at least fifty years, between proponents of matching costs and revenues as the basis of income measurement and those who think that income should be measured by measuring changes in net worth, thus giving conceptual primacy to the balance sheet and changes in it. The superiority of the balance sheet approach is demonstrated, and the paper shows how the liability for and the expensing of abandonment costs, which will be incurred at the termination of a project such as the exploitation of a natural resource such as an oil field, can be accounted for more elegantly by means of a balance sheet approach than by a matching approach, contrary to what has been argued in the literature.

In 1991, Robert Elliott and Peter Jacobson, writing in the *Journal of Accountancy*, declared a "national emergency in U.S. accounting." "The U.S. financial accounting model," they said, "is broken and needs to be fixed. Its periodic, historical, cost basis financial statements served the bygone industrial era well, but are not sufficient for evaluating information-era companies." Unfortunately, that article was short on specific suggestions as to what a new model might look like. Now, as this meeting in Venice celebrates the quincentenary of the publication of Luca Paciolo's treatise on double-entry bookkeeping, we in America are "waiting for Jenkins," i.e. the report of the AICPA's Special Committee on Financial Reporting, chaired by Edmund Jenkins. One of the tasks of that committee has been to explore alternatives to the existing historical cost model. All of the evidence from the committee so far is that we

should expect no radical changes in the model, but rather some modest move towards reform.

This paper is less ambitious than the Elliott-Jacobson article, for by "accounting model" is meant no more than the traditional financial statements, the balance sheet and the income statement, and the basis on which they are prepared. (Nothing will be said about the statement of cash flows). It is truly remarkable that, 500 years after Paciolo, our financial reporting system still rests on them, and in view of the ferocity with which proposals for change are resisted, it seems unlikely that they will be superseded in the foreseeable future. In any case, the only proposal for change that I know of that does not rely on

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these familiar statements is the Utopian suggestion that corporate data banks should be freely accessible to users of financial information so that users can take whatever disaggregated data about an enterprise that they want and rearrange them to meet their needs. In a competitive free-enterprise economy, making all private information public is unlikely ever to be politically acceptable. To suppose otherwise is to posit a total change in the way we do business.

The purpose of this paper is to spell out the criteria that a model for preparing the traditional financial statements should meet. By "model" here is meant simply the body of accounting principles to be followed. Implicit in those principles is the need to serve the needs of the users of financial information. There is substantial agreement about what those needs are; yet there is persistent disagreement, despite the term "generally accepted accounting principles," about which set of principles, which model, would best serve those needs. The aim of this paper is to describe such a model.

My criteria, seven in number, are virtually axiomatic; yet I am forced to conclude that the present historical cost model fails to meet any one of them.

### THE CONCEPTUAL PRIMACY OF THE BALANCE SHEET

It should not be necessary, in this quincentenary year, to re-assert the primacy of the balance sheet in choosing an accounting model and the superiority of an income concept based on changes in net worth over one based on matching costs and revenues. But, remarkably, there are still some well-known accounting writers, at least in the U.S. and the U.K., who remain wedded to a matching approach. I shall cite one from each country.

In the United States, Robert Anthony is an impenitent believer in the primacy of the income statement and the matching approach to income. In his conceptual framework, *Tell it Like it Was* (Anthony 1983), his Concept 3.04 (p. 70) reads as follows:

Income should be measured directly by measuring revenues and expenses rather than indirectly by measuring changes in assets and liabilities.

Presumably, in this context, by "changes in assets and liabilities," Anthony means changes in their values. As an example of the kind of argument he uses to support this view, consider the following:

Take depreciation as an example [of the problems created by an asset/liabilities approach]. The asset/liability view suggests that depreciation should be measured by observing the amount of change in a depreciable asset during a period. But there is no way of making such an observation for most depreciable assets. The revenue/expense view looks at depreciation as an expense associated with the periods during which the asset provides service. This is the conventional view and the correct view (ibid. p.68).

Of course, the diminution in asset values as assets depreciate is observable, i.e. measurable where ever a market for used assets exists, and the resulting numbers, though under GAAP we do not at present use them, would usually be more meaningful than the arbitrary allocations that Anthony prefers. However, the more specific the assets and the less perfect the market, the less useful will market values be in measuring depreciation. A suggestion for dealing with this situation is made later in this paper.

The British enthusiast for matching whom I shall cite is Ron Patterson, a technical partner in the U.K. national office of Ernst & Young and co-editor of that weighty volume, *U.K. GAAP—Generally Accepted Accounting Practice in the United Kingdom* (Ernst & Young/Longman). The title, and especially the subtitle, of a paper that Patterson contributed to *Accountancy* (Patterson 1990) is self-explanatory. It is "Primacy for the P & L Account: Have the IASC and David Solomons Placed Undue Emphasis on the Balance Sheet to the Detriment of the Profit and Loss Account?" The references in the subtitle are to the IASC's conceptual framework and to my *Guidelines for Financial Reporting Standards* (Solomons 1989).

Patterson starts with a question that is not a valid one: "Should primacy be given to the balance sheet or to the profit and loss account

when there is a perceived conflict between the two?" There cannot be a conflict between the two any more than there can be a conflict between the two sides of an equation—unless, of course, "profit" and "loss" are defined as something other than change in net worth from nonowner sources. Unfortunately, Patterson does not say what he means by profit or income except for frequent references to matching. He says on page 82:

The fundamental problem with [the balance sheet approach] is that it abandons the matching concept in many instances. I think this is inappropriate both because it flies in the face of much of generally accepted accounting practice and, more importantly, because it would often give rise to meaningless figures in the profit and loss account.

The reader will find no examples in his paper of "meaningless figures in the profit and loss account" resulting from the balance sheet approach. At the same time, Patterson does not seem to be at all concerned about meaningless figures in the balance sheet. Indeed, he describes nonmonetary assets as "simply a deferred cost which has been incurred by the balance sheet date but is being carried forward to be matched against future expected benefits." That is simply not in accord with any present authoritative definition of an asset. Incidentally, surely it is "inappropriate," to use Patterson's word, to appeal to generally accepted accounting practice for support when it is that very practice that is under scrutiny.

I am quoting Patterson's paper at some length because he poses an accounting problem that, contrary to his assertion, can be handled particularly neatly by a balance sheet approach. It is the problem of accounting for the costs of restoration of an oil field when all commercial reserves have been extracted. The treatment suggested has a good deal of relevance to the project that the FASB is considering on nuclear plant decommissioning costs, and also to its project on present-value based methods.

Here is Patterson's explanation of a matching approach treatment.

The [British] oil industry Statement of Recommended Practice [SORP] on abandonment

costs recommends that provision for such costs should be built up by a process of systematic charges to the profit and loss account over the life of the field .... The SORP discusses two balance sheet presentations—either providing the full liability from the outset with an offsetting deferred asset which is amortized over the life of the field, or netting the two to show a growing liability .... Clearly, these recommendations follow a matching approach, and give rise to items in the balance sheet which would not be permitted under a balance sheet approach .... There is no question that a liability exists, and the result of the balance sheet approach would be that the full amount of the liability was both incorporated in the balance sheet and expensed immediately on signature of the contract.

The journal entries for a correct balance sheet approach treatment are shown in figure 1; they handle the problem more effectively than either method described by Patterson.

The total cost of the field to be capitalized when it is being drilled is the cash outlay (assumed here to be \$1000) plus the discounted present value of the estimated future abandonment cost, assumed to be \$100 (add zeros as necessary), and the field is estimated to have a life of ten years. The present value of \$100 discounted for ten years at an assumed interest rate of 8% is \$46.32. The accretion of the abandonment liability for the first year is \$3.70, and so on. The total cost of the field is amortized annually as it becomes exhausted. In addition to the charge for amortization, each year's profit and loss account shows a debit for the interest to be added to the liability as its present value grows with approaching abandonment. When abandonment takes place, the costs of restoring the site are charged to the liability account.

Of course, the original estimates of the abandonment costs and of the life of the field would have to be adjusted from time to time as circumstances changed or as new information became available; but that would be no different from other revisions of estimates.

Using the recommended method, all of the items in the balance sheet are genuine assets and liabilities. The wells at cost less amortization are genuine assets and the provision

**FIGURE 1**  
**Journal Entries Illustrating a Balance Sheet Approach to Abandonment Costs**

1/1/1	Oilfield	\$1046.32
	Cash or Creditors	1000
	Provision for abandonment costs	46.32
	Initial investment in field	
31/12/1	Amortization expense	104.63
	Provision for amortization	104.63
	Amortization of field for year 1	
	Interest expense	3.70
	Provision for abandonment	3.70
	Interest on abandonment liability at 8%	
31/12/2	Amortization expense	104.63
	Provision for amortization	104.63
	Amortization of field for year 2	
	Interest expense	4.00
	Provision for abandonment	4.00
	Interest on abandonment liability at 8%	
31/12/10	Amortization expense	104.63
	Provision for amortization	104.63
	Interest expense	7.41
	Provision for abandonment	7.41
	Amortization provision	1046.32
	Oilfield	1046.32
	Writing off the field on exhaustion	
	Provision for abandonment	100
	Cash or creditors	100
	Outlay for abandonment costs	

for the cost of abandonment (at its present value) is a genuine liability. The cost of the field is shown, as it should be, as the aggregate of the original outlay and the present value of the expenditure to be incurred when it is exhausted. The diminution of the asset and the growth in present value of the liability are legitimate profit and loss debits. The balance sheet approach comes through this test much better than does the matching approach.

Patterson's views have more recently, and regrettably, been given wide circulation in a document (dated September 1993) dissemi-

nated by the U.K. firm of Ernst & Young, entitled *The Future Direction of U.K. Financial Reporting*.

#### **The Rationale for a Balance Sheet Approach**

There are several reasons for preferring a balance sheet approach. One is summed up by Johnson and Storey (1982) when they say: Business enterprises are in essence asset processors; hence, assets and changes in them are central to the existence and operations of those enterprises.

Since 1982, intangible assets such as R&D and trained personnel, even though unrecognized in

the balance sheet, have gained in importance. Yet the truth of the quotation still stands.

Even proponents of the matching view are forced to define revenues and expenses in terms of changes in assets and liabilities. Thus, Anthony defines revenues as "those additions to entity equity resulting from operating activities of the period that can be reliably measured" (Concept 6.03, 160), and he later says that "equities are thought of as claims against the assets" (p. 269). Paton and Littleton, perhaps the earliest proponents of the matching view, say that "the revenue account is designed to reflect and gauge the augmentation of resources ...," and by "resources" they meant assets.

The FASB's definition of revenues is unambiguous:

Revenues are *inflows or other enhancements of assets* (emphasis added) of any entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations (SFAC No. 6, para. 78).

This is the fundamental reason for taking the balance sheet approach, but there are subsidiary reasons also. If there is not a strict relationship between the process of income determination and changes in owner's equity, debits and credits are apt to creep into the income statement that do not represent real transactions or the effects on the enterprise of real events and conditions—items like charges for future maintenance, for example. This opens the way for income smoothing, which is probably why preparers tend to prefer the matching approach. Further, the matching approach threatens the integrity of the balance sheet as a statement of financial position, for it is liable to become a temporary resting place for all kinds of items that are being "carried forward to be matched against future expected benefits," in Patterson's words.

In brief, it is time to inter the matching approach with other discarded accounting concepts like secret reserves and the FASB's first thoughts in SFAS 15 on accounting for troubled debt restructuring.

## CRITERIA FOR CHOOSING AN ACCOUNTING MODEL

It is surprising that more attention has not been paid to the criteria that should guide us in choosing a preferred accounting model. To the extent that it has been discussed at all, it has generally been thought sufficient to talk about the trade-off between relevance and reliability. For example, in the IASC's *Framework for the Preparation and Presentation of Financial Statements* (1989), the Committee is content to say that "the selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability" (para. 110). The qualitative characteristics of accounting information, which are criteria by which the quality of information may be judged, are not to be confused with the criteria for choosing an accounting model. Nor are the IASC's two underlying assumptions, as set out in paragraphs 22 and 23 of their statement. These are the accrual basis of accounting and the assumption that financial statements are prepared for an enterprise that is a going concern.

The FASB does no better in its Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1984). Paragraph 70 of that Statement reads as follows:

Rather than attempt to characterize present practice as being based on a single attribute with numerous major exceptions for diverse reasons, this concepts Statement characterizes present practice as based on different attributes. Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this concepts Statement suggests that use of different attributes will continue, and discusses how the Board may select the appropriate attribute in particular cases.

The Board then reverts to a consideration of the qualitative characteristics and the crite-

ria for the recognition of accounting items. None of this has much to do with the selection of an accounting model; and, as is well known, the Board made no such selection.

The Accounting Standards Board in Britain, in its draft Statements of Principles, has taken a major step forward toward the kind of model that is advocated here. Yet, although the reasoning that has led it in that direction is stated clearly enough, readers are left to deduce the criteria that the chosen model satisfies.

The FASB has said most of what needs to be said about the qualitative characteristics of accounting in its Concepts Statement No. 2. The Board has emphasized the importance of relevance and reliability as the primary qualities to be sought after, and I assert that the model my criteria point to could result in more relevant and more reliable information than the model now in use. To the extent that those qualities are at the heart of what the users of financial information need, the model therefore better serves those needs.

The five criteria put forward in my Guidelines are restated here and expanded somewhat to show that they do point to a model based on "value to the business," sometimes called deprival value. If the criteria are sound, any model that is inconsistent with one or more of them must be judged to be unacceptable. Thus my preferred model can be arrived at by a process of excluding the alternatives.

#### **Criterion No. 1**

The balance sheet should be a true and fair statement of the entity's financial condition at the balance sheet date, i.e. it should show all its assets and liabilities, and only its assets and liabilities, in conformity with the accepted definitions of those terms, that satisfy the agreed criteria for recognition.

This criterion is not concerned with valuation, but only with what the balance sheet contains. The criterion excludes deferred costs and losses that do not represent probable future economic benefits. Whether it also excludes goodwill and other nonseparable intangibles is more controversial. My present view (which differs from the view I expressed in my

*Guidelines*) is that the definition of an asset should require that it be separable from the rest of the entity. Goodwill, whether it has been generated internally or is the result of an acquisition, is simply the difference between two valuations, namely, the aggregate of the values of the net separable assets and the value of the enterprise as a going concern. Only the values of the net separable assets strictly qualify for inclusion in the balance sheet because they alone can be measured with sufficient certainty to merit recognition. A balance sheet is not intended to and cannot be expected to show the value of the continuing enterprise as a whole. That value should be left to be arrived at by analysts or investors, with the help of the information that the accountant can provide. The model advocated here can contribute to that valuation process more effectively, it is claimed, than any of its competitors.

All that will be said here about the criteria for recognition in the balance sheet is that an item must have a magnitude that can be measured and verified with reasonable certainty.

Criterion No. 1 calls for the inclusion in the balance sheet of items that are not now usually included, such as brands and trademarks, and certain research and development expenditures, if they are separable and *if they can be valued with reasonable certainty*. More often than not, those items would be excluded because the criteria for recognition could not be satisfied. If sufficiently relevant, information about them could be disclosed outside the balance sheet.

#### **Criterion No. 2**

The entity's recognized assets and liabilities should be carried in the balance sheet at their value to a going concern at the balance sheet date.

The term "value to a going concern" is used here in its literal meaning, i.e. what the entity would pay for its assets at the accounting date if it did not have them, and how much money it could raise currently by incurring its present liabilities. In the interests of simplic-

ity, the focus will be on the asset side of the balance sheet.

Value to a going concern, as it is defined here, at once excludes historical cost as a general basis of valuation. Historical cost is value to the going concern at the time that assets are acquired, but only exceptionally at any later time, i.e. only if both general and relative prices are stable. It is appropriate to refer here to a paper presented to the EAA in 1993, by Peasnell et al. entitled *The Reliability of Historical Cost Numbers as Proxies for Deprivation Values*. The title of that paper is self-explanatory. Its conclusion was that "the proposition advanced in this paper [is] that HC [historical cost] is a better surrogate for deprivation values [DV] than would be produced by using DV itself ...." Their reason for arriving at this conclusion is that historical cost is more reliable, in the sense that there is more likely to be consensus among measurers about HC than about DV. This is as plausible as saying that black and white are better surrogates for red and green than using red and green themselves because there may be differences of opinion among observers about *how* red or *how* green an object is.

My dissatisfaction with this paper is made more acute when the authors say that "it is possible to envisage situations where the bias introduced by using HC as a proxy for DV is more than outweighed by increased precision of estimation (lower  $V$ ) [variance]." This is indeed an elegant way of saying that it is better to be precisely wrong than roughly right.

Returning to the second criterion, the other possible meaning of "value to a going concern" is net realizable value. Net realizable value will represent value to a going concern if the buying and selling prices of assets are the same, which they normally are not. Realizable values normally are the relevant values for a *liquidating* concern, not a *going* concern. But they do have a role in determining value to the business if assets are not worth replacing.

Value to a going concern clearly points to "value to the business" or deprivation value as the preferred basis of valuation for balance sheet purposes. Deprivation value, as is now well

known, is current cost or recoverable amount; whichever is lower. This concept was the basis for the FASB's statement No. 33, and is well explained in paragraph 99(h) of that document.

### Criterion No. 3

The profit or loss shown by the income statement for the accounting period should represent the increment or decrement of real financial capital that has accrued to the entity during the period.

There is broad agreement that the concept of income or profit implies that no profit emerges until an enterprise has maintained its capital. Unfortunately there is still disagreement about how we should define capital. There are two main grounds for dispute. Is it financial or physical capital that should be maintained? And if it is financial capital, should it be maintained in money terms or in real terms?

The third criterion makes an unequivocal choice of financial capital over physical capital, because the concept of physical capital cannot be made operational for accounting purposes except perhaps in a very simple type of enterprise dealing in a single commodity and using a single kind of equipment. The problems of aggregation otherwise are insurmountable. Moreover investors in corporations, who are the dominant stakeholders to whom financial reports are addressed, have claims only to financial capital, not to the physical assets used in the business.

As for the choice between maintaining financial capital in money terms or in real terms, i.e. in terms of purchasing power, in a hyperinflationary economy one would have no question about the right choice. Only maintaining capital in real terms makes sense. In choosing an accounting model, surely the preferred model should be one that will be serviceable in all conditions, whether inflation is currently a problem or not. So the model opts for the maintenance of the purchasing power of financial capital, i.e. real financial capital.

Now note what this implies for our methods of measuring income. For one thing, it disqualifies an accounting model based on historical cost because such a model excludes

unrealized gains and some unrealized losses. Suppose a real estate company owns several apartment blocks. The apartments produce rent, and are also appreciating in value faster than the general price level is rising. Under a historical cost system, the company's income statement will show the profit as being equal to the net rental income. The asset appreciation will not show up. The income statement will fail to show by how much financial capital, either in real or in money terms, has grown during the period.

Criterion No. 3 also disqualifies NRV as a basis of valuation. Highly specific tailor-made assets, even when they are still virtually new, rarely have a resale value equal to their cost. If those assets have to be written down to their realizable value immediately after acquisition, the owner would have to show a loss simply as a result of having invested in them.

The criterion is consistent with the use of deprival value, so long as net income is adjusted for changes in the purchasing power of the opening capital. Of course, in a period of price stability, nothing much is lost if this adjustment is not made; but the next criterion suggests that it would be wise to make the purchasing power adjustment consistently.

Incidentally, it is worth noting that the IASC's conceptual framework makes a dangerously erroneous statement, which is directly relevant to our present inquiry, on the subject of capital maintenance. This appears in paragraph 106 of their Concepts statement, where they say "the financial capital maintenance concept ... does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain." The fact is that the maintenance of financial capital, however defined, requires some kind of current value model, and is inconsistent with a historical cost model except in quite unusual circumstances, namely, circumstances where both general and relative prices are constant. Where general and/or relative prices are fluctuating, as they normally are, a historical cost model will not correctly track changes in the level of financial capital.

#### **Criterion No. 4**

Accounting measurements should be made consistently and should be comparable from year to year.

#### **Criterion No. 5**

Numbers that are aggregated should be truly additive.

Financial analysts, and indeed all users of financial information, assert that comparability from year to year and across enterprises is necessary if information is to have its full value. The fourth criterion simply calls for the preferred accounting model to employ consistent measurements and to provide comparable information.

This fourth criterion reinforces the need for the purchasing power adjustments called for by the third criterion. Accounting numbers, such as net income and sales revenue, are not truly comparable from year to year if they represent dollars or pounds of varying purchasing power. Equally, the results of different enterprises are not truly comparable if the enterprises use inconsistent measurement methods. This is another aspect of the case against historical cost. If one company accounts for inventory on a FIFO basis and another uses average cost (to say nothing of LIFO), comparability is lost. The same is true if different depreciation methods are used. Further, "cost or market, whichever lower" destroys comparability when companies have to take write-downs when prices fall but are not permitted to take write-ups when they rise.

The consistency rule is clearly broken by our present methods of accounting for goodwill. To include goodwill in the balance sheet when it has been purchased but not when it has been internally generated—a much more common situation—is certainly not consistent. And the additivity rule is broken when "cost or market" requires historical costs and current values to be added together.

Note that the use of deprival value for all balance sheet items does preserve consistency, comparability, and additivity. Deprival value does require the use sometimes of current cost and sometimes of recoverable amount, if lower,

(i.e. recoverable amount being defined as the higher of net realizable value or net present value of expected cash flows), but these are additive because in all cases they represent values to a going concern. This cannot be said of the hybrid systems advocated in some quarters, which adopt different valuation bases for different classes of assets.

**Criterion No. 6**

All of the information given by the financial statements should be verifiable.

**Criterion No. 7**

All of the information given by the financial statements should have a value that exceeds its cost.

The cost-benefit criterion for financial information, or indeed for all information, is fairly self-evident, and at the same time difficult to apply because of the subjective nature of the value of information. Yet it should not be ignored. That there are costs to preparers of providing information is obvious. The costs to users of studying and analyzing it are less obvious. The FASB had some useful things to say on this subject in paragraphs 133–144 of its SFAC 2, and it is not proposed to add to that discussion here.

The requirement that information be verifiable is easier to implement than the cost-benefit criterion. Contrary to what is often asserted, verifiability is the great strength of “value to the business” because DV is grounded in current market values except where an asset is not worth replacing but is worth more to the business than its liquidation value. Current costs or NRVs are current market values, determined by actual market transactions. They need not always be transactions entered into by the entity itself; they may be transactions entered into at the relevant date by comparable entities, but that still makes them better representations of economic reality than allocations of historical cost can usually be. Moreover, allocations of historical cost, of the kind that are made, for example, when purchases are allocated between the cost of inventory and the cost of goods sold, are not verifiable except in the sense that

someone can check the arithmetic to see that it accords with the accounting convention that has been chosen.

Admittedly there will be situations where the current cost of a specialized asset may be difficult to determine. In such a case, the asset's historical cost adjusted by a specific index number that reflects changes in the prices of comparable assets may, after suitable adjustment for depreciation, serve as an acceptable surrogate for current cost. This position is supported by Arnold et al., in their *The Future Shape of Financial Reports* (1991). Note that this is quite different from Peasnell et al.'s assertion that unadorned historical cost is always a suitable proxy for deprival value.

The verifiability criterion is not only transgressed by the use of historical cost, in many situations. It is also transgressed when management *intent* is allowed to determine the balance sheet treatment of assets. This is done by the FASB's SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, issued in May 1993. Paragraph 1 of the Introduction to that Statement reads as follows:

This Statement addresses the accounting and reporting for certain investments in debt securities and equity securities. It expands the use of fair value accounting for those securities but retains the use of the amortized cost method for investments in debt securities *that the reporting enterprise has the positive intent and ability to hold to maturity* (emphasis added).

That kind of accounting is objectionable for two reasons. First, it is impossible, at the time debt securities are acquired, to verify management's intent to hold them to maturity; and second, intent should be determined by accounting information, it should not determine it. Indeed, it is tempting to add an eighth criterion to the list, to require that management intent should not determine how a transaction is to be accounted for; but I conclude that the verifiability criterion takes care of that.

Intent creeps into accounting in another way, and that is in the way we sometimes distinguish between fixed and current assets. If

current assets are defined as assets held for conversion into cash in the ordinary course of business, and fixed assets are defined as assets held for use, we are using intent as the basis of the distinction. We shall be on safer ground if we abandon the fixed/current distinction altogether, and simply classify assets according to their ease of liquidation, or (what is virtually the same thing) according to the transaction costs involved in their liquidation. This is in accord with the classification of assets by Arnold et al. in *The Future Shape of Financial Reports*, and indeed I have little quarrel with their conclusions generally.

### CONCLUSION

If the criteria that have been formulated in this paper for choosing an accounting model are accepted as appropriate, indeed compelling, then it is impossible to escape the conclusion that our present body of generally accepted accounting principles needs to be radically revised. In particular, it is impossible to reconcile the criteria with a historical cost

basis of accounting, for historical cost runs foul of every one of them. On the other hand, a "current cost constant purchasing power" model accords well with all of them.

It is perhaps this good fit that caused one of the reviewers of my *Guidelines*, Michael Mumford, to harbor the "suspicion" that "the criteria may not follow from broadly accepted general principles, but that they were chosen with a view to supporting the conclusions" (Mumford 1989, 386). The fact is that this is a "chicken and egg" situation. It is not at all uncommon to reach a conclusion intuitively and then to go back and trace the mental path by which one reached it. For me, the criteria were indeed there first, but were not clearly formulated until the virtues of a current cost model with a purchasing power adjustment had become an established part of my thinking.

In any case, which came first is not important. What is important is to evaluate the criteria, and if they are found to be valid, to find out where they lead.

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