A STUDY OF EFFORTS TOWARD UNIFORMITY IN CORPORATE FINANCIAL STATEMENTS

By

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PREFACE

Since the establishment of American professional accounting organizations during the latter part of the nineteenth century there has been an increasing interest in the development of accounting principles and rules for the preparation of published corporate reports. This interest cuts across all lines of society, since the problem affects directly or indirectly each individual having a stake in the economy. Recently the work of the accounting profession has been criticized by persons in various walks of life. These criticisms of the profession, together with renewed interest and a change of programs within the American Institute of Certified Public Accountants, have prompted the selection of this thesis topic.

The objective of this dissertation is to point the way toward resolving the argument within the accounting profession over reduction of alternative practices as reflected in corporate financial statements. This objective necessitates recounting the evolutionary development of accounting, examination of the basic problems in accounting and in the formulation of ac-

counting principles, consideration of the points that have been made for and against uniformity, and criticism of the current organization for formulation of accounting principles and its work to date.

The writer is interested primarily in the financial statements of corporations organized for profit and not subject to direct government regulation by such agencies as the Interstate Commerce Commission. Of course, a large part of this study may be applicable incidentally to proprietorships, partnerships, or regulated industries. An interest in financial statements necessarily implies some concern with the records from which the statements are developed, but the real concern is the evolution of the body of theory which supports the statements. While accounting in other countries is considered, it is of interest primarily as it affects accounting in the United States. Internal uses of its own accounting data within a corporation are a separate phase of accounting with which this paper is not concerned.

The writer is grateful to the university teachers, fellow graduate students, and former associates, who have given him inspiration and assisted him in various ways in this writing. A real debt is owed to the authors

of many books and articles that were the immediate sources of information. Most of the ideas contained herein were received directly or indirectly from others. In some cases the ideas received by the writer may be entirely different from the message intended by the source. Credit is given to the sources of all such ideas that the writer could identify. Appreciation in no less degree is extended to the originators of those ideas that cannot be connected with a specific source.

The writer is especially appreciative of the assistance rendered by those who have been directly interested in his work, Professors A.J. Penz and J.E. Lane.

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CHAPTER I

INTRODUCTION

The Art of Accounting

Need for accounting services.--The outstanding feature of the economic progress made by Western Civilization in the past two centuries was the centralization of control of wealth. This was a natural result of growing knowledge as to uses of capital and the need to concentrate vast amounts of capital for a single purpose or for a coordinated series of purposes. Concomitant to the concentration of capital under central authority came new concepts of fiduciary responsibility. The corporate form of business organization was developed under laws fixing responsibility and defining its limits. Centralized control was the progenitor of modern accounting. Separation of ownership from control fathered modern financial accounting.

Obviously, a business organization did not have to be very large before its manager found himself unable

to summarize mentally the results of its operations, unable to observe personally all operations, and unable personally to handle each financial transaction. Thus, accounting became an essential tool for internal control of operations. As the size of businesses increased, levels of responsibility were added, and accounting became increasingly useful in the internal operation of the enterprise.

However, another facet of accounting is of primary interest here. Control is within the purview of this paper only with respect to the control exercised by an outside stockholder over the use of his capital. Fiduciary responsibility, as it runs from the management team to outside stockholders, is at the core of the problems discussed. Financial accounting facilitates this relationship between corporate management and outside stockholders, as well as the ancillary relationships between the business unit and other outside parties.

Financial accounting.--Financial accounting encompasses the financial statements -- balance-sheet, income statement, and statement of retained earnings, with supporting schedules and notes -- which usually are

found in corporate annual reports, together with the entire body of theory, practice, principles, concepts, conventions, and rules applicable in the preparation of these statements.

Functions of financial accounting.--To state all the functions of financial accounting would be as difficult as stating all the causes of the fall of Rome. It may be said that the one function of financial accounting is to facilitate the economic advancement of society. Subordinate to this are an infinite number of functions. On one functional level the purpose of financial accounting is to communicate financial facts. Beyond this level some of the functions of financial accounting are: to measure performance of management, to help potential investors to decide whether to invest, to facilitate governmental regulation, and to facilitate equitable distribution of the fruits of industry to the factors of production.

One of the characteristics that makes financial accounting difficult is that its functions are numerous and sometimes conflicting. Furthermore, while adapting the art to serve the many functions of financial accounting one must not lose sight of the necessity to

accomplish also the internal purposes of accounting with a single set of records. The situation is further confused by the divergence of the socio-economic philosophies of the interested parties, and the natural tendency of man toward a biased interpretation of facts. Financial accounting is caught in the middle of the controversies among various interests, and apparently, it will remain there. The task is to adapt the art to serve many functions according to a compromise of viewpoints to be arrived at and constantly readjusted through arbitrated settlements among selfish groups subscribing to differing philosophies.

The Accounting Profession

Growing responsibility.--The task of accountants seems formidable when one thinks only of the complexity of the art as it is presently constituted. But these complexities developed over many years, and over the same years succeeding generations of accountants arose to meet conditions just a little more challenging than those met by their predecessors. In the nineteenth century there were almost no accountants who could lay

claim to being members of a profession. There was very little accounting work to be done for purposes other than control of operations within the enterprise. Just as the twentieth century has been one of unparalleled industrial expansion, concentration of economic power, and extension of governmental regulation, so it has been the century of phenomenal growth of the accounting profession. From a few dozen professional accountants in 1900, the profession had grown to about 100,000 by the middle of the century and continues to grow at a comparable rate. While the profession was growing in numbers, its members were growing in stature to face the increasing responsibilities thrust upon them by a complex economy. It is only natural that a profession whose task it is authoritatively to reflect events, the interpretation of which is a matter of opinion rather than one of absolute truth, would find itself the object of severe criticism.

Criticism of the profession.--The accounting profession has been criticized for doing what it has not done, for not doing what it is not supposed to do, and occasionally for just cause. One of the chief points of criticism, probably a justifiable one, has been the

fact that two accountants independently using the same set of facts would very likely prepare two sets of financial statements that are quite different. And this feat would be accomplished without deviating from generally accepted procedures.[1] A large part of the clangor heard about this situation arises from self-criticism. Many members of the profession have tried against strong opposition to rectify the condition. This action has taken the form of discussion and research which has helped to reduce alternative practices allowed under generally accepted accounting principles. The beginning of such efforts can hardly be fixed, but it is apparent that in recent years the profession has become increasingly interested in uniform accounting principles. Action seems to have been taken without adequate planning, and the results to date leave something to be desired. It is hoped that a critical analysis of the problems involved will contribute something toward their eventual solution.

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[1]T.A. Wise, "The Auditors Have Arrived," Fortune, Vol. LXII (November, 1960), pp. 151 et seq.

Purpose and Prospectus

It is the writer's purpose to present enough historical background of the accounting art and of the accounting profession to explain the existence of alternative procedures and the controversy regarding them. Then the writer hopes to show what has been done to alleviate the situation; why it is difficult to eliminate alternatives; why subjectivity cannot be eliminated from financial statements; why the cure might be worse than the disease; and what further action might be taken to improve the condition.

Chapter 2 describes the development of accounting in such a way as to impress upon the reader the evolutionary nature of accounting as it met the needs of a changing economy. The succeeding chapter continues to follow the line of evolutionary development in a modern world of professional men who find a need to explain and justify their methods. It will be noted that the pressures affecting the development of accounting are applied through socio-economic institutions unknown a few years earlier. Then in Chapters

4 and 5 an effort is made to present some of the more basic problems that accountants face in their day-to-day practices and some of the problems they face professionally in the establishment of guides to practice. In Chapters 6 and 7 are presented the common arguments that have been given in favor of uniformity and in favor of flexibility. In Chapter 8 some of the ideals that have guided the profession in formulation of accounting principles are discussed. In Chapter 9 recent efforts to formulate accounting principles and postulates are summarized and criticized. And in Chapter 10 the previous eight chapters are summarized and some recommendations are made.

CHAPTER II

HISTORICAL BACKGROUND

Antecedents of bookkeeping.--Accounting, as it is known today, should be viewed as a transient technique in an evolutionary process having its origin in prehistoric days and subject to continued refinement extending, as to time and as to design, beyond comprehension. From the study of uncivilized peoples it is conjectured that man first learned to count by twos, numbering possessions according to the number of his ears (or hands, etc.). As civilization crept forward and man's possessions increased, he learned to count in tens by his fingers or in twenties by his fingers and toes. Probably, it was economic success resulting in increased possessions that prompted man to learn to count more efficiently. Perhaps the more nearly civilized tribes began to wear primitive shoes at this stage of development, determining our decimal system of numeration

in preference to a "vigintimal" system. In addition to a system of numeration, a written language was a necessary antecedent of bookkeeping. In all probability the mode of development of social institutions required the use of earliest forms of bookkeeping in government to a greater extent than in commerce.

> The development of social life and especially the formation of states or sovereignties levying any form of taxation necessitated, in addition to a knowledge of numbers, a power of holding count and reckoning. In this we find the origin of the science of accounting. It antedated the stating of accounts as we understand them,--since that could not take place until some monetary standard had been adopted in which items composing an account could be expressed in terms of equality.[1]

Given numbers, written language, and money, further development toward modern accounting depended only on the need for it. The need for accounting was inherent in the development of an extensive commerce. Of course, private property had existed from the earliest civilization; however, there was no compulsion to account for private property until production and exchange over-shadowed conquest and rape. Concurrent with the expansion of commerce there was

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[1]Richard Brown, A History of Accounting and Accountants, (Edinburgh: T.C. & E.C. Jack, 1905) p. 16.

perforce a growth of capital and credit. These antecedents of bookkeeping existed in ancient civilizations: private property, capital, commerce, credit, writing, money, and arithmetic.[2] It is quite likely that during the Dark Ages, when all of the institutions of civilization were in a state of ferment, men of commerce were quietly inventing, selecting, trying, expanding, and improving many systems of accounts. It is known that a debit and credit system of bookkeeping was in use in 1211, in Florence.[3] However, the first published writing to give a detailed description of double entry bookkeeping did not make its appearance until 1494.

Paciolo.--In Venice in 1494, Fra Luca Paciolo published his Summa de arithmetica geometra proportioni et proportionalita. This work included a complete description of double entry bookkeeping. It was translated into many languages and used for years through-

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[2]A.C. Littleton, Accounting Evolution to 1900, (New York: American Institute Publishing Co., Inc., 1933), pp. 12-21.

[3]Wilmer L. Green, History and Survey of Accountancy, (Brooklyn: Standard Text Press, 1930), p. 85.

out the civilized world.[4] Paciolo made no claim to originality, but he stated that his work described the system then utilized in Venice. From this statement it is evident that double entry bookkeeping was not invented in the usual sense, but that it evolved over a period of years.

Paciolo is also the earliest writer credited with a contribution toward uniformity.

> Paciolo's treatise on bookkeeping which was published in 1494 was the answer to an insistent economic demand for a standardized system of recording business transactions.[5]

Development under the influence of Paciolo.--In the sixteenth century there were relatively unsuccessful efforts by other authors to write about bookkeeping, but Italian bookkeeping as described by Paciolo was the dominant influence.

> Down to the minutest details we find identically the same methods prevailing among book-keepers whether they hail from Venice, Nuremberg, Antwerp, or London. . . . This

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[4]Edward Peragallo, Origin and Evolution of Double Entry Bookkeeping, (New York: American Institute Publishing Co., Inc., 1938), p. 55.

[5]Green, p. 91.

> uniformity in certain characteristic practices of the time was partly due to the fact that young men who intended to become merchants went to Italy, there to acquire a knowledge of commerce which was not to be obtained in the same degree elsewhere.[6]

Before long, translations of Paciolo's work were available in England, Holland, France and Germany. The English translation by Hugh Oldcastle appeared in 1543, and it was republished by John Mellis in 1588. The method of bookkeeping thus established was so well adapted to conditions of commerce at that time that there was little immediate call for improvement. In fact the basic principles of the Italian system have remained applicable to this day, having been gradually expanded to meet new conditions as business grew in size and complexity.

> The careful reader of Paciolo's text is likely to be amazed to note how little basic change there has been in bookkeeping, and to be more than ever convinced that the underlying principles of double entry are as simple and as fundamental as addition and subtraction, and therefore not at all subject to change. The accountant is apt to feel not a little elated in the thought that the foundation of what later became accountancy was already firmly laid at a time when some of the basic processes of arithmetic were still chaotic.[7]

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[6]Brown, p. 127.

[7]Littleton, p. 77.

Contribution of early teachers.--It is evident that the group most influencing the spread of the knowledge of bookkeeping was the teachers. Paciolo was a teacher of the order of St. Francis. Oldcastle and Mellis were both London school masters. Holland's best known contributor of the sixteenth century, Simon Stevin, was a university teacher. The Dutchman, Nicolaus Petri, who introduced the idea of multiple books of original entry, apparently was a teacher of arithmetic, geometry, and bookkeeping. Germany's Passchier-Gossens, a teacher of writing, arithmetic, French, and bookkeeping, made a contribution toward clarity and simplicity in ledgers. However, for the most part the contribution of teachers in the seventeenth and eighteenth centuries was not in the nature of innovation, rather it was in preservation and dissemination of the established discipline. Improvements were made by those daily encountering the problems presented by growing trade, industry, and finance. When the center of commerce shifted from Italy to Western Europe, Germany, Holland, and England surpassed Italy in the art of bookkeeping.

Evolution of accounting services.--Just as the

knowledge and use of bookkeeping followed commerce geographically, it can be shown also that the techniques evolved in response to the needs of business.

> Medieval bookkeeping developed from humble beginnings. At first business transactions, along with other social or political events, were entered in what might be described as a diary, but with the rise of commerce this crude method of record keeping had to give way to a more efficient system. The first double-entry book to appear was the ledger. It had the accounts divided bilaterally or vertically, and was supported by numerous memorandum books. The ledger probably developed from the debtor and creditor relationships of merchants. It is possible that, with the revival of Medieval commerce and with the increasing importance of fairs, the necessities of business exchange forced merchants to keep records comparable to receivable and payable ledgers. Gradually, with the increasing needs of a growing trade, the ledger was made to include assets, liabilities, expenses, and income. The journal appeared considerably later than the ledger. . . . Double entry was the result of a long culmination of difficulties resulting from the increasing complexities of trade. It came about gradually, almost imperceptibly.[8]

It has been mentioned that probably one of the prehistoric needs for numeration and reckoning arose out of government and taxation. However, at the time that double entry bookkeeping was evolving the Roman Empire declined and fell. In the absence of strong

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[8]Peragallo, op. 1-2.

central governments the extensive adaptation of double entry bookkeeping in government awaited another age. After the resurgence of strong rulers we find Simon Stevin making the first significant attempt to introduce "Book-keeping for Princes."

In the latter part of the sixteenth century and in the seventeenth century bookkeepers found it necessary to adapt their art to large enterprises. Enterprises tended to outgrow the ability of one man to control, necessitating records of performance for management purposes. The fact that the owner and the manager were no longer identical necessitated records of accountability. The principal purpose of bookkeeping became to account for the income of business enterprise and the consumption of factors of production.

However, bookkeeping remained largely unchanged as to method until the nineteenth century. Not until the industrial revolution with its emphasis on production and world trade did bookkeeping free itself of antiquated forms and really forge ahead toward the development of modern accounting. During the three centuries from Paciolo to the industrial revolution

the development of bookkeeping was a functional evolution. Typically, the teachers and practitioners of bookkeeping did not consider why an entry should be made in a certain way, but they blindly followed instructions and examples. In the nineteenth century with the emergence of interest in the theoretical basis of bookkeeping and the expansion of a records system into a comprehensive discipline giving business management an effective control over its affairs, bookkeeping expanded into accounting.

The functional evolution in response to economic need that marked the development of bookkeeping continued. As bookkeeping evolved into accounting, its theoretical basis became increasingly significant. The inquiring mind and penetrating discussion as to the "why", as well as the "how" were prerequisite to the fabrication of a competence to meet the challenge that accountants were to face.

It has been mentioned that the industrial revolution ushered in the age of the large enterprise, which gave impetus to the development of accounting. This trend toward bigness brought increasing pressure

in England in favor of freedom to incorporate. After several years of resistance the government yielded to the pressure and granted expanding commercial enterprise the privilege of incorporation. This event thrust upon accounting new and greater responsibilities. The rights of creditors under limited liability had to be protected. Income had to be measured in order to establish the amount of dividends permissible under the law. The increasing separation of owner and manager gave a new complexion to accountability. The continuity of this new type of entity gave new importance to periodic statements and added new significance to depreciation accounting. The companies' acts prescribed an audit. The industrial revolution gave to society power machinery, the factory system, and wage workers, thus creating a climate in which cost accounting could not fail to grow.

From an economic point of view there was a revolution--the industrial revolution. Accounting made great strides, but there was no accounting revolution.

> In this advance, however, we cannot point to any striking revolution. The development has not been characterized by any startling dis-

> coveries of new principles or the introduction of entirely novel methods, but rather by the steady working out, with modifications suited to changing conditions, of those principles and methods which were already well understood and practised by the old "accomptants."[9]

Influence of socio-economic conditions.--While accounting grew for the most part at a slow but steady gait, there were occasions when dramatic incidents or conditions had a definite effect on the course and rate of its change. There was an awakening of interest in auditing standards and in uniformity of application of accounting principles brought about by such spectacular events as the McKesson and Robbins case and the Royal Mail case. The great depression preceded by the stock market crash led to the enactment of the Securities Act and the Securities Exchange Act requiring disclosure of more facts, more uniform statements, and more thorough audits by independent accountants. The inauguration of an income tax with its graduated and ever increasing rate stimulated interest in the definition of income, annual closings, and allowances for depreciation.

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[9]Brown, p. 315.

Problems arising out of war required study, discussion, and authoritative decisions by professional societies and government agencies.[10]

A more gradual and somewhat more nebulous effect on accounting resulted from the trend toward welfare statism. This shift in the attitude of the people resulted in big government, requiring masses of data and astronomical tax revenue. However, in addition it led to an expansion of the groups having a legitimate interest in business data. In addition to stockholders, managers, suppliers, and creditors who have an interest of long standing, now it is accepted that employees, their representatives, customers, government agencies, the public in general, and perhaps competitors have a right to certain business data. In fact it is even being suggested that accountants must learn to measure business success in terms of something other than net income as this is no longer a valid criterion.[11]

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[10]Charles B. Couchman, "Uniform Accounting for Industry," The Journal of Accountancy, Vol. LVIII (November, 1934), pp. 333-57.

[11]Norton M. Bedford and Nicholas Dopuch, "The Emerging Theoretical Structure of Accountancy," Business Topics, (Autumn, 1961), p. 60.

Influence of early accounting societies.--

Another important element in the historical background of modern accounting is the influence of the early professional societies. The first association of accountants is thought to have been the Collegio dei Ragionati which was founded in Venice in 1581. Eventually, the association became so powerful that only its members were permitted to perform accounting functions in connection with public administration and courts of law. Membership was strictly limited to those having stated residence, moral, intellectual, and experience qualifications. At this early date it appears that the professional society enforced a substantial degree of uniformity in practice by exercising a power to exclude those who did sub-standard work. The profession was organized similarly in Milan in 1745, and later in other Italian cities. From the activities of these early societies it is apparent that there was a distinction between accountants and bookkeepers prior to the existence of the activities now called financial accounting.

The Institute of Accountants of Edinburgh was

organized January 31, 1853, and it was chartered by Queen Victoria, October 23, 1854. Similarly, The Institute of Accountants and Actuaries in Glasgow was organized at about the same time, and a few years later another group in Aberdeen received a charter. The members of these societies selected the title "Chartered Accountant." Not until the 1870's did the accountants in the cities of England and Wales form societies, and not until May 11, 1880, did they receive their charter under the title, The Institute of Chartered Accountants in England and Wales. The contributions of the British societies in the nineteenth century were principally in establishing qualifications and examinations for members and in advisory service regarding bankruptcy, corporation legislation, and legislation directly prescribing accounting "principles" or policies. Laws affecting principles of accounting seem to have hampered the societies in Great Britain in any effort to develop accounting standards.[12]

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[12] A. A. Fitzgerald, "Accounting Standards," Proceedings of the Australian Congress on Accounting. (Sydney: Australian Congress on Accounting, 1949), pp. 9-36.

The accounting societies in the United States have been much more active in the matter of accounting principles or standards. Their organization will be mentioned in a later chapter where a discussion of their influence is more appropriate.

CHAPTER III

DEVELOPMENT OF ACCOUNTING PRINCIPLES IN THE TWENTIETH CENTURY

The Process of Development

Introduction.--Having considered the origin and early development of accounting, there follows an *a priori* conclusion that the natural state of accounting must be one of non-uniformity. Such a product of evolutionary process could not be otherwise. However, while accounting was growing up there were unifying forces exerting a steadily increasing influence upon the practices of the profession. It is now appropriate to consider the development of accounting theory and the need for uniformity. Before discussing the organizations, agencies, and individuals who have made substantial contributions to the development of accounting principles, one should attempt to understand some of the stages that an accounting practice, principle, or proposition might go

through on the way to general acceptance and some of the forces affecting the process. In this respect one of the most important facts to be recalled is that there is little, if any, opportunity for sound experimentation with new ideas. The discipline certainly is not susceptible to study by which all factors save one are held constant so that the effects of changes in the variable factor can be observed. Further experimentation in the sense of trial of a new idea by numerous practitioners under varying conditions also is severely restricted by the profession.[1]

Fundamental truth.--According to some authorities, accounting principles or postulates represent fundamental truths, apparently lying dormant through the ages waiting to be discovered. Such truths may be discovered deductively or empirically.

> Fundamental truth in accounting may therefore either be generalized out of practical experience or deduced from stated premises which are accepted as true in themselves, or proved to be true by argument. In the one case the propositions are considered as truths because experienced men agree that out of various possibilities, these

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[1]Alvin R. Jennings, "Accounting Research," Proceedings of the Twentieth Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1958), pp. 3-13.

> are the most desirable, the most descriptive of what seems best. In the other case the propositions are considered as truths because they follow by logical analysis from prior propositions which are obviously true. When both methods yield similar results, we may feel sure we have obtained an expression of fundamental truth.[2]

Acceptance.--Others are of the opinion that principles of accounting are not fundamental truths but principles that have authority based on acceptance. The argument has been advanced that in the development of the system of accounting just as in the development of systems of government or law there must be a period of unquestioning acceptance of traditional beliefs before free discussion can be usefully undertaken.[3] Accounting has many traditional beliefs. Perhaps, there was a period of unquestioning acceptance. If so, it certainly has ended. Useful, free discussion has been progressing for several years in the task of deciding which traditional methods should be adhered to and which should be modified. There is a presumption in

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[2]A.C. Littleton, "Tests for Principles," The Accounting Review, Vol. XIII(March, 1938), pp. 18-24.

[3]George O. May, "Accounting as a Social Force," The Canadian Chartered Accountant, Vol. XLIV(May, 1944), pp. 274-80.

favor of a rule or principle of long standing, but changed conditions may have made it inappropriate. Traditional beliefs must now stand re-examination.

Empiricism.--James L. Dohr was of the opinion that the development of accounting had been largely a matter of empiricism--a natural continuation of the evolutionary development of bookkeeping as previously discussed. In a complex economy accounting is a highly intricate art involving matters of economics, law, engineering, mathematics, and other arts and sciences. In making a decision an accountant is likely to draw on a knowledge of related disciplines without realizing that he has done so. In the usual case there are adequate reasons for accounting practices even though the accountant's explanation of his procedures is, in some instances, no more than that they are "conventional."[4] Others say that principles that have been derived from practice contain a wisdom that is not always immediately apparent after their unquestioned

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[4]James L. Dohr, "An Introduction to the Art of Accounting," The Accounting Review, Vol. XXII(April, 1947), pp. 151-61.

adoption has made them "conventional."[5] Herbert Heaton agrees that accounting has developed empirically by trial and error and that yet unstated principles are recognized and acted upon. In view of this situation, he advances as a first principle the principle of selection.

> The selection among alternatives (which is an underlying problem of accounting) must be such that the individual who uses accounting statements as a basis for legitimate judgement and action would arrive at the same judgement and take the same action, if he could study and interpret the underlying data from which the accountant has made selection.[6]

Unsound principles.--Some authorities take the position that when accounting principles are generalized out of practical experience unsound principles may become generally accepted. If an accountant faces a peculiar situation he may apply a principle that he

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[5]T.H. Sanders, H.R. Hatfield, and U. Moore, "Report of the Subcommittee Appointed to Study 'A Statement of Accounting Principles'," The Journal of Accountancy, Vol. LXXI(January, 1941), pp. 58-62.

[6]Herbert Heaton, "Selection: The Principle That Permits Accounting To Adapt Itself To Any Contingency," The Journal of Accountancy, Vol. LXXXVII(June, 1949), pp. 470-473.

would not consider applicable under ordinary circumstances. Or a client may influence an accountant to accept a presentation in a situation in which the amount is not material or the presentation is not so widely at variance with best practice to cause the accountant to withdraw. After a few instances of this nature involving reputable members of the profession other accountants are likely to find cause to follow the example. A textbook writer is likely to describe the practice as acceptable. Thus, a large body of precedent could be established for a procedure that was first reluctantly undertaken as an exception.[7]

Surely there have been a great many more sound than unsound accounting principles established by the exemplary force of the pioneers of the profession.[8]

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[7]Carmen G. Blough, "The Need for Accounting Principles," The Accounting Review, Vol. XII (March, 1937), pp. 30-37.

[8]Louis Goldberg, "The Development of Accounting Standards or Principles," Accounting and Auditing Standards, (Melbourne: Asian and Pacific Accounting Convention, 1960), pp. 15-25.

Influence of Government

Modes of effect.--An analysis of the influences of statutes and governmental agencies upon accounting has revealed four modes of effect: (1) Some agencies and statutes merely impose a record keeping requirement upon business. (2) Other statutes and agencies create problems which accountants must handle, e.g. the uncertainties of renegotiation of contracts or the possibility of liabilities arising from violations. (3) Other statutes and agencies have a direct influence on accounting concepts and thinking, e.g. cost allocations. (4) Finally, there are statutes and agencies having a direct influence on accounting thought and practice, and in some cases government agencies have the power to select accounting principles for certain classes of business enterprise.

It is this fourth mode of effect that is of primary interest. The power of government in this respect has been exercised in varying degrees. An agency may require information returns to be filed, and this requirement may include financial statements

which are made available to the general public. Experience has shown that an unhealthy situation can sometimes be corrected merely by publishing facts. The requirement may go a step further and require the statements filed to conform to a generally accepted practice as established by an industry or by a profession. Furthermore, the agency may have the power to prescribe certain detailed rules or principles to attain "uniformity" or to avoid "misleading statements."[9]

Interstate Commerce Commission.--The first significant governmental action directly affecting accounting came in 1894, when the Interstate Commerce Commission began its efforts to standardize the accounts of carriers coming under its jurisdiction. However, interest is primarily in actions that affect the accounting of business in general.

Income tax laws.--In 1909, the government began taxing corporate income, but the present income tax

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[9]William W. Werntz, "The Influence of Administrative Agencies on Accounting," Handbook of Modern Accounting Theory, Morton Backer, (New York: Prentice-Hall, Inc., 1955), pp. 99-118.

law is the latest of a series beginning in 1913.[10] Congress enacted the 1913 income tax law without consulting members of the accounting profession. This law was a completely unworkable attempt to tax cash-basis income. Its effect on accounting principles and on the accounting profession was limited. One deleterious effect extending to the present arose from the requirement that tax returns be prepared on the calendar year basis.

Accountants had long advocated depreciation accounting without convincing business men generally of its merits. But when depreciation became an allowed deduction for income tax purposes, business men readily accepted depreciation accounting for financial statement purposes. The revisions of the code through the years have had an increasing impact on accounting practice and on accounting thought. The increasing tax rate in itself has served to accentuate the importance of the accounting concepts affected. In so far as the

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[10]P.F. Brundage, "Influence of Government Regulation on Development of Today's Accounting Practices," Selected Readings in Accounting and Auditing, Mary E. Murphy, (New York: Prentice-Hall, Inc., 1952), pp. 132-37.

code and regulations require a certain concept be followed in the computation of taxable income, they tend to establish a uniform practice for financial statement purposes. A required income tax method may in a period of years become accepted by business men in general and the less sophisticated accountants as the correct method. As a matter of convenience, accounts are often kept on the income tax basis, because the differences between "best" accounting and the income tax method are not considered to be worth the trouble of keeping duplicate records or making adjustments between two concepts.

A somewhat more elusive effect in this connection arises from the fear of management that a different handling of a matter for financial statement purposes might negate their arguments before the Internal Revenue Service and the courts should they be required to defend their computation of taxable income.[11] The internal revenue code, regulations, and

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[11]George R. Catlett, "Factors that Influence Accounting Principles," The Journal of Accountancy, Vol. CX(October, 1960), pp. 44-50.

court decisions represent a body of tax accounting theory quite different from financial accounting theory. Since the revenue code is relatively uniform in its application to business, generally it is believed that its influence is in the direction of uniformity.[12] It should be pointed out that the income tax laws probably have had an even greater effect on accountants than on accounting. The income tax has added a new field to the profession of accountancy, and in addition it has opened doors to accountants giving them the opportunity to point out the need for their accounting and auditing services. This expansion of the profession no doubt has assisted its efforts to develop uniform principles.

Federal Trade Commission.--The first governmental agency to concern itself directly with the diversity in financial statements of business in general was the Federal Trade Commission. Pursuant to a study of the statements made by merchants and manufacturers, the Federal Trade Commission asked the assistance of

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[12]Werntz.

the American Institute of Accountants[13] in the establishment of standards. The AICPA prepared a memorandum recommending form, content, and verification for financial statements. The emphasis in this memorandum was on auditing, but its effect toward uniformity of corporate financial statements extended beyond any previous accomplishment. This memorandum, "General Instructions for a Balance-Sheet Audit of a Manufacturing or a Merchandising Concern" was published by the Federal Reserve Board in 1917[14] to help bankers protect themselves against losses. It has been reprinted widely and revised several times.[15] However, catastrophic events in the coming years were to create a climate in which compulsive action was to replace in some measure persuasive cooperation.

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[13]The American Institute of Accountants changed its name to American Institute of Certified Public Accountants in 1957. Hereafter it will be referred to as AICPA.

[14]Federal Reserve Board, "Uniform Accounting," The Journal of Accountancy, Vol. XXIII(June, 1917), pp. 431-33.

[15]Marcus G. Eaton, "Financial Reporting in a Changing Society," The Journal of Accountancy, Vol. CIV(August, 1957), pp. 25-31.

Securities and Exchange Commission.--As has been previously mentioned, the stock market crash of 1929, and the depression that followed set the stage for a new departure in economic philosophy. The reform atmosphere, having inherited pungency from a recent history of abuses in the securities markets, influenced the Congress to pass the Securities Act of 1933 and the Securities Exchange Act of 1934.[16] The Securities Exchange Act created the Securities and Exchange Commission with certain regulatory powers having a direct bearing on accounting. These laws require that certain corporations must be registered with the Commission before their securities can be offered for sale to the public. The law also gives the Commission broad powers to prescribe the form in which the information required by the law shall be set forth, and the items or details to be shown in the statements included in the application for registration. The Commission also has authority to prescribe the methods to be followed

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[16]Sinclair Armstrong, "Corporate Accounting Standards Under Federal Securities Laws," Proceedings of the Eighteenth Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1956), pp. 61-69.

in the preparation of reports and in making the valuations reported in the statements.[17] It is through the exercise of this power that influence of the Securities and Exchange Commission has become of primary importance in the establishment of uniformity in accounting.

To the deterioration of investor confidence in the securities markets has been attributed considerable responsibility for the severity and duration of the great depression. The Securities and Exchange Commission has been given much credit for the efficiency of the securities markets in serving the economy in the recent era of expansion. The need for the securities laws can be seen more clearly by reflecting on the rapid increase in the use of corporate forms of organization, the increase in typical size, and the subdivisions of ownership. The chasm between ownership and control is ever-widening, creating a presumption that financial reports to stockholders would be found increasingly vital.[18]

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[17] Louis H. Rappaport, SEC Accounting Practice and Procedure, (New York: The Ronald Press Company, 1956), p. 17.

[18] Armstrong.

The accounting activities of the Commission are directly in point here. The Commission requires conventional balance sheets, income statements, and statements of retained earnings along with supporting schedules. A corporation's first application for registration must give prior-years' information also. The form and content of these statements are set forth in Regulation S-X. This regulation did not create any new accounting principles or practices, but merely set forth the extent of detailed information required, as worked out with the advice and cooperation of the profession. It has been changed periodically to maintain its professional acceptance. Many have advocated the inclusion of currently accepted accounting principles in Regulation S-X, and others have recommended the inclusion of theories not yet generally accepted. However, the Commission has been reluctant to usurp professional prerogatives. On occasion the Commission has seen a need for the removal of discrepancies or the establishment of a uniform rule with regard to a specific practice and has issued a rule or an opinion

to accomplish this.[19] It is obvious that the work of the Commission has been a force in the direction of uniformity.

In addition to its work directly concerned with accounting principles and practices, the Commission's indirect influence is also important. One of the Commission's requirements is that the financial statements filed with it must be "certified" by an independent accountant. Since independence is not an unblemished virtue, inborn in accountants, there are occasions when the profession needs the bolstering influence of the Commission. Management cannot change an accounting principle by changing accountants. Neither can management avoid the fact that the staff of the Commission can reject its registration statement, if it is not in accordance with sound accounting principles.[20]

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[19] Earl C. King, "Presentation of Pertinent Data in Financial Statements," Proceedings of the Tenth Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1948), pp. 3-16.

[20] Harry A. McDonald, "How Cooperation in Development of Accounting Principles by SEC and Profession Helps Investors," The Journal of Accountancy, Vol. XCI (March, 1951), pp. 411-15.

The beneficent effect of the Commission's activities was attested by a survey made of large corporations not required to be registered with the Commission. Of the 1200 companies having at least 750 stockholders of one class and two million dollars in total assets, 85 per cent gave stockholders a complete set of statements, but at least 50 per cent of them fell below the standard required of registered corporations.[21]

However, serious questions have been raised as to the long-run desirability of an agency having such broad powers over accounting as does the Securities and Exchange Commission. George O. May objected in these words:

> Looking to the future, I am convinced that the grant of power to the Federal Trade Commission, and later to the Securities Exchange Commission, to control the accounting of general business corporations whose securities are listed, was not in the public interest. It seems to me to have been the more unnecessary since an alternative procedure, more in harmony with the American system of checks and balances and more likely to prove efficacious, was ready to hand.[22]

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[21] Armstrong.

[22] George O. May, Financial Accounting, (New York: The Macmillan Company, 1943), pp. 64-65.

May's basic fear seems to have been that non-accountant bureaucrats in the Commission would make decisions establishing accounting principles. Experience indicates that his fears probably were unfounded.

Herbert F. Taggart pointed out that a requirement that a report to a governmental agency be prepared on an unsound basis would cause the same to prevail for other purposes, because of the expense and inconvenience of maintaining duplicate records. He also pointed out that a rule imposed by a governmental agency might prevail after changed conditions made it illogical, because of passive acquiescence to a government requirement.[23]

William W. Werntz has pointed out three dangers to accounting development from the actions of administrative agencies. A tendency toward inertia as exemplified by the accounting of railroads under the Interstate Commerce Commission he considered most harmful. His second point was that administrative agencies have a

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[23]Herbert F. Taggart, "Troubles That Arise When Government Control Agencies Try to Prescribe Accounting Procedures," The Journal of Accountancy, Vol. XCV (March, 1953), pp. 296-304.

restricted viewpoint, not the breadth of coverage necessary to the development of principles and practices. Third, he pointed out that government action might modify thought, e.g. the tax treatment of items has become a major consideration in accounting thought.[24]

New York Stock Exchange.--Perhaps the moderate, plodding attitude in the application of its compulsive powers by the Securities and Exchange Commission can be attributed to the fact that reform measures had been initiated prior to its inception. In 1930, an era of cooperation began between the Stock List Committee of the New York Stock Exchange and the Special Committee on Co-operation with Stock Exchanges of the AICPA.[25] This cooperation was intended to implement the efforts of the Stock Exchange to secure reasonable uniformity in the annual reports of listed corporations. By 1932 a series of meetings and an exchange of correspondence had culminated in the issuance of the first authoritative

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[24]Werntz.

[25]Study Group on Business Income, Changing Concepts of Business Income. (New York: The Macmillan Company, 1952), pp. 34-37.

statement of accounting principles. This statement consisted of five paragraphs dealing with realization of income, capital surplus, earned surplus, treasury stock, and receivables from officers, employees, and affiliates. Obviously, this first effort was neither comprehensive nor detailed, but it was a strong force in the direction of uniformity, and it was to become the nucleus of an ever-expanding body of accounting principles.[26]

AICPA.--Since the AICPA had accepted the responsibility for formulation of accounting principles, it proceeded to create a Committee on the Development of Accounting Principles. The first report of this Committee to the Council of the AICPA was published in November, 1934. In this report it was pointed out that accounting principles cannot be arrived at by pure reasoning, but must find their justification in practical wisdom. Hence, it was decided to act with care and deliberation, and to endeavor to secure the concurrence of higher authority in the rules and princi-

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[26]Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932.

ples to be adopted. In this first report the Committee recommended that the Institute formally adopt the five rules or principles formulated in conjunction with the New York Stock Exchange. It further recommended a sixth rule, one with regard to the accounting for exchange of capital stock for property, donation of a part of the stock to the corporation, and sale of the donated stock.[27]

The codified principles of accounting were six in number until 1938, when another committee, the Committee on Accounting Procedure, added a recommended practice with regard to gain or loss on the sale of treasury stock. Then in 1939, these rules were reissued by the Committee on Accounting Procedure in "Accounting Research Bulletin No. 1."[28] This was the first of a series of fifty-one bulletins relating to accounting principles and rules, and four bulletins relating to accounting terminology. The last of the

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[27]Special Committee on Development of Accounting Principles, "Report of Special Committee on Development of Accounting Principles," Bulletin of American Institute of Accountants, (November 15, 1934), p. 10.

[28]Accounting Research Bulletin No. 1, pp. 1-9.

series was issued in 1959, after twenty-one years of accounting progress.[29]

Pursuant to a 1957 proposal by Alvin R. Jennings, a study was made for the purpose of revising the Institute's research program. The Accounting Principles Board was created to have sole authority within the AICPA to make pronouncements on accounting principles and to govern the activities of a research staff. The immediate objectives adopted for the Board and the Research Staff were: (1) to make a study of the basic postulates underlying accounting principles generally, and (2) to make a study of broad principles of accounting. It was also recognized that rules or other guides for the application of principles in specific situations would require attention. The need for more accounting research was recognized with respect to the foregoing objectives.[30] As fruits of this action The

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[29]Committees on Accounting Procedure and Accounting Terminology, Accounting Research and Terminology Bulletins, (Final Edition, New York: American Institute of Certified Public Accountants, 1961).

[30]Special Committee on Research Program.

Basic Postulates of Accounting, by Maurice Moonitz, Director of Research, was published in 1961; and A Tentative Set of Broad Accounting Principles for Business Enterprises, by Robert L. Sprouse and Maurice Moonitz was published in 1962. These publications did not receive the whole-hearted endorsement of the Accounting Principles Board, and they were received with mixed feelings by the profession in general. Further comment with regard to these publications will be made in Chapter 9.

American Accounting Association.--In 1936, the Executive Committee of the American Accounting Association made its first significant contribution toward the establishment of accounting principles by publication of "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements."[31] This was an attempt to set forth some of the bases upon which accounting statements rest. It was admittedly experimental and not all-inclusive. The stated objective was

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[31]F.P. Byerly, "Formulation of Accounting Principles or Conventions," The Journal of Accountancy, Vol. LXIV(August, 1937), pp. 93-99.

that every corporate report should be based on accounting principles which are sufficiently uniform and well understood to justify the forming of opinions as to the condition and progress of the business enterprise. The "Tentative Statement" consists of twenty pronouncements under the general topics of costs and values, measurement of income, and capital and surplus. There were revisions in 1941, 1948, and 1957, with eight supplementary statements from 1950 to 1954.[32]

Individuals.--In addition to the contributions of agencies and organizations toward formulation of accounting principles there have been many individuals whose contributions have been significant. The work of L.R. Dicksee, H.M. Hatfield, R.H. Montgomery, G.O. May, H.A. Finney and other individuals was the predominant influence in accounting early in the twentieth century. In the early days there was no professional organization on whose authority a practitioner could

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[32]Committees of the American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, (Madison, Wisconsin: American Accounting Association, 1957).

rely. While the authority of agencies and organizations was being established they utilized the knowledge and prestige of individuals. At the same time the number of publications grew phenomenally. However, it appears that the professional organizations now are the source of authority recognized by authors, teachers, and practitioners alike.

CHAPTER IV

BASIC PROBLEMS IN ACCOUNTING

Introduction.--To one who has never become involved in the controversy between the group advocating flexibility and the group advocating uniformity in the application of accounting principles, the failure of the disputants immediately to become reconciled may be quite perplexing. In this and the following chapter some of the difficulties faced by accountants individually and as members of the profession will be discussed.

It seems logical that in order to understand what makes accounting complex one should start with the functions of accounting. And in order to examine the functions of accounting a logical point of departure is the official definition of accounting.

> Accounting is the art of recording, classifying, and summarizing in a significant manner

> and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.[1]

It is obvious that recording in itself would not present any problem, but to record in a manner to make classifying, summarizing and interpreting possible might be quite another thing.

Classification and summarization.--The problem of classification might be considered a simple one--all that is necessary is that like things be grouped together. However, business transactions are not susceptible to analysis into a definite and rigid number of effects. Accountants are constantly faced with new situations requiring judgment in classification.[2] How much alike must items be in order to fall into the same classification? How significant must an item be, and how different, in order to justify another classification?

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[1]Committee on Terminology. Accounting Terminology Bulletins, Bulletin No. 1, (New York: American Institute of Certified Public Accountants, 1953), p. 9.

[2]Charles B. Couchman, "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" The American Institute of Accountants Fiftieth Anniversary Celebration, (New York: American Institute of Accountants Publishing Co., Inc., 1937), pp. 233-64.

Summarization causes similar dismay. To what extent should information be summarized? Even a minimum of summarization may be misleading to a person who needs detailed information. On the other hand presentation of great detail may mislead by obscuring a relevant item in a mass of minutiae. It appears that in the art of classifying and summarizing there is no substitute for the judgment of an able accountant.

Common denominator.--According to the definition of accounting the art requires expression in terms of money. It has been mentioned previously that a system of money was a necessary antecedent of bookkeeping. A common denominator is an absolute necessity.[3] Classification and summarization of the effects of business transactions could not be accomplished without such a tool. Accounting literature is replete with articles lamenting the unsuitability of money as the common denominator. Accounting principles require that the monetary unit be treated as a constant measure of value. This is admittedly imperfect. Many have advocated the

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[3]Committees of the American Accounting Association, p. 60.

adoption of a system of index numbers to supplement the monetary unit as the common denominator of accounting. However, a closer look reveals that such a statistical product is itself the result of a colossal computation based on a multitude of judgments and subject to readjustment as the populace changes its buying habits. Could accountants be searching for absolutes in a world of relativity?

Periodicity.--Another difficulty inherent in accounting is the problem of periodicity. Business is no longer a series of ventures to be accounted for separately, but it is a relatively uniform series of similar transactions expected to be continuous and appropriately accounted for on a periodic basis.[4] It is obvious that a going concern will have numerous transactions, each of which might affect more than one period. It is the accountant's task to fit these transactions into annual periods in such a way as to make possible a significant summary of the effects of trans-

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[4]Correspondence Between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932.

actions for each period.[5]

A companion to the problem of periodicity is the problem of consistency. When reports of business activity are prepared periodically, it is essential that the same guidelines be followed in preparation of the reports from period to period in order that the progress of the business unit will be indicated.

Interpreting.--The original official definition of accounting was identical to the revised version above, except that it did not contain the word "interpreting."[6] Not only is the meaning of the expression, "interpreting the results of financial transactions," subject to controversy, but at least one authority had previously stated that interpretation was beyond the scope of accounting principles.

> Beyond principles which conceive of accounting function as an information service and of accounting

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[5]G.H. Newlove and S. Paul Garner, Advanced Accounting, (Boston: D.C. Heath and Company, 1951), Vol. I, p. 413.

[6]Accounting Research Bulletin No. 7, p. 58.

> as a quasi-statistical methodology, there lies interpretation. It is outside of the province of accounting principles to deal with interpretation. The conclusions one draws from accounting data, once it is as complete as we can make it and disclosed as clearly as we can devise, are individual, depending much more upon the understanding and skill of the interpreter than upon the accounting data available.[7]

According to this same authority, accounting has only one function--to furnish dependable, relevant information about business enterprise. The Committee on Accounting Procedure chose not to give a detailed definition of accounting for fear of limiting its scope. For a better understanding of the functions of accounting one must consider the uses and the users of accounting data.

Users of accounting data.--The group primarily interested in accounting data is business management. Accounting is a necessary tool in centralized control, a characteristic of business in the twentieth century.[8]

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[7] A.C. Littleton, "The Relation of Function to Principles," The Accounting Review, Vol. XIII (September, 1938), pp. 233-41.

[8] Edgar O. Edwards and Philip W. Bell, The Theory and Measurement of Business Income, (Berkeley, California: University of California Press, 1961), pp. 110, 270 et seq.

However, the accounting records are under the direct control of the management team, enabling it to obtain the desired data presented in the desired form. The accounting profession, in the formulation of principles, is more interested in protecting the interests of groups external to the operating unit. This is a function of financial accounting.

Accountants generally consider stockholders to be the most important group of users of financial statements. No doubt this is true when speaking of large enterprises.[9] There is a need for measurement of the stewardship and performance of the management group to whom the stockholders entrust their capital.[10] To the degree that financial events are subject to different interpretations, accounting must furnish principles, rules or conventions to guide accountants in their application of judgment, thus helping to effect an equitable reconciliation of the interests of the parties.

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[9] W.A. Paton and A.C. Littleton, An Introduction to Corporate Accounting Standards, (Madison, Wisconsin: American Accounting Association, 1940), p. 2.

[10] Dohr.

Investors should use accounting data to make decisions as to whether to buy, to sell, and to grant a proxy. Of course, some accountants doubt the ability or willingness of transient investors to read corporate reports. It is doubted also that they have sufficient interest to read them.

> For years most of us have been urging the necessity for giving more attention in reporting to the stockholder's requirements--especially those of the transient stockholder. . . .But no good can be served by working up great enthusiasm, great missionary zeal, which is out of line with the actual possibilities. . . .I am in favor of improving accounting reports, but I question our ability to save the speculator's "hide" by this means.[11]

Similarly, suppliers are interested in the financial data of a business unit from the standpoint of credit risks involved and from the standpoint of the stability of markets. Also customers have a legitimate interest in the financial affairs of an enterprise because of the relationships of price to cost, and because financial affairs bear upon ability to

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[11]William A. Paton, "Accounting Reports," Proceedings of the Third Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1940), pp. 5-12.

perform.[12]

Government has a variety of interests in accounting data. The Internal Revenue Service is interested in accounting data as a basis for taxation. The Securities and Exchange Commission is interested in protecting investors. Regulatory agencies are interested in costs as a basis for rate schedules. There are both federal and state agencies interested in protection of employees. Courts find accounting data useful in judicial proceedings. Numerous governmental and private agencies are interested in accounting data as a basis for economic statistics for guidance to lawmakers and to business. Each group approaches financial statements with a different point of view, and from the same data would receive different messages. Nevertheless, the accountant is expected to produce a single set of statements suitable for the use of all groups.[13]

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[12]Herman W. Bevis, "The Accounting Function in Economic Progress," The Journal of Accountancy, Vol. CVI(August, 1958), pp. 27-34.

[13]James J. Caffrey, "Plain Talk in Accounting," Challenges to the Accounting Profession, (New York: American Institute of Accountants, 1947), pp. 31-35.

The problem of the multiplicity of users of financial statements is further confused by their lack of accounting training and by the indefinite character of accounting terminology. In accounting the same term is often used in different senses, and often a term is used that has one meaning to the layman and another to the accountant. Accountants have not utilized Greek or Latin terms as have lawyers and scientists, but they have consistently attempted to make their statements understandable to people having little knowledge of accounting. Obviously, this is a basic problem of the profession.

Multiplicity of goals.--It is anticipated that the present trend in the attitude of society toward corporate responsibility will further complicate the task of the accountant. Heretofore business has had as its primary objective, if not its sole objective, maximization of profit. This premise presented accountants with the primary task of measurement of business income. While there long has been discussion as to items includable in the computation of

business income, recently the controversy has been enlivened by new ideas. One new idea is that "cost savings" be included as a component of business income.[14] Other writers anticipate the addition of social advancement as another goal of business.[15]

Summary.--It has been shown that there are several basic problems in accounting. There are difficulties inherent in the statistical methodology, i.e. in classification and in summarization. There are difficulties in the variety and nature of the events with which accounting is concerned and in the inadequacy of the common denominator in which they must be expressed. There are difficulties arising from the variety of groups using financial statements, and these difficulties are accentuated by the conflict of interests of the groups involved.[16] When to these points of

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[14]Edwards and Bell, p. 110.

[15]Bedford and Dopuch.

[16]Leonard Spacek, "Challenge to Public Accounting," Harvard Business Review, Vol. XXXVI(May-June, 1958), pp. 115-24.

difficulty is added the controversy as to the definition of business income and the likelihood that the business enterprise will recognize additional goals, it is quite apparent that the task before the profession is monumental.

CHAPTER V

DIFFICULTIES ENCOUNTERED IN THE DEVELOPMENT OF ACCOUNTING PRINCIPLES FOR UNIFORMITY IN FINANCIAL STATEMENTS

Variety of conditions.--A moment's reflection on the number and variety of business enterprises in the United States is revealing. It already has been pointed out that such variety creates for accountants a problem in adaptation. The problem is much more exacting when the objective of uniformity is added. To prepare a body of theory on which the statements of any sort of business can be based, and which will render the statements comparable to other statements of different businesses based on the same body of theory, is no easy task. Certainly, the more diverse the accounting entities covered, the more general in

nature must be the principles applied.[1] Heretofore accounting standards have been viewed as a doctrinal background to guide the accountant in the exercise of judgment. The accountant has been free to choose the procedure suitable to diverse enterprises operating under varying conditions.[2] It is inconceivable that sufficiently detailed standards could be laid down to minimize the accountant's exercise of judgment without forcing some illogical applications.[3]

Conflicts of interests.--Similarly, the difficulties arising from the number and diversity of uses and users of financial statements extend into the arena of principles formulation. Beyond the differences in information needed and differences in ability to understand financial data there is the problem of conflict of interests. With respect to this problem it can be

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[1]Study Group on Business Income, pp. 106-107.

[2]F. Sewell Bray, Precision and Design in Accounting, (London: Gee & Company Publishers Limited, 1947), p. 93.

[3]William W. Werntz, "Problems in the Application of Accepted Accounting Principles," Proceedings of the Fourth Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1941), pp. 10-19.

seen that socio-economic philosophy must enter into the formulation of accounting principles. Developments in recent years tend to recognize the interests of organized labor and of consumers in financial facts, and perhaps as an outgrowth of this recognition the general public and the government have an increasing role in the development of accounting principles. Labor leaders have already questioned specific corporate income figures,[4] and it is only a matter of time until they will question the fairness of the body of theory upon which income figures are based. The general public is concerned about the fairness of the distribution of the economic income of business enterprise. There must be fair prices, fair wages, and a fair return on capital. The key to a decision as to the fairness of distribution of economic income is the corporate annual report and the accounting principles upon which it is based. The problem of conflict of interests extends to management vs. stockholders, small stockholders vs. large stockholders, and present stockholders vs. prospective

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[4]Spacek.

stockholders.

Conflicting concepts and principles.--Just as there are conflicts among the viewpoints of different users of financial statements, there are also conflicts among basic postulates, doctrines, or approaches to accounting theory as well as between similarly defensible principles. For instance, an accountant consciously or sub-consciously selects either the proprietary theory or the entity theory in his approach to a decision on an accounting proposition. While the two approaches are generally recognized as acceptable, in many cases they will lead the accountant to quite different presentations of the same facts.[5] It is difficult, if not impossible, to reconcile the differences with regard to tentative principles of two groups when one emphasizes the entity theory while the other emphasizes the proprietary theory. There is another conflict arising from the relative importance of the balance-sheet and the income statement. When approaching a proposition with the emphasis on fairly reporting

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[5]Garner.

periodic income one may get quite different results from what he would get if he had emphasized financial position. Similarly, these points of view would have a significant bearing on the willingness of the members of the profession to accept a somewhat inflexible set of accounting principles. The principle of conservatism comes into conflict with the principle of consistency. The principle of consistency comes into conflict with the principles regarding valuation of inventories.[6] A conservative attitude with regard to income of one period conflicts with conservative statement of income in subsequent periods. The outstanding common characteristic of these conflicting viewpoints, concepts, and principles is that none can be said to be so inherently superior as to be alone regarded as acceptable.[7]

Individual bias.--It has been pointed out that there are differing, logical, generally accepted, but

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[6]Stephen Gilman, Accounting Concepts of Profit. (New York: The Ronald Press Company, 1939), p. 174.

[7]Harold A. Eppston, "Accounting in Evolution," The Journal of Accountancy, Vol. LXX(August, 1940), pp. 128-34.

irreconcilable positions that accountants might take with regard to a proposition. Accountants are human, or at least they possess some human frailties.[8] Often an accountant or a group of accountants will take a position that they can support with cogent reasons and maintain that position unalterably awaiting the opposition's disproval and ignoring the fact that neither can the opposition's position be disproved.[9]

Writers on the subject of uniform accounting standards sometimes give the impression that what they really favor is uniform adoption of their own views by the profession. Articles favoring uniformity often advocate the acceptance of a new practice. Is this not an advocation of uniformity and flexibility in the same breath? Uniformity requires concessions. For instance, advocates of uniformity may be called upon to choose between uniformity and the privilege of assuming a flow contrary to fact in inventory valuation.

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[8]Robert L. Dixon, "Criticisms of the Tentative Statement of Accounting Principles," The Accounting Review, Vol. XVI(March, 1941), pp. 49-55.

[9]Werntz.

They may find it expedient to continue to accept historical cost as a basis for financial statements rather than to urge price level accounting upon the profession. Of course, it is a virtue to cling tenaciously to one's convictions, but resoluteness retards movement toward uniformity.

In addition to this forgivable propensity to favor one's own position there are instances of self-interest less befitting a professional accountant. Accountants sometimes take a theoretical position, consciously or sub-consciously, because the immediate effect appears to be a generally lower corporate income tax. In other situations the motive might be specifically to minimize the tax liability of a valued client or group of clients.[10] The nadir of professional impropriety is reached when an occasional accountant resists the trend toward uniformity for fear of reducing the art of accounting to such a simple state that technicians would replace professional practitioners. However, regardless of what form the art of accounting

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[10]Gilman, pp. 175-76.

may take in the future, never will the community cease to require the services of such an able group of men as now practice accounting. Furthermore, if it were possible to construct a system under which the objectives of accounting could be accomplished by less able men it would be the obligation of the profession to do so.

Divided responsibility.--While pointing out the shortcomings of accountants in the formulation of uniform accounting standards, one should not overlook the fact of divided responsibility in this area and the fact that the accounting profession has taken the lead. It has been accepted for many years that management is primarily responsible for its own financial statements. It follows that, since management is primarily responsible for its statements, it has the responsibility for choosing from among accepted methods of implementation those methods that shall be adopted by the corporation. However, this does not fix upon management the responsibility for deciding which methods are acceptable.[11]

Some spokesmen for the profession feel that

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[11]Study Group on Business Income.

industry should accept a greater degree of responsibility for accounting principles. Of course, this would not necessarily remove the task from the hands of accountants. An opinion of the Interstate Commerce Commission in 1914 held the accounting officer to be directly responsible for corporate statements.[12] However, it is the duty of the profession to select the standards by which its members will judge the statements before giving an opinion as to their fairness.[13] There is only a contractual relationship between the independent accountant and his client. The accountant cannot force his views upon management, but with the aid of a clear, concise statement of accounting principles bearing the prestige of the profession he must persuade the client to accept a fair presentation of the facts.[14] The AICPA must continue to accept primary responsibility for accounting principles, and it must continue to

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[12]The Securities and Exchange Commission, "Who is Responsible for Accounting Reports?" (Release No.2043).

[13]Littleton.

[14]Ibid.

welcome the cooperation of such organizations as the American Accounting Association and the Financial Executives Institute.

Relationships to other fields of knowledge.--Additional problems in developing uniform accounting standards arise from the relationships between accounting and other fields of knowledge. Accounting is criticized for its flexibility and inexactness because the uninitiated attribute the quality of exactness to any communication using mathematics. However, accounting communication also uses language, which is most inexact.[15] In fact, a good portion of the efforts of lawyers and the courts have the objective of translating language into communication that cannot be misunderstood and the objective of interpreting communications not so stated. Accounting in general and corporation accounting in particular is influenced by statutory and common law, promulgated by legislators and courts which are often unfamiliar with accounting.[16] It is difficult to see

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[15]Werntz.

[16]Gilman, p. 174.

how accounting can be any more uniform than is the law with all of its inaccuracies, contradictions, and split decisions.[17] These influences of the law are in addition to the more direct effect of government, e.g., direct regulation of accounting through the Securities and Exchange Commission, the direct effect of taxation, and the effect on accounting thought of sanctions imposed by income tax laws. Economists generally advocate more uniformity than has been considered attainable from a practical standpoint.[18] However, economists advocate more detail in financial statements, and the more detail required in statements of unlike businesses the more difficult it is to present comparable statements. Financial analysts recently have contributed to the difficulty by casting a shadow over the importance of net income as conventionally determined on the accrual basis. However, their emphasis on cash-flow analysis

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[17]George O. May, "The Choice Before Us," The Journal of Accountancy, Vol. LXXXIX(March, 1950), pp. 206-11.

[18]Charles T. Taylor, "An Economist Looks at Financial Statements," Georgia Business, Vol. VIII (April, 1949), pp. 7-21.

may advance the cause of uniformity by pointing up the apparent lack of interest in conventional statements on the part of investors. Students of business management often consider accounting to be too uniform, too resistant to change, and unadaptable to the needs of management.[19] However, there is no conflict between uniformity in financial accounting and flexibility in the branch of accounting that directly serves the needs of management.

Prescribing limits of standardization.--Another difficulty presents itself when one attempts to prescribe the limits of standardization. How much standardization is practicable without stifling the progress that might be born of flexibility?[20] How much latitude can be left to the practitioner without sacrificing comparability? How much uniformity is required for effective communication of financial data to the interested party having limited accounting training?[21] Flexible principles

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[19]Billy E. Goetz, "What's Wrong with Accounting," Advanced Management, Vol. IV(Fall, 1939), pp. 151-57.

[20]Couchman.

[21]Brink.

are subject to varied interpretations, while at the same time flexible principles would be more closely adhered to. The more rigid the principles the more necessary is machinery for their revision.[22] In fact, in view of the almost insurmountable difficulties involved in establishing principles, it appears that machinery for constant revision is the most important requisite. Establishment of principles is an evolutionary process involving intensive research for the mobilization of the knowledge and experience of generations.[23]

Terminology.--One of the peripheral perplexities involved in accountants' imperfect communication, relative to the formulation of principles, is one of terminology. It has been customary in accounting to adapt lay phraseology to express technical ideas of a financial nature while other disciplines often coin new words or apply a Greek or Latin root word to any new idea. The AICPA has published a limited number of definitions and

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[22]Goldberg.

[23]A.A. Fitzgerald.

recommended usages, but in the usual case the accounting meaning of a term can be surmised only from its general definition. A similar problem in terminology has developed with regard to formulation of accounting principles.

Principle.--There has been considerable discussion as to whether accounting principles are in fact principles or mere rules. The disagreement arises from the fact that the word principle has several definitions, and each definition is subject to interpretation and application according to one's own predilection. According to Webster's Dictionary, some of the uses of the word are: a general or fundamental truth; a comprehensive and fundamental law, doctrine, or assumption on which others are based or from which others are derived; an elementary proposition; a governing law of conduct; an opinion, attitude or belief that exercises a directing influence on life and behavior; a rule or code of usually good conduct by which one directs one's life or actions.[24] Some of the uses given by Funk and

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[24]Webster's Third New International Dictionary of the English Language Unabridged, G.&C. Merriam Company, 1961.

Wagnalls Dictionary are: a source or cause from which a thing proceeds; fundamental cause; that which is inherent in anything, determining its nature; a general truth or law; a settled law or rule of conduct.[25] It is appropriate for an official body to define the terms used in its pronouncements as is often done in legislative acts. However, accounting organizations have not adopted such a policy. The first official body to adopt some of the elements that have come to be called "generally accepted accounting principles" referred to the six items adopted as "rules or principles."[26] Apparently the committee recognized that the name by which these pronouncements are called is of only secondary importance.

Rule.--According to Webster's Dictionary a rule is defined as: a prescribed, suggested, or self-imposed

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[25] Funk and Wagnalls New Practical Standard Dictionary of the English Language, Funk and Wagnalls Company, 1955.

[26] Committee on Accounting Procedure, American Institute of Accountants, Accounting Research Bulletins, Bulletin No. 1, (New York: American Institute of Accountants, 1939), p. 6.

guide for conduct or action; a regulation or principle; an accepted procedure, custom, or habit having the force of a regulation; one of a set of usually official regulations by which an activity is governed; a standard by which something is judged or valued; a principle regulating or held to regulate the practice of an art or science. Funk and Wagnalls Dictionary defines a rule as: a method or principle of action; common or regular course of procedure, or customary standard or form; an authoritative direction or enactment. It is apparent from the definitions of principle and rule that the committee could justify the use of either or both terms in connection with its actions.

Probably the din over the use of the term principle was amplified by the use of the phrase "generally accepted accounting principles" in the standard short-form of accountant's report. Some accountants and many interested laymen seem to think this phrase implies a codified statement of principles having only slightly less veneration than the Law of Moses. However, the basic requisite to communication is that the reader attempt to understand the meaning intended

by the writer. It is the writer's prerogative to select from the several accepted definitions of a word the one that best expresses his thought and to apply the term to his use without suffering criticism because of the fact that the term could be used otherwise.

While the Committee on Accounting Procedure of the AICPA did not find it desirable to elaborate on its choice of terms, at a later date its chairman explained the use of the term principle as being more directly under the Oxford Dictionary definition: fundamental truth, law, or motive force--a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice.[27] The Committee on Accounting Procedure indicated this definition to be appropriate to its use of the word.[28] The AICPA has explained the meaning of "generally accepted accounting principles" as a body of conventions for dealing with

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[27]Gilman, p. 191.

[28]Committee on Accounting Procedure, American Institute of Accountants, Accounting Research Bulletins, Bulletin No. 7, (New York: American Institute of Accountants, 1939), p. 60.

accounting problems, and in the explanation it is indicated that official expressions of these principles are not complete in their coverage.[29] The words "generally accepted" imply that the principles are not to be found in any single concise codification.[30]

Convention.--The explanation of the committee uses the term convention, which frequently has been applied to what the auditor's report calls "generally accepted accounting principles." According to Webster's Dictionary a convention is defined as: an agreement or decision about basic concepts or principles voluntarily but not altogether arbitrarily arrived at though based neither on physical experiments nor on a priori judgments; an axiom or principle regarded as true by convention; a rule, custom, or belief widely accepted and established by long usage. According to Funk and Wagnalls Dictionary a convention is defined as: general consent, or some-

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[29]Committee on Cooperation with Bankers and Other Credit Grantors, American Institute of Accountants, 40 Questions and Answers about Audit Reports, (New York: American Institute of Accountants, 1956).

[30]Clifford V. Heimbucher, "The Applicability of Generally Accepted Accounting Principles," 1954 Annual Meeting Papers, (New York: American Institute of Accountants, 1954), pp. 146 et seq.

thing established by it; precedent; custom; specifically, a rule, principle, form, or technique in conduct or art. Certainly there are conventions among "generally accepted accounting principles," but it is hard to see in the definitions any justification for the outcry over the choice of words.

Standard.--Another term that has been applied widely to generally accepted accounting principles is standards. Some of the definitions of the word standard found in Webster's Dictionary are: something that is established by authority, custom, or general consent as a model or example to be followed; a carefully thought-out method of performing a task; standard applies to any rule, principle, or measure used to determine the quantity, weight, or extent, or especially the value, quality, level, or degree of a thing. According to Funk and Wagnalls Dictionary the word standard is defined as: any established measure of extent, quantity, quality, or value; hence, any type, model, or example for comparison; a criterion of excellence; test; as a standard of conduct or taste. There are other words that have been used to denote

specific items or the entire body of generally accepted accounting principles, but these four--principle, rule, convention, and standard--are the most common.

Postulate.--Recently the term postulate has acquired new significance. According to Webster's Dictionary the word postulate may mean: a proposition advanced with the claim that it be taken for granted or as axiomatic; an essential presupposition, condition, or premise (as for a train of reasoning, a philosophic system, or a school of thought); an underlying hypothesis or assumption; a statement (as in logic or mathematics) that is assumed and therefore requires no proof of its validity. And some of the definitions given in Funk and Wagnalls Dictionary are: a proposition claimed or basis of argument laid down as well known or too plain to require proof; a self-evident truth; specifically, a self-evident statement regarding the possibility of a thing, especially of a geometric construction; a condition precedent that must be assumed to explain or account for a thing; a hypothesis; an unproved assumption. The Committee on Terminology of the AICPA indicated its understanding of the meaning of the word

postulate in this quotation: "Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally adopted, do they become principles of accounting."[31] In 1958 the Special Committee on Research Program of the AICPA adopted another definition. "Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment. . . ."[32] This definition was followed in Accounting Research Study No. 1, and while it is not mandatory, it appears that this definition will be the accepted definition in accounting literature for some time.

Obviously, there is justification for use of each of the terms. The user's choice of terms, no doubt, hinges on what particular principle he happens to be thinking of or the feature that he sub-consciously

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[31] Accounting Research Bulletins, Bulletin No. 7.

[32] Special Committee on Research Program, American Institute of Accountants, "Report to Council of the Special Committee on Research Program," The Journal of Accountancy, Vol. CVI (December, 1958), pp. 62-68.

emphasizes. The one who chooses the word standard is emphasizing the idea that generally accepted accounting principles represent a sort of model by which variations may be judged.[33] In the use of the word convention there is an emphasis on experience and custom. Use of the word rule implies a sub-conscious emphasis upon those principles that constitute guides handed down by authority. Those who prefer the word principle are emphasizing universality and everlastingness. And the word postulate may be applied to accounting principles of a primary nature forming a basis for subsidiary or implemental principles. It is doubtful that those who have adopted one of these words ever could be convinced that one of the others would be preferable. However, it appears to be desirable that members of the profession accept the term principle on the grounds that it is not incorrectly used and that it has official sanction. There are more important questions to be resolved.

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[33] S. Paul Garner, "The Development of Accounting Principles or Standards," Accounting and Auditing Standards, (Melbourne: Asian and Pacific Accounting Convention, 1960), pp. 1-13.

Uniformity.--A quite different situation exists with regard to accountants' use of the word uniformity. There has been considerable discussion of accounting matters in which the term is used, but very little discussion of just what is meant by uniformity. According to Webster's Dictionary the word uniform means: marked by lack of variation, diversity, change in form, manner, worth, or degree; showing a single form, degree, or character in all occurrences or manifestations; marked by complete conformity to a rule or pattern or by similarity in salient detail or practice; consistent in conduct, character, or effect; lacking in variation, deviation, or unequal or dissimilar operation. And Funk and Wagnalls Dictionary gives these definitions: being the same or alike, as in form, appearance, quantity, quality, degree, or character; not varying; unchanging; agreeing with each other; harmonious; accordant; consonant. According to these definitions it seems that the word uniform implies an absolute quality that is somewhat foreign to the economic side of life. Probably, each writer, each speaker, and each reader, has in mind his own interpretation of

the word, and perhaps this is a causal factor in the heated controversy that has built up over the past few years. Of course, when accountants speak of uniform accounting principles they mean accounting principles that will provide for uniform results. The chief objectives of advocates of uniformity are comparability within industries and between industries, objectivity to accomplish removal of the effect of individual bias, and implementation of independence and other ethical considerations.

In all probability the term uniformity as understood by accountants is not an absolute quality, but it has varying degrees of intensity as to which there is no mutual understanding between writers and readers.[34] To approach an understanding on this question accountants should consider how their viewpoints with regard to certain principles or practices fit into the various degrees of intensity of uniformity. Those who consider uniformity to mean a complete

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[34]Victor Z. Brink, "Safeguarding the Interests of Corporate Stockholders," The Journal of Accountancy, Vol. LXXII (September, 1941), pp. 235-43.

absence of variation would assume an advocate of uniformity in accounting to be advocating a system in which any given transaction could be reflected in the statements in only one way. One who takes a little milder approach to the controversy would accept as uniform a system in which a transaction must be reflected in a certain way, or if an optional method is selected, opinion must be denied. A little further from the absolute would be a requirement that a transaction must be reflected in the one acceptable way or differences resulting from the use of an alternate method must be quantified and explained.[35] Stepping a little further from the absolute, a given transaction must be reflected in a certain way or an exception taken in the accountant's report. No doubt, other degrees of intensity could be contrived to extend those suggested here, but these are sufficient to demonstrate that failure of communication is a contributor to the controversy over uniformity.

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[35] A.C. Littleton, "High Standards of Accounting," The Journal of Accountancy, Vol. LXVI (August, 1938), pp. 99-104.

CHAPTER VI

THE CASE FOR UNIFORMITY

Communication.--The most important work of the public accounting profession is its independent verification of financial data. One of the chief functions of the profession is to insure against the statements' reflecting optimism or pessimism on the part of corporate management.[1] In order for corporate reports to be useful they must communicate facts to persons who do not otherwise have access to these facts. Accounting is the language in which most financial facts must be communicated. Languages are by nature something less than perfect means of communication. These imperfections generally result from a combination of two factors, the complexity of the language or the failure of the parties to acquire a thorough knowledge of the

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[1]Spacek.

language. Accounting, just like any other language, falls short in its role as a means of communication due to complexity and unfamiliarity. Perhaps complexity and unfamiliarity are one cause seen from opposite viewpoints. Would not a reduction in the number of alternative practices both decrease complexity and tend to increase understanding of the principles on which financial statements are based?

Confidence.--In order for financial statements to be useful communications of financial facts, the users must have confidence in them. It is human nature to view with suspicion anything that is not easily understood. There are infinite levels of understanding. Not everyone can or needs to understand corporate reports, but most accountants agree that their statements should be understandable by people having a limited knowledge of accounting.[2] Some accountants are prone to explain away lack of confidence, failure to communicate, or misunderstanding as resulting from a lack of knowledge

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[2]Harry N. Case, "Building Confidence in Reports," Proceedings of the Tenth Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1943), pp. 17-22.

on the part of the reader. Accountants know the limitations of their art, hence they seldom draw unwarranted conclusions from financial statements. Understanding limitations may avoid unwarranted conclusions, but realizing a lack of information is not equivalent to obtaining facts on which to base conclusions. The profession can be strengthened by increasing the usefulness of its statements through building confidence by way of reducing available alternative practices and acquainting readers of corporate reports with a less complex language of finance.[3]

Measurement.--Expanding one more step beyond the central theme of usefulness, another element within the province of accounting is measurement.[4] The word measurement generally carries a connotation of exactness. However, further analysis of the uses of the word reveals that measurements are really only near

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[3]George O. May, "Uniformity in Accounting," Harvard Business Review, Vol. XVII(Autumn, 1938), pp. 1-8.

[4]Leonard Spacek, "Can We Define Generally Accepted Accounting Principles?" The Journal of Accountancy, Vol. CVI(December, 1958), pp. 40-47.

enough to exactness to be useful for the intended purpose. In most cases the important consideration is that measurement be based on an objective scale, and that related measurements be based on the same scale. Such is the case in accounting. Periodic net income cannot be determined with exactness, but it should be measured by an objective set of principles that are generally applicable.[5] Subjectivity in measurement cannot be eliminated, but it can be reduced by carefully reducing alternative procedures in favor of accepted, objective, conventional principles.

Power of corporate management.--Additional grounds for advocating the establishment of uniform accounting principles can be realized from analysis of the business environment in which the art is practiced. No one could question that modern America is a business oriented society. The business community is corporation dominated, and the predominant influence is the large to gigantic corporation. The corporation

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[5]Arthur C. Kelley, "Can Corporate Incomes Be Scientifically Ascertained?" The Accounting Review, Vol. XXVI(July, 1951), pp. 289-93.

is no longer the same breed as when originally conceived. Nowadays corporation managers are a self-perpetuating, self-determining, and sometimes a self-serving group. Management tends to control the stockholders rather than be controlled by them.[6] Beyond maintaining a reasonable rate of earnings and dividend payments management needs do little to avoid rumblings from the equity owners. Proxy fights are difficult, expensive, and rare. Management is relatively free to seek its own emolument. The stockholder who has no closer relationship with corporate management than that of ordinary share-owner has his greatest protection in the accounting profession. For the protection of society it is mandatory that better communication be established between the outside stockholder and the independent accountant.

Valuation of securities.--A few years ago net income for the year or the average for recent years was

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[6] J.A. Livingston, "What's Wrong With Financial Reporting?" The Journal of Accountancy, Vol. CXII (August, 1961), pp. 28-33.

usually a major factor in computation of capital values of equity securities. Securities were usually valued at a multiple of average earnings.[7] Probably, this is a major factor in the shift of emphasis from the balance-sheet to the income statement. It is possible that diverse practices in measuring periodic income may be leading to another shift in emphasis. While the profession has been working to reduce alternative practices, new situations in business have developed rapidly giving rise to new divergent practices and somewhat nullifying the efforts of the profession. These developments along with inadequate disclosure have made valuation based on net income difficult, if not meaningless.[8]

According to one authority, stockholders, financial analysts, and the securities markets appear to be giving more weight to other factors than to net income

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[7]T. Dwight Williams, "Financial and Operating Reports for Stockholders," Proceedings of the Eighth Institute on Accounting, (Columbus, Ohio: The Ohio State University, 1946), pp. 65-73.

[8]Allen B. Richards, "A Note on Depreciation and Inventory Valuation Methods Used by Food Companies," The Accounting Review, Vol. XXXVI(July, 1961), pp. 472-73.

in the valuation of stocks. The accountant's most sacred concepts, packaged in accrual basis accounting, are subordinated to cash-flow earnings.[9] When cash flow and dividends, rather than net income, are paramount in determining market values, it must be because investors do not understand income statements, because they do not have confidence in net income measurement, or perhaps because conventional measurement of net income is unsound. Earlier in this chapter it was indicated that lack of uniformity may lead to failure of communication, misunderstanding, and skepticism on the part of the user of financial statements.

Socio-economic viewpoint.--Beyond the benefits to stockholders that might come from uniformity in financial statements, there would be benefits from the socio-economic point of view. It has long been established that capital should move with great ease horizontally from an industry which is overcrowded to one which offers good openings for it. Similarly, it should

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[9]Arthur M. Cannon, "What's Wrong With Financial Reporting?" The Journal of Accountancy, Vol. CXII (August, 1961), pp. 28-33.

move vertically from the control of the less prudent to the control of the more prudent business managers.[10] As the economy becomes more complex lack of knowledge hampers the movement of capital. It is believed that a widespread knowledge of the operations of business would help direct capital into channels where it is most needed, thus benefiting the investor as well as society in general. In fact such efficient movement of capital might decrease the cost of credit.[11] This efficiency resulting from increased knowledge of financial facts would result from acceptance by the accounting profession and by business of uniform principles as a basis for financial statements.

It has been through a complex industrial economy that man has attained a longer span of life garnished with physical comforts. Plaintive longing for the simplicity of the past is misconceived or insincere,

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[10] Alfred Marshall, Principles of Economics, (New York: The Macmillan Company, 1948), pp. 311-13.

[11] H.W. Singer, Standardized Accountancy in Germany, (Cambridge: University Press, 1944), pp. 62-63.

and inconsequential. Mankind demands the products of modern industry.[12] Modern industry requires the accumulation of capital from widespread sources into single enterprises. Great accumulations of capital under centralized control naturally result in remoteness of the owners of capital from the productive resources. The greater this remoteness, the greater the need for communication of data. Centralization of economic power is the compulsive force behind the development of modern accounting. The inactive investor's need for financial data indicates a need for communication of useful information through the language of accounting. The increasing number of economic interrelationships creates other needs for economic data.

Control in a complex economy.--There are numerous classes of users of economic data--some with an interest in statistical information compiled from financial statements.[13] In addition to the many private users of financial data there are governmental authorities

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[12]Maurice H. Stans, "The Future of Accounting," Handbook of Modern Accounting Theory, Morton Backer, (New York: Prentice-Hall, Inc., 1955), pp. 583-601.

[13]Herman W. Bevis, "The CPA's Attest Function in Modern Society," The Journal of Accountancy, Vol. CXIII (February, 1962), pp. 28-35.

requiring data for purposes of revenue, control, and statistical compilations. The variety of users of financial data, the multiplicity of corporate units in which they are interested, and the need for integrable data in economic statistics underscores the necessity of uniform principles as a basis for financial statements.[14]

It is only natural in a complex economy where there is a widespread need for accounting data that persons not fully aware of the intricacies of the art would interest themselves in its shortcomings.[15] Lawyers have observed the flexibility of accounting practices with alarm. (The absence of uniformity in law has already been pointed out.) The ultimate absurdity was a lawyer's suggestion that the legal profession should take over and prepare a set of accounting principles and standards.[16] More likely, but hardly desirable, is the possibility that investors, labor unions, or the general public will importune Congress

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[14]Singer.

[15]William W. Werntz, "Standardization of Accounting Principles," Year Book, (New York: Controllers Institute of America, 1938).

[16]Taggart.

to provide legislation fixing accounting rules through regulatory legislation.[17] Accountants generally abhor such an eventuality.

There seems to be a growing public opinion that many large corporations constitute monopolies or near monopolies. The charge naturally follows that prices are artificially high and that profits are unreasonable. The verification or contradiction of this charge must come from accounting data, and to be effective, it must be data in which the general public has confidence. Many people in the government, as well as the general public, lack confidence in corporate reports even though they have been audited and certified by public accountants.[18]

The fact that government might step into the picture with minimum standards which are likely to become maximum standards in practice and the fact that legislated standards are likely to mark the end of

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[17]Albert J. Bows, "The Urgent Need for Accounting Reforms," Speech before Shreveport Chapter, National Association of Accountants, October 15, 1959.

[18]Carman G. Blough, "Challenges to the Accounting Profession in the U.S.," The Journal of Accountancy, Vol. CVIII(December, 1959), pp. 37-42.

progress have been considered sufficient justification for the profession's adoption of uniform standards.[19] Louis Goldberg has said that setting of standards by the profession merely to avoid the misfortune of having them prescribed by law would undermine the ethical basis of the standards.[20] Accountancy has a professional obligation to serve the community. If legislation of accounting principles is imminent, it must be because the people think that accounting principles are necessary. Under these conditions it is the duty of the profession to convince the people that accounting principles are unnecessary, accept legislation of principles, or as the best qualified body proceed to formulate accounting principles.

Positive philosophy.--In Chapter 3 it was pointed out that some accepted accounting principles may have developed from the reluctant concurrence by a public

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[19]Jacob Kraayenhof, "International Challenges for Accounting," The Journal of Accountancy, Vol. CIX (January, 1960), pp. 54-58.

[20]Goldberg.

accountant in a procedure not then considered acceptable except in the circumstances peculiar to the case. According to Arthur M. Cannon, a generally accepted principle of accounting is usually something somebody else tried and got away with.[21] It is to be hoped that if such a sad philosophical state exists in accountancy it will not long endure. To survive in a dynamic economy accounting must be adaptable to new conditions. Such adaptability requires that accounting be founded on a positive philosophy.[22] Accounting need not rely on negatively established conventions. "What has been done" and "what is being done" must not continue to overshadow "why certain procedures are proper." Principles of accounting can be established by a process of reasoning.[23] Probably, there is more logic behind

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[21]Arthur M. Cannon, "Discussion Notes on 'The Basic Postulates of Accounting'," The Journal of Accountancy, Vol. CXIII (February, 1962), pp. 42-53.

[22]Konrad Engelmann, "In Search of an Accounting Philosophy," The Accounting Review, Vol. XXIX (July, 1954), pp. 383-90.

[23]Harry Norris, Accounting Theory, (London: Sir Isaac Pitman & Sons Ltd., 1948), pp. 5-6.

accounting conventions than is apparent. The accumulated wisdom of generations often supports social customs that have no perceptible foundation. In the formulation of a uniform set of accounting principles members of the profession would undoubtedly unveil a considerable body of logic that was subconsciously applied by the pioneers.

Independence.--The question of uniformity vs. flexibility also has a bearing on the public accountant's most worthy attribute, independence. The accounting profession is prone to treat independence as an absolute quality. The Securities and Exchange Commission speaks of accountants being in fact independent.[24] However, as a practical matter there are degrees of independence, and there are shortcomings in its effectiveness. Large segments of the public have voiced a lack of confidence in corporate reports as "certified" by public accountants.[25]

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[24]United States Securities and Exchange Commission, Regulation S-X, (Washington: United States Government Printing Office, August 20, 1953), p. 2.

[25]Arthur C. Kelley, "Definitive Income Determinations: The Measurement of Corporate Incomes on an Objective Scientific Basis," The Accounting Review, Vol. XXIII(April, 1948), pp. 143-55.

Their lack of confidence was later supported by an investigation by the Securities and Exchange Commission. From a survey of the reports of corporations not coming under S.E.C. regulations it was concluded that it was management policy that determined the nature of the annual report and that unless accountants can point to legal requirements as to the extent of disclosure they are often unable to insist on a position contrary to that of management.[26] In a study made by L. Vann Seawell of 765 annual reports in 1956-57, it was found that independent accountants not only concur in practices that result in a less-than-best presentation, but they also concur in practices that they cannot justify.[27] Alternatives are selected on the basis of serving the interests of management. It is the combined effect of imperfect independence, lack of uniformity in accounting principles, and non-committal wording of the auditor's opinion that seriously detracts from the value of the

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[26] Ibid.

[27] L. Vann Seawell, "Corporate Annual Reports--Financial Fantasy," Business Horizons, Vol. II (Fall, 1959), pp. 92-101.

opinion. The opinion does not say that the statements make the fairest presentation. The auditor may think the statements are not a fair presentation. His only firm obligation is that he be able to fit the practices selected by corporate management into flexible, vague, conflicting, "generally accepted accounting principles."[28] A formulated set of uniform accounting principles would bolster the independence of the public accountant in the protection of the interested outsiders.[29]

The arguments favoring uniformity are persuading, but there are also strong points to be made in opposition to uniformity.

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[28]Russell Morrison, "What's All This About Accounting Principles?" Speech Before North Penn Chapter, National Association of Accountants, April 4, 1961.

[29]Samuel J. Broad, "Recent Developments in Accounting and Auditing," The Journal of Accountancy, Vol. LXXVIII (September, 1944), pp. 185-95.

CHAPTER VII

THE CASE FOR FLEXIBILITY

Distrust of management.--The demand for a formulated set of generally accepted accounting principles is based largely on distrust of management. However, if this distrust of management is justified, uniform accounting principles would be of limited value as a safeguard against it.[1] There is no substitute for integrity in stewardship. Of course, there are conflicts of interest between management and stockholders, but one must not overlook the fact that they more often have interests in common. The accounting practices selected by management from acceptable alternatives as appropriate to its situation are not necessarily self-serving and injurious to outside interests.[2] One must

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[1]George O. May, "The Choice Before Us."

[2]Herman W. Bevis, "Riding Herd on Accounting Standards," The Accounting Review, Vol. XXXVI (January, 1961), pp. 9-16.

guard against the assumption that variations can reflect only the coloring of the facts by the interested party having power. Variations in accounting practice can represent managements' carefully selected methods of presentation of the facts in complex settings known best to them.[3]

Indefinability of periodic income.--Most advocates of uniformity have specifically favored reduction of flexibility in the determination of periodic net income. Perhaps there is an amount of income for each enterprise for each year that is true and correct, and meaningful for all purposes. If there is such an amount of income, it is the result of certain business transactions, not a creation of accounting procedures. It is a function of accounting to measure periodic income. The measurement of periodic income involves many vague concepts impossible of exact application, e.g. the matching concept involves appraisal of existing assets and predicting

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[3]Victor H. Stempf, "A Critique of the Tentative Statement of Accounting Principles," The Accounting Review, Vol. XIII (March, 1938), pp. 55-62.

future usefulness of other assets.[4] True periodic net income is a concept beyond the practical reach of men. It is possible that too much is expected of the art of accounting.[5] George O. May once remarked that accounts can rise no higher in the scale of certainty than the events which they reflect.[6]

If the profession were able to lay down a rigid set of rules for the measurement of periodic income, the result probably would be more criticism rather than less. Already, there is dissatisfaction with the profession's rules tending to define periodic income. Further efforts to define the indefinable might create additional dissatisfaction; in fact such action could render net income figures virtually meaningless.

Complexity of the problem.--The concept of uniformity extends beyond a fixed determination of

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[4]"Should Accounting Rules Be Fixed by Law?" The Journal of Accountancy, Vol. LXXXIV(November, 1947), pp. 354-55.

[5]"Uniformity and Certainty in Accounting," The Journal of Accountancy, Vol. LXXXV(April, 1948), pp. 275-76.

[6]"Uniform Accounting," The Journal of Accountancy, Vol. LXXXII(November, 1946), pp. 360-61.

periodic net income. Some people advocate a complete, basic, comprehensive, symmetrical code of accounting principles. Apparently, their natural desire for definite answers to their questions leads them to believe that an accounting code could be set up to govern the accounting for all possible transactions.[7] No doubt this group overlooks the infinite variety of transactions, the continual change in the nature of business transactions, and the fact that the "truthful" handling of many transactions would require powers of exact prognostication. While a complete code of accounting principles may represent an ideal to be longed for, the idea requires considerable adaptation to fit it for pragmatic contemplation by businessmen and accountants.

Along with this longing for a complete code of accounting principles comes a longing for simplicity--often it is a demand for simplicity. "Financial statements must be simple enough to be understood by a ten-year-old." The general public sees no reason

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[7]James L. Dohr, "Reflections on the Development of Accounting Procedures," The Journal of Accountancy, Vol. LXXIV(July, 1942), pp. 41-45.

why financial statements should not be simple. "To the simple everything is simple." However, a moment's reflection on the Federal Income Tax Code will remind the reader that it has been impossible to devise a simple, workable, and equitable tax code.[3] Even with the advice of the leading authorities in accounting and law, Congress has been relatively consistent in complicating the code with successive "simplifications." If it is impossible to define taxable income both fairly and simply, will it not also be impossible to define periodic net income both simply and fairly? It is unlikely that there are any wise enough today to formulate a complete code of accounting principles.

While the objective of uniformity in accounting practices throughout industry is logical and attractive, it is likely that rigidity in accounting would lead to obfuscation rather than communication of economic facts. Of course, the broad general principles that provide the limits of flexibility are not inexpedient, but within these limits the most revealing financial

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[3] Greer.

statements are those designed by a particular enterprise for its particular needs in the light of knowledge of peculiar conditions.[9] Stifling the accountant's judgment with rigid uniformity could very well perpetuate mediocrity. Firmly established minimum requirements often become both maximum and minimum in practical experience.[10] Limiting alternative modes of expression in accounting, the language of business, would be somewhat analagous to limiting Shakespeare to the vocabulary of an eighteenth century Cockney child.

Perpetuation of mediocrity.--Accounting, as the language of business, must be adaptable to varied and changing conditions. Those who advocate rigid uniformity to provide exact comparability would end progress. The stagnation of accounting for railroads is an example of what uniformity can do when applied to a single industry.[11] The effect would be multiplied if uniformity

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[9]T.H. Sanders, "Reports to Stockholders," The Accounting Review, Vol. IX(September, 1934), pp. 201-19.

[10]Dixon.

[11]Harold W. Scott, "Current Accounting Trends in Corporate Reporting of Financial Information," Selected Papers, (New York: Haskins & Sells, 1960), p. 77.

were advanced to the extent necessary to achieve comparability between industries. Progress in accounting results from individual enterprises and individual accountants adopting and promoting new practices on the basis of their soundness and usefulness, even though they are not generally accepted. The individual or small group in disagreement with the majority is frequently right. It is from this disagreement that the majority get ideas that develop into new and better practices.[12] To restrict severely individuals in experimenting with new ideas would impede progress. Colonel Robert H. Montgomery opposed the substitution of fixed rules for opinion and discretion. In his opinion standardization or unionization would have prevented the great progress of the accounting profession in the first half of the century.[13] Sir Arthur Lowes Dickinson attributed England's trailing the United States in accounting matters to the fact that

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[12]Broad.

[13]Lawrence L. Vance, "Current Problems and Accounting Theory," The Accounting Review, Vol. XIX (July, 1944), pp. 231-33.

in England the profession was hampered by laws and principles on accountancy, whereas in the United States there was an absence of impediments.[14]

Developments in society may appear to the individuals experiencing them to be slow, evolutionary advancement. But to those who write the history of these times the middle of the twentieth century will be one of relatively rapid change.[15] The interaction of scientific, political and economic innovation presents the accountant with new situations daily.[16] The art must remain adaptable to conditions not yet conceived. The profession must not adopt any measure tending to crystallize accounting principles however adequate they may be currently.[17] In any immediate effort to settle uniform principles of accounting those prin-

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[14] A.A. Fitzgerald.

[15] Stempf.

[16] Bevis.

[17] T.H. Sanders, "Progress in Development of Basic Concepts," Contemporary Accounting, Thomas W. Leland, (New York: American Institute of Accountants, 1945), pp. 1-21.

ciples presently generally accepted would no doubt continue to be accepted. Other principles not yet generally accepted no doubt would be considered, with some being accepted and some rejected. However, there may be hidden principles yet unknown or unstated that might never be uncovered.[18] The probability that crystallization will result from uniformity is too great, and the consequences of stagnation are too severe to risk abandonment of flexibility.

Differences between issuers.--Contradictions in accounting principles and variety in accounting practices of business enterprise are the chief bases for criticism of the accounting profession. The criticism is based on the assumption that the differences are objectionable and unjustifiable. Variety is not necessarily objectionable.[19] Uniformity in accounting practices might imply similarity where diversity would be more descriptive of the situation.

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[18]Couchman.

[19]T.H. Sanders, "Government by Accounting Principles," Harvard Business Review, Vol. XXII (Spring, 1944), pp. 265-76.

There are differences between industries, and there are differences between units of the same industry. These differences require diverse applications of accounting principles.[20] A cut-and-dried application of rigid rules is likely to result in serious misrepresentations. Even when two enterprises are in the same kind of business the judgments of the two managements are different when applied to the same circumstances.[21] The factors that might lead different managements to different judgments are innumerable. Some of them are: differences in rate of turnover of inventory or receivables, differences in usual terms of sale, differences in ratio of fixed assets to total capital employed,[22] differences in number and proximity of competitors,

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[20]Stempf.

[21]Weldon Powell, "The Challenge to Research," The Journal of Accountancy, Vol. CIX(February, 1960), pp. 34-41.

[22]Samuel J. Broad, "Recent Efforts to Increase Significance of the Figure of Net Income," The Journal of Accountancy, Vol. LXXXIX(May, 1950), pp. 376-81.

relative stability of prices, differences in number of customers, differences in their assumptions as to the permanence of the organization,[23] and differences in the power of the accounting officer within the management group.

Different uses.--In addition to the variation that may be justified by differences in the issuers there are variations that may be justified by differences in uses or users.[24] Accounting practices that are appropriate for one use are not necessarily appropriate for another use. The selection of alternative practices must be made with regard for the user primarily interested in the facts to be presented without forgetting that the statements so prepared may be adapted to other uses. Uniform accounting would be likely to sacrifice all other interests for the benefit of the one that happened to be dominant at the time that the uniform principles were adopted.[25] It is unlikely

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[23]Bevis.

[24]Ibid.

[25]"Uniform Accounting."

that there can be rigid rules to govern an art in which truth is a matter of point of view rather than an absolute.

Overemphasized variations.--Any criticism of accounting is likely to start with a recitation of variations in accounting practice with the resulting different interpretations found in financial statements. Of course, there are differences, but critics overlook the fact that it is the conflict which is given publicity. The wide areas of consistency and agreement are overlooked.[26] As evidence of the limited extent of the pain caused by flexibility, one may recall the fact that only minor difficulties were encountered by the government in using accounting data as a basis for wartime statistical control.[27] The need for financial statements based on uniform accounting principles for

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[26]Research Department of the American Institute of Accountants, "Corporate Accounting Principles," The Journal of Accountancy, Vol. LXXX(October, 1945), pp. 259-66.

[27]Stuart A. Rice, "Use of Accounting Data in Economics and Statistics," Challenges to the Accounting Profession, (New York: American Institute of Accountants, 1947), pp. 24-30.

the use of economic statisticians seems to be overemphasized.

Inadmissible examples.--One of the assumptions on which criticism of flexibility is based is that alternative procedures are chosen without justification and that the results are so widely divergent that they could not be fair presentations. This divergence is sometimes "proved" by hypothetical application of alternate practices to a set of facts. In such examples alternatives are selected solely for the purpose of producing divergent results.[28] The reader is left to assume that practicing accountants are likely to select equally divergent practices. Would it not be better to assume that an overwhelming majority of accountants would choose neither of the alternatives marking the limits of acceptability, but something between? Is it not more reasonable to assume that accountants would not base their selection of alternatives on a desire for the highest or the lowest figure, but would apply to the problem an accumulation of knowledge of the art of accounting and of the particular business environment?

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[28]Greer.

Such examples are more misleading than are financial statements based on flexible application of accounting principles.

Comparability not assured by uniformity.--Another assumption on which advocates of uniformity base their arguments is that uniformity will automatically provide comparability of financial statements. This assumption is thoroughly discredited by the following statement by Herman W. Bevis:

> Incidentally, where any of the standards deriving from government sources have been sweeping, even for issuers presumably rather homogeneous, three lessons have been learned. First, the standards always fail to provide comparability in many important details. Second, the more extensive and detailed the prescribed standards, the more exceptions and loop holes, and the more difficult the enforcement. And third, inflexible standards which are continued after change in the conditions for which they were once suitable, can commence to hide a state of affairs, rather than fairly reflect it.[29]

If the case for flexibility needs further support, argument can be based on basic American philosophy. It is hoped that individual freedom, rather than increased control remains a basic objective of society.

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[29]Bevis.

There seems to be a trend toward strait jacketing business with rules to fit every situation. Adoption of a uniform set of accounting principles would further this restriction of business. Such a trend is incompatible with the free enterprise system.[30]

Finally, the case for flexibility can draw on the wisdom of some of the best known authorities on accounting matters.[31]

> Accounting must be regarded as a process involving the recognition of custom and convention in the use of judgment, rather than as the application of rigid and unvarying rules.
>
> -George C. May

> Under circumstances constantly encountered in practice ordinary fairness and common sense may compel us to make exceptions to the simplest statements of principle. It is also obvious that when and to what extent such exceptions should be made cannot be reduced to rule of thumb, but always remain matters of judgment and experience.
>
> -H.P. Byerly

> I do not ask for standardization of accounting practice or procedure; that would mean the substitution of fixed rules for opinion and discretion.
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> -Robert H. Montgomery

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[30] Ibid.

[31] Howard C. Greer, "What Are Accepted Principles of Accounting?" The Accounting Review, Vol. XIII (March, 1938), pp. 25-31.

CHAPTER VIII

THE ETHICAL BASIS FOR UNIFORM ACCOUNTING PRINCIPLES

Introduction.--The basic function of financial accounting is interpreting. The functions of recording, classifying, and summarizing, as far as financial accounting is concerned, are merely means to an end. Implied by the word interpreting is communication, and by the word communication, language. All of the serious criticism of financial accounting is directed toward interpretation and communication. Users of financial statements can criticize only: (a) the accountant's interpretation of events, i.e. the picture formed in the mind of the accountant by his knowledge of accounting principles and of financial events, or (b) the way in which he communicates this picture to others. The picture received by the accountant through knowledge of financial events involves principally legal concepts, socio-economic philosophy, and practical business

experience including conventional accounting practices. The picture received depends largely upon the vantage point of the viewer. To transmit ideas from the mind of the accountant to an investor or other interested party requires a medium that is understood by the communicants. Any vehicle of communication may be called a language.

The function of accounting principles is to assist the accountant in perceiving meaningfully and in transmitting understandably. The meaningful perception may be defined as truth. An expression of a perception may be understood or not, whether it is true or not.[1] But for the expression to have utility, it must be (1) understood and (2) it must relate to a true perception.[2] All of the rules and principles of financial accounting are implemental to these two requisites, and they can be better understood and appreciated if they are considered with the two precepts in mind.

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[1]Louis O. Kattsoff, Elements of Philosophy, (New York: The Ronald Press Company, 1953), p. 163.

[2]Dohr.

Truth.--It is obvious to any student of accounting that there are elements of varying degrees of importance and varying breadth of applicability included in generally accepted accounting principles.[3] Also there have been advanced under the names of basic principles, canons, postulates, etc., several transcending, enduring, and comprehensive qualities that are supposed to represent a point of departure from which accounting principles can be extended. One such sterling desideratum is truthfulness.[4] In order to evaluate this quality one first should consider the meaning of the word truth. The concept of truth vs. falsehood is not as simple as sometimes visualized. One test of truth is self-evidence. A thing may be so clearly true as to leave no room for doubt. A judgment in question may be true because it is consistent with other relevant judgments. Or a judgment may be true because it works satisfactorily in practice.[5]

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[3]Greer.

[4]Sanders, Hatfield, and Moore.

[5]G. Watts Cunningham, Problems of Philosophy. (New York: Henry Holt and Company, 1924), pp. 115 et seq.

All of these tests of truthfulness may find application in accounting.

Perhaps one of the faults of accountants is that the self-evidence theory is too frequently applied. To one who has spent a life-time in the accounting profession, conventional representations are likely to seem self-evidently true. However, a moment's reflection will remind anyone of occasions when an accepted, self-evident truth turned out to be a misconception. To be safe, reliance upon the self-evidence theory as a justification for an accounting practice should be limited to the simplest of propositions. Similarly, the consistency theory is not always reliable. This theory presupposes that the related judgments by which consistency is measured are true. But they may be consistent because they are erroneous. Furthermore, it is quite possible that a judgment which is inconsistent with present knowledge will be found to be true. The pragmatic theory of workability is criticized on the grounds of vagueness and its dependence on further definition. However, it is probably the criticized characteristics that make the theory attractive to the

sub-conscious of accountants.

Utility.--It has been said that whatever guides one truly is true. Truth has been defined as utility--not utility as a tool of private ambition, but in rendering the service that the idea purports to render.[6] The writer once heard a group of certified public accountants discussing the merits of consolidated statements vis-a-vis conventional statements. From one side the argument was,"if you are going to show a true picture you must present a consolidated statement." The opposition adopted a similar line in support of conventional statements. Obviously, in this case, what is useful is truthful. It is also obvious that truthfulness depends upon the points of view of the communicants. The evasiveness of truth in accounting has been recognized.[7] And the practical source of concepts of truth in the experience of men has been noted by accountants.[8] The relationship between truth and

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[6]John Dewey, Reconstruction in Philosophy, (New York: Henry Holt and Company, 1920), pp. 155 et seq.

[7]McDonald.

[8]D.R. Scott, "The Basis of Accounting Principles," The Accounting Review, Vol. XVI(December, 1941), pp. 341-49.

usefulness was expressed by George O. May in this statement:

> 1. Accounting must be true to the canons, principles, or standards by which it professes to be bound.
>
> 2. Accounting determinations must not be proffered to the unlearned as representations of fact. . . .
>
> 3. There must be no concealment of the fact that accounting rests on a framework of assumptions. . .accepted as being useful, not as demonstrable truths.[9]

It is not intended to present herein a conclusive discussion of truth, but it is hoped that this brief summary will indicate that usefulness is the significant criterion of truthfulness in accounting. Truthfulness implies usefulness--not useful in any narrow sense, but useful to the avowed purpose, faithful to principles; admittedly imperfect, interpretive, predictive, and fallible, yet useful.

Usefulness also has been advanced as the most basic postulate underlying accounting principles.[10]

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[9]George O. May, "Truth and Usefulness in Accounting," The Journal of Accountancy, Vol. LXXXIX (May, 1950), p. 337.

[10]William H. Whitney, "The Basic Postulates of Accounting," The National Public Accountant, Vol. VII (June, 1962), pp. 4 et seq.

> It follows from the concept of accounting as a service function in the field of business, that the fundamental principle of accounting is usefulness. The only reason for the existence of a service function is that it be useful. The usefulness of accounting must be in that field of business which it serves. The fact that it is useful is the reason why it exists, and the increased need for its services is the reason why it has grown so rapidly in recent years. Everything which follows in any statement of accounting principles must be judged by the standard of usefulness.[11]

The Committee on Terminology of the AICPA in 1940 recognized usefulness as the acid test of accounting principles.

> Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting.[12] (Emphasis supplied.)

The interpretation that is to be given to the word usefulness in connection with accounting principles has been indicated by specifying that accounting must serve a useful social purpose. The art is not

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[11] E.B. Wilcox and R.H. Hassler, "A Foundation for Accounting Principles," The Journal of Accountancy, Vol. LXXII (October, 1941), pp. 308-14.

[12] Accounting Research Bulletins, Bulletin No. 7.

to be adapted to the furtherance of personal aims or to the profit of a particular individual or group. A moment's reflection upon this concept will reveal a subtle implication of conflict of interests. The idea of conflict of interests brings to mind another ideal of the accounting profession--justice or fairness.

Justice.--In law and government there are two concepts of justice--the justice received in administration of the law and the justice that is a criterion of a good law. Justice in the formulation of accounting principles is analagous to the latter.

> What we are seeking is not merely the justice that one receives when his rights and duties are determined by the law as it is; what we are seeking is the justice to which law in its making should conform.[13]

The abstract conception of justice originated in the evolution of civilized society as a regulative principle essential to the life of gregarious man. Plato visualized justice, not as a natural desire of mankind, but as a compromise between man's desire to do

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[13]Benjamin N. Cardozo, The Paradoxes of Legal Science, (New York: Columbia University Press, 1928), p. 31.

injustice to others with impunity and his desire to suffer no injustice. Herbert Spencer realized the importance of justice in accounting. ". . . he sympathizes with the anger of a friend who has been led by false statements to join a disastrous enterprise. . . . His sense of justice is offended." Spencer also pointed out that it is through generations of experience that a clear distinction between legitimate acts and illegitimate acts is possible.[14] In an urban society sustained by an industrial economy abstract justice must be sharpened into definite guidelines for economic conduct. Conflicts of interest are becoming ever more acute. The experience of men forms their socio-economic philosophy, and from their socio-economic philosophy emerge compromise judgments as to what is just and what is injust. Accounting principles must reflect a justice that is in accord with the tenor of the times.[15]

This justice is reflected in part by laws enacted by representatives of the people. It is the

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[14]Herbert Spencer, Synthetic Philosophy: Justice, (New York: D. Appleton and Company, 1891), pp. 35-36.

[15]D.R. Scott.

duty of accountants and the function of accounting principles to implement the law and to extend the idea of justice to the areas of its purview in which the law is silent. In this discussion justice and fairness are considered to be synonymous.

Leonard Spacek has said, "The one basic accounting postulate underlying accounting principles may be stated as that of fairness--fairness to all segments of the business community(management, labor, stockholders, creditors, customers and the public) . . . ."[16] Implicit in the postulate of fairness are statements of financial position and income without bias. Any one-sided presentation is necessarily unfair. The postulate of fairness is visualized as universal and eternal, while the recognition of rights that constitute fairness may change as conditions and attitudes change. Thus, the underlying postulate would be permanent while the principles derived in its implementation would be constantly subject to change.

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[16]Leonard Spacek, "Comments," The Basic Postulates of Accounting, Maurice Moonitz, (New York: American Institute of Certified Public Accountants, 1961), pp. 56-57.

In the foregoing discussion it has been demonstrated that in accounting truth is a subjective quality, the existence of which depends upon a system of opinions founded in economic philosophy, experience, and conventions. Furthermore, it has been pointed out that as applied to accounting, truthfulness implies usefulness in its broadest sense. Also the subjectiveness of justice (or fairness) has been considered from the viewpoint of its origin as a social concept adaptable to conditions. Having established the subjectivity of the very foundations of accounting, the question of a place for objectivity in accounting must be considered.

Objectivity.--So many authorities, especially the Securities and Exchange Commission,[17] have advocated objectivity as a basic desideratum that it must have some merit. The foundation of accounting principles is subjective; however, accounting principles can be applied objectively. To the extent that rules have been developed to govern the accounting presentation of financial events, financial statements are objective

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[17]McDonald.

in nature. To the extent that the accountant is free to reflect the same financial event in different ways, financial statements are subjective. Those who advocate objectivity in accounting are favoring the formulation of more rules, thereby leaving fewer alternatives in the accounting process. Numerous reasons have been given for advancing the cause of objectivity. Among the reasons are conflict of interests between management and outside stockholders, the inadequacy of the independence of public accountants, and the effect of personal bias even in the presence of good faith. In this connection the desirability of consistency and comparability in financial statements reinforces the arguments of the advocates of uniform principles.[18]

Consistency and comparability.--As previously mentioned, communication is essential to the fulfillment of the interpretive function of accounting. In this communication accounting is the language. Essential to communication is consistency in the language

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[18] Ibid.

vehicle and an understanding of the language by the communicants. For the sake of communication there is a need for consistency in terminology and consistency in methods of valuation. There are different aspects of consistency. When selecting from among alternative procedures the principle applied must not be inconsistent with principles applied to other items in the statements. In other words, principles that are consistent with each other form a coherent body of theory. However, when accountants speak of consistency, they usually refer to the idea that the same procedures should be followed by a given entity in its financial statements from year to year. Consistency thus provides comparability of financial statements for a corporation from year to year.[19]

While consistency is no doubt desirable, it is sometimes used to excuse procedures not in accordance with generally accepted accounting principles. A questionable practice is often continued year after year ostensibly for the sake of consistency.[20] While

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[19]Arthur M. Cannon, "Tax Pressures on Accounting Principles and Accountants' Independence," The Accounting Review, Vol. XXVII (October, 1952), pp. 419-26.

[20]Catlett.

consistency may provide comparability of statements for different periods for the same entity, it does nothing for comparability between two entities, and it may even hinder such comparisons. Comparability among entities requires a set of detailed rules and procedures and their general acceptance. To the extent that consistency is used to excuse continued use of methods that are not generally accepted it destroys comparability.

Adaptability.--To these mutually contravening desiderata may be added adaptability. Accounting must be adapted to the needs of a specific business.[21] To the extent that the needs of a particular business differ from the needs of other businesses and to the extent that accounting is adapted to the needs, comparability is lost. Changes in the conditions surrounding a business unit may suggest a need for change in accounting procedure in contravention of consistency. The rigidity implied in the idea of uniformity for the

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[21] E.B. Wilcox and R.H. Hassler.

sake of comparability seems to be irreconcilable with the idea of adaptability.[22]

Good faith, responsibility, duty, public interest, and social responsibility.--Other abstract ideals have been suggested as necessary foundations for accounting principles. Good faith, responsibility, and duty to clients have been recommended as unchanging basic principles of accounting.[23] However, these ideals seem to represent principles of the accountant in the conduct of his practice, rather than the principles of the art itself. Social responsibility and consistency with the public interest also have been mentioned in the literature as basic standards of financial reporting.[24] While these ideals may be somewhat nebulous for guidelines in formulating specific principles, no one could deny that they are proper considerations for the profession in its

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[22]Sanders, Hatfield, and Moore.

[23]Maurice E. Peloubet, "50 Years of Development of Accounting and Auditing," Fiftieth Anniversary, (New York: The New York State Society of CPA's, 1947), pp. 34-44.

[24]Maurice H. Stans, "How New Standards of Financial Reporting Grow From Social Responsibility of Accountants," The Journal of Accountancy, Vol. LXXXVI (August, 1948), pp. 98-106.

efforts to establish generally accepted accounting principles.

Beyond these basic desiderata that have been suggested as guidelines in formulation of accounting principles there have been numerous suggestions advancing other ideals as essential in the effort to establish uniform principles. Some of the suggested ideals are merely synonymous terms expressing the same thought. Many of them are overlapping. Some of them are contradictory. The task of the profession in stating accounting postulates and principles is not one to be resolved in any given period of time, but the problem will outlast the profession. The most important job is to design a permanent organization to continually re-examine and restate the guidelines of the profession.

CHAPTER IX

PRESENT ORGANIZATION FOR STATEMENT OF ACCOUNTING POSTULATES, PRINCIPLES, AND RULES AND ACCOMPLISHMENTS TO DATE

Organization

Jennings' Plan.--In chapter 3 it was mentioned that the present organization of the AICPA for the purpose of developing accounting principles was established pursuant to a recommendation by Alvin R. Jennings, president of the Institute in 1957. Jennings' purpose is clearly indicated by this quotation.

> I would like to make it clear that I propose to address myself primarily to the consideration of the question of how successful we have been in narrowing areas of difference and inconsistency in the preparation and presentation of financial information. . . .[1]

Jennings was concerned about criticisms of the

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[1] Alvin R. Jennings, "Present Day Challenges in Financial Reporting," The Journal of Accountancy, Vol. CV(January, 1958), pp. 28-34.

financial reporting standards of the profession. While some of these criticisms vaguely called for adequate reports of quality rather than quantity, the more serious criticisms were based on two well known related conditions. Due to the wide choices available in accounting methods, it is not possible to compare the operating results of companies within a given industry, much less between different industries. And there is a widespread misunderstanding of financial statements, especially as to their limitations.

Jennings recognized the fact that progress had been made in the quarter-century since the AICPA accepted responsibility for formulating accounting principles. Beginning with the work of the Committee on Cooperation with Stock Exchanges and continuing with the work of the Committee on Accounting Procedure much had been done to further development and recognition of generally accepted accounting principles and to narrow the areas of difference and inconsistency in accounting practices. After reviewing the work of the Institute

Committees, Jennings summarized his view of the existing situation with regard to accounting principles and procedures. While new differences and inconsistencies are constantly cropping up, the areas of differences and inconsistencies in financial reporting had been narrowed substantially through general acceptance of accounting principles. The AICPA had accepted responsibility for the development of accounting principles, but it had failed to coordinate the efforts of other organizations in this field. The AICPA's methods of research gave no opportunity to test new ideas, but tended to stifle creative thinking.

Having made these observations, Jennings presented a seven point plan for consideration of the Institute membership. (1) Development of accounting principles should be regarded as in the nature of pure research. (2) There should be a research organization as an adjunct to the AICPA, rather than as a formal part of it. (3) The research staff should have adequate academic and experience background preferably from industrial

and academic pursuits as well as public accounting. (4) Industry and the accounting profession should share the cost of the research. (5) The research organization should carry on continuous re-examination of basic accounting assumptions and develop authoritative statements for the guidance of the profession and of industry. In performance of this duty the research staff should consult with representatives of industry, education, and regulatory agencies. (6) The research staff should submit its statements to the Council of the AICPA for approval or rejection. (7) A statement having the approval of two-thirds of the members of the Council voting should be considered binding upon the members.

In addition to this plan for accounting research, Jennings presented a four point challenge to the profession. (1) We must re-emphasize our faith in generally accepted accounting principles as necessary to an objective determination of the fairness of financial representations. (2) The Institute must continue to accept primary responsibility for formulating accounting principles

with the cooperation of interested groups. (3) Accounting principles must be sufficiently rigid and sufficiently flexible. (4) The Institute must increase its efforts to educate non-accountants in the use of accounting data.[2]

Committee on Research Program.--The Special Committee on Research Program with Weldon Powell as chairman was appointed in December, 1957, to study and recommend methods of research, methods of formulating accounting principles, and means of securing compliance with accounting principles. This study was confined almost exclusively to financial accounting.

The report of the Committee was published in December, 1958.[3] Included in this report were the basic considerations which guided the Committee in arriving at its recommendations. The general purpose of the AICPA as expressed by the Committee should be to advance the written expression of

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[2]Ibid.

[3]Special Committee on Research Program.

generally accepted accounting principles, to narrow the areas of difference and inconsistency in practice by persuasive methods, and to lead in the thinking on unsettled and controversial issues. These problems require attention at four levels: postulates, principles, rules, and research. The Committee gave a new definition of the word postulate: "Postulates are few in number and are the basic assumptions on which principles rest." Broad principles should be formulated on the basis of the postulates, and rules should be developed in relation to the postulates and principles. The Committee visualized a set of principles similar to the statements on accounting and reporting standards of the American Accounttng Association and a set of rules similar to the accounting research bulletins issued by the AICPA. These postulates, principles, and rules should be formulated primarily with reference to the problems connected with published financial statements of industrial and commercial corporations. The ablest members of the AICPA should undertake this work and they

should enlist the cooperation of government agencies, stock exchanges, and other professions.

The Committee recommended that the organization for carrying out its proposed program should consist of an Accounting Principles Board and an accounting research staff. The Board should consist of eighteen members of the Institute selected on the basis of ability. The Board should have sole authority within the AICPA to make pronouncements on accounting principles, and it should cooperate with the research staff in selection of research projects, fiscal administration, and in an advisory capacity on the research projects. The research staff should consist of a director of accounting research, from three to five senior members, and two or three junior members on a permanent basis. The director should have authority to publish accounting research studies, but he would be expected to rely heavily upon the views of the advisory committee of the Board as to the suitability of the studies for publication.

The Committee anticipated that the director

of accounting research periodically would publish accounting research studies. The studies were intended to provide the profession and the public with discussion and documentation of accounting problems and indicate possible solutions in accordance with basic postulates and principles. Being tentative rather than authoritative, they would present matters for consideration and experimentation, and perhaps they would form the basis for authoritative pronouncements at a later date by the Board. It was recommended that the first such studies be concerned with the basic postulates and the broad principles of accounting.

It was expected that the Accounting Principles Board would issue authoritative statements of what constitutes generally accepted accounting principles. These statements would ordinarily be based on previously published accounting research studies, and they would be compatible with the basic postulates and broad principles of accounting. Thus the Board could approve an accounting research study making it a statement of accounting principle, or it could

disapprove a study, or it could leave the study in its tentative status until such time as further action was considered appropriate. The authority of the statements would rest largely on their general acceptance. They would not be binding upon the membership of the AICPA. However, the Board might occasionally submit certain of its pronouncements for the approval of the Council or of the membership, on which approval it would become mandatory upon the membership.[4] The recommended program as outlined by the Committee was unanimously approved with only minor change by the Council of the AICPA in April, 1959.[5]

The Basic Postulates of Accounting

Summary.--The first release of the accounting research staff was The Basic Postulates of Accounting by Maurice Moonitz, Director of Accounting Research, published in 1961 by the AICPA. The instructions to the research staff were broad and, with respect to

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[4]Special Committee on Research Program.

[5]The Certified Public Accountant (New York), May, 1959, p. 11.

basic postulates, consisted mainly of the new definition which has been quoted previously herein. In selecting an approach to the problem Moonitz ruled out the axiomatic approach as too abstract, the ethical approach as too subjective, and the pragmatic approach as too likely to serve a special interest. He preferred to approach the task through consideration of the problems faced by accountants in their economic or political environment, and he undertook to limit his efforts to the exploration of only as much of the environment as relates to the problems that accountants deal with. Having observed the differences in accounting problems, the differences in accountants' understanding of these problems and the differences of opinion of accountants he concluded that heavy reliance must be placed on deductive reasoning in the development of accounting postulates and principles. After recognizing the problem the proper question is, "What ought to be?" rather than, "What is?"

The study of the relationship between the environment and accounting problems yielded five postulates:

A-1. QUANTIFICATION. Quantitative data are helpful in making rational economic decisions, i.e., in making choices among alternatives so that actions are correctly related to consequences.

A-2. EXCHANGE. Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers.

A-3. ENTITIES. Economic activity is carried on through specific units or entities.

A-4. TIME PERIOD. Economic activity is carried on during specifiable periods of time.

A-5. UNIT OF MEASURE. Money is the common denominator in terms of which the exchangeability of goods and services, including labor, natural resources, and capital, are measured.

Carrying the study further into the field more directly concerned with accounting, the research staff presented four supplementary propositions that are implied by the first group of postulates and are more readily connected to the practical performance of the art of accounting.

B-1. FINANCIAL STATEMENTS. The results of the accounting process are expressed in a set of fundamentally related financial statements which articulate with each other and rest upon the same underlying data.

B-2. MARKET PRICES. Accounting data are based on prices generated by past, present or future exchanges which have actually taken place or are expected to.

B-3. ENTITIES. The results of the accounting process are expressed in terms of specific units or entities.

B-4. TENTATIVENESS. The results of operations for relatively short periods of time are tentative whenever allocations between past, present, and future periods are required.

In addition a third set of propositions, the imperatives, was presented. This set of propositions is less widely applicable than the others, and it is more in the area of what "ought to be."

C-1. CONTINUITY. In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely.
Corollary. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

C-2. OBJECTIVITY. Changes in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like, should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms.

C-3. CONSISTENCY. The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

C-4. STABLE UNIT. Accounting reports should be based on a stable measuring unit.

C-5. DISCLOSURE. Accounting reports should disclose that which is necessary to make them not misleading.

Comments.--As related in previous chapters, accounting has evolved over the centuries since man first learned to number his possessions. Obviously, any effort to set down, at this late date, the postulates on which the discipline rests must yeild a somewhat platitudinous assortment of ideas. There is considerable doubt that all of these fourteen propositions are postulates of accounting. Furthermore, it is doubtful that all of them are assumptions as required by the definition under which they are presented. Certainly almost any other accountant would have arrived at a different set of postulates, omitting some of Moonitz' and adding others. The line of distinction between postulates and principles is not clear, and the desirability of distinguishing between them is questionable.[6] The soundness of the idea and the scope of its applicability are more important.

The monograph was published for information and discussion and was not required to have the ap-

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[6]Whitney.

proval of the Accounting Principles Board. Neither was it required to have approval of the Project Advisory Committee. However, two membersof the latter have commented. Arthur M. Cannon emphasizes the need for consistency and comparability as justification for efforts to develop postulates and principles. He encourages group discussion of the postulates by state CPA societies in order that the monograph may fulfill its purpose. While Cannon considers the postulates to be self-evident, and even though he is not in complete agreement with them, he thinks that they satisfy the requirements of the Board and show promise for the whole program.[7]

Leonard Spacek, another member of the Project Advisory Committee, approved of the publication of the monograph for purposes of analysis and discussion, even though he quite thoroughly disagrees with its contents. In his opinion some of the postulates are not supported by logic. He considers it essential

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[7]Cannon, "Discussion Notes on 'The Basic Postulates of Accounting.'"

that a sound framework of accounting theory be built around the objectives of accounting and should involve consideration of "justice, truth, and fairness." Spacek has concluded that the one basic postulate of accounting is "fairness."

William H. Whitney has voiced definite disagreement with Moonitz' approach as well as the results of his study.[8] He agrees with Spacek that the observations presented in the monograph cannot serve as the basic foundation on which sound accounting principles can be established. Whitney also presents several ideas, some of which he thinks may prove to be postulates. They are: accountability, usefulness, integrity, professional status, materiality, double-entry, net profit, confidential nature of accounting, and varying scope of postulates and principles.[9]

A Tentative Set of Broad Accounting Principles
For Business Enterprise

Summary.--A companion to the monograph on

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[8]Whitney.

[9]William H. Whitney, "The Basic Postulates of Accounting," The National Public Accountant, Vol. VII (July, 1962), pp. 2 et seq.

postulates, A Tentative Set of Broad Accounting Principles for Business Enterprises, by Robert T. Sprouse and Maurice Moonitz was published in 1962 by the AICPA. This study presents considerable discussion tending to justify a sharp departure from current practice. It is chiefly concerned with measurement of assets, liabilities, stockholders' equity, and net income. The iconoclastic nature of the monograph can be seen from the following severely condensed summary of the principles developed in the study:

> A. Profit is attributable to the whole process of business activity, and any procedure which assigns the profit to periods should be continuously re-examined.
>
> B. Changes in resources should be classified among the amounts attributable to price level changes, changes in replacement costs, sale, and other causes such as accretion or discovery.
>
> C. The existence of assets is independent of their acquisition, and all assets of the enterprise should be reported in the financial statements.
>
> D. The problem of measuring an asset is the problem of measuring future services based on a past, current, or future exchange price.
>
> E. All liabilities should be reported in the financial statements. And those liabilities requiring cash settlement should be measured by the present value (based on market rate of interest) of future payments.

F. Those liabilities which call for settlement in goods or services should be measured by their agreed selling price.

G. Stockholders' equity should be classified according to its source with a separate classification for retained earnings.

H. On a statement of operations, data should be classified at least into revenues, expenses, gains, and losses. . . .Gains include such items as the results of holding inventories through a price rise. . . .Losses include items such as the results of holding inventories through a price decline.

Comments.--The monograph was published for information and discussion and was not required to have the approval of the Accounting Principles Board or the Project Advisory Committees. However, members of the latter were entitled to have their comments published in the monograph. Nine committee members had their views published. Andrew Barr considered these principles to be a significant departure from present practice requiring critical examination and testing before general acceptance. Carman G. Blough described the "so-called principles" as either untried, or tried and found wanting. Oscar S. Gellein stated that publication of the monograph will serve no useful

purpose. He felt that the principles had not been tested for practicability and reasonableness. Herbert E. Miller commented that the recommended principles would make accounting more subjective. But a more serious criticism was that important changes are proposed without recommending any means by which the profession might move from the position it now supports to the position advocated by Sprouse and Moonitz. Leonard Spacek was of the opinion that the postulates and the principles are not adequately supported nor successfully defended. William W. Werntz thought it would be a disservice for the study to be published in its present form. His objections were numerous. There is insufficient distinction between generally accepted practices and proposed additions and changes. The monograph contains no ground rules for transition to the new basis. There is an imbalance of treatment between sectors of accounting principles. The discussion minimizes the importance of sale as the point of realization. Use of a lower replacement cost as justification for reducing asset values is not sufficient justification for using a higher

replacement cost as a basis for increasing asset valuations. Widespread use of implied interest rates is neither feasible nor desirable. John H. Zebley, Jr. said that the study contributes very little toward resolving the differences of opinion that exist in practice as to what constitutes generally accepted accounting practice. Paul Grady commented at length and in general about the evolution of accounting principles. His closing remark may be interpreted as an objection to any drastic change in accounting principles. "If it is objectively, competently and courageously applied, the scrub brush of good accrual accounting holds the solution to most of the dingy areas of accounting practice."

Unqualified approval of both the study of postulates and the study of principles came from Arthur M. Cannon. In his opinion these proposed improvements will go far in the direction of truly reflecting "financial conditions and results of operations" in the statements that purport to make such representations. The idea that he finds par-

ticularly attractive is the proposed change from cost-based to current-valued assets and net worth in financial statements.

It is apparent that somewhere between the original proposal by Jennings and its implementation by publication of the two monographs by the Director of Accounting Research, the basic motive was lost sight of. As indicated by the quotation at the beginning of this chapter, Jennings was primarily interested in narrowing areas of difference and inconsistency. Surely he intended to recommend a program that would extend consistency and comparability. This is the goal of advocates of uniformity. These same words were repeated as a basic consideration of the Special Committee on Research Program, ". . .to narrow the areas of difference and inconsistency in practice." The Committee also advocated persuasion rather than compulsion in achieving compliance. A moment's reflection on the ideas expressed in Chapter VIII will remind the reader of the importance of personal viewpoints in interpreting financial facts. However, a few individuals in high position should not take

advantage of their position in advancing their personal viewpoints over the objections of so many of their duly appointed advisors and in direct conflict with the purpose for which they were employed. This was the view of the Committee on Research Program.

> The director of accounting research would exercise administrative supervision at all times, and would have authority to publish the results as an accounting research study. As to the latter, however, he should give due consideration to the views of the project advisory committee, and ordinarily would be expected not to proceed contrary to strong opposition of the group.[10] (Emphasis supplied.)

The postulates and principles proposed in the monographs may be logical, and they may prove to be practical. However, it is evident that they do not point in the direction of reduced differences; compliance is not likely to be achieved by persuasion; and they were published even though their content was not approved by the project advisory committees. The members of the AICPA apparently have inadvertently sponsored compilation and distribution of iconoclastic literature consisting largely of proposals previously

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[10]Special Committee on Research Program.

made by persons not in a position to understand the basic purposes of accounting nor the impracticability of their idealistic conceptions of the business environment.

CHAPTER X

SUMMARY AND CONCLUSION

Summary

Origin and early development.--Accounting in its present form has evolved over thousands of years of seeking practical solutions to economic problems, beginning with the numbering of possessions by prehistoric man. Development of techniques in bookkeeping and accounting has continued in response to need brought about by economic advancement. The first significant attempt to set down a guide to the recording of business transactions was by Fra Luca Paciolo in 1494 in Venice. His work was widely translated, and the system that he described is the foundation of present practice. The early writers and teachers generally added only minor refinements

to Paciolo's work. Those who attempted sharp departures from this early orthodoxy were notably unsuccessful. The early accounting societies, especially in Italy and the British Isles, also were a strong influence toward the establishment of the system described by Paciolo and toward the reduction of alternative practices.

Accounting principles in the twentieth century.--The evolutionary development of double entry bookkeeping and accounting naturally resulted in a discipline founded upon conventions and indistinct principles. It was not until the twentieth century that significant efforts were made to state the principles that justify existing accounting practices. Attempts have been made to extract principles from practical experience and to deduce principles by logical analysis. To the degree that the principles of accounting have been settled upon, adherence to them has been fostered by the exemplary force of professional leaders, the persuasive force of professional societies, and in some cases by the compulsive force of statutes and governmental agencies. One of the strongest arguments

against uniformity in accounting has been the likelihood that standardization would crystalize the discipline in its current stage of evolution. Evidence of such crystalization can be seen in industries having their accounting practices directly regulated by governmental agencies. The AICPA first accepted responsibility for accounting principles when in 1932, it cooperated with the New York Stock Exchange in issuing five rules for the preparation of corporate financial statements. Since that time the AICPA has issued fifty-one Accounting Research Bulletins which form the nucleus of accounting principles.

Basic problems in accounting.--The basic functions of accounting are to be found in its definition--recording, classifying, summarizing, and interpreting. In these functions are subtle implications of procedures and techniques that constitute the basic problems of accounting. Summarization implies the use of a common denominator. The use of the monetary unit as a common denominator and the assumption of its stability have been under fire for several years. It has become customary to interpret financial data on

the basis of annual periods. The problem of periodicity of business income encompasses most of the problems in accounting. Additional problems arise from the diversity of users and uses of financial statements, and from the conflicts of interests among the users. Further complications are anticipated as business men accept considerations other than the profit motive as legitimate goals and call upon accountants to measure achievement accordingly.

Difficulties in the formulation of accounting principles.--Attempts to formulate a uniform set of accounting principles encounter additional problems. The variety of business units and the variety of transactions seem to defy standardization. The differing points of view of interested parties add to the problem. This is especially true since society has expanded the list of persons and groups having a legitimate interest in business data. It is only natural that opposing interests advance conflicting principles in the interpretation of financial facts. A general lack of knowledge of accounting and of its limitations present a serious problem. The division of responsibility for

financial statements between corporate management and the public accounting profession makes for confusion and delay in the formulation of principles governing the statements.

Arguments for uniformity.--Many arguments have been advanced in favor of reducing alternative presentations in financial statements. The most basic reason that can be given for uniformity is to facilitate comparisons of statements of different companies for the same period. Reduction of alternative practices also would facilitate communication of financial data by reducing complexity of the language, accounting. By thus promoting understanding of financial statements by laymen, confidence in the data would be promoted. The need for objectivity in measurement is another point in favor of uniformity. The power of corporate management in comparison to that of outside stockholders, and the fact that it is usually corporate management which selects the accounting procedures to be followed points up the need to reduce those alternatives from which they may select.

The public accountant also needs more uniform accounting principles to bolster his independence. The need of statisticians, economists, and financial analysts to select and use certain figures from financial statements without analyzing them requires some assurance that the statements were based upon the same set of principles.

Arguments for flexibility.--The arguments favoring flexibility have been equally numerous. Proponents of flexibility argue that conflicts of interest and the power of management vs. the small stockholder are over-emphasized. Management usually serves stockholder interests. Accounting measures periodic income that is created by business transactions. These transactions are diverse and often their effect can be only estimated. Accounting must not attempt to make the uncertain, certain; the inexact, exact; nor the different, like. In situations where accounting has been made uniform it has become stagnant and inadequate under changing conditions. In most cases the accounting procedures selected by cor-

porate management and public accountants are appropriate to the situation peculiar to the business unit. Differences are usually justified. Experience has shown that imposition of uniform principles will not necessarily provide for comparability between companies.

Desiderata.--Most of the criticism of accounting is concerned with communication and interpretation. Accounting attempts truthful interpretation and communication. But in accounting truthfulness may be defined as usefulness when usefulness is not narrowly interpreted. Implied by usefulness from the social point of view is justice or fairness. And fairness implies a large degree of objectivity or freedom from personal bias. A measure of consistency would be achieved by objectivity on the part of the accountant. Good faith, social responsibility, and duty to clients are encompassed by the more basic desiderata.

Current efforts.--Pursuant to a suggestion by Alvin R. Jennings the AICPA in 1958 replaced the

Committee on Accounting Procedure with an Accounting Principles Board and an accounting research staff. The avowed purpose was to narrow areas of difference and inconsistency in the preparation and presentation of financial information. At this writing the Accounting Principles Board has made no pronouncements. However, the Director of Accounting Research has published two monographs concerning accounting principles, The Basic Postulates of Accounting, and A Tentative Set of Broad Accounting Principles for Business Enterprise. These monographs present the views of the authors, and they are not endorsed by the AICPA nor any of its committees. Neither have they been well received by members of the profession.

Conclusion

Having reviewed the evolution of accounting, the development of accounting principles to date, the problems involved in accounting and in the formulation of principles, and the arguments for and against uniformity, it remains only to recommend a plan to reduce the magnitude of the problem. Recommendations will be

made as to the codification of principles and as to the organization for the task.

Codification of principles.--Recent efforts toward codification of accounting principles (in the comprehensive sense) have assumed the necessity of distinguishing between postulates, principles(in the narrow sense), and rules. Experience has indicated the impracticability of this distinction, and the need for it is doubted. The scope of a principle's applicability is the important consideration. The broader the required applicability the less specific a principle can be. A very few broad principles may apply to all accounting units. A more detailed set of principles may apply to corporations. A set of principles applicable to corporations organized for profit can be still more detailed. Those applicable to large, listed corporations may be even more specific. By narrowing the scope of applicability to large, listed corporations engaged in manufacturing, the appropriate detail can be extended. When the type of accounting unit is further restricted, for example, to machine

tool manufacturing, the set of principles can be sufficiently detailed to produce financial statements having a most useful degree of comparability between units. In other words, accounting principles should recognize inherent differences between accounting units, but accounting principles should be such as to produce comparable data relative to units that are in fact comparable. All business units are alike--all business units are different. Accounting principles must preserve a degree of consistency and comparability among the statements of all business units with a greater degree of comparability among the statements of units within an industry.

It should be generally recognized that a single set of statements might not be appropriate to all uses and users. Accounting must be adaptable to many useful purposes. It would be a good practice for the public accountants' report to specify the purposes for which the statements are intended. The short form report is often inadequate in published statements. The report assumes a greater knowledge of accounting on the part of the reader than is appropriate. If the public accountant felt free to give his opinions according to his own design his

work would be more useful to the public, generally.

The evolutionary nature of accounting must be recognized as must inertia of business men and practicing accountants. Any codification of principles representing a sharp departure from present practice cannot achieve general acceptance. The two monographs by Moonitz, and by Sprouse and Moonitz can have only propaganda value. Real progress must be slow. A practical step would be a restatement of currently accepted principles in a more appropriate form. The restatement should be published in loose-leaf form, numerically indexed in a manner to make deletions and additions easy and to indicate planned revision. Principles (postulates, rules, etc.) should be stated briefly and simply. Discussion and illustrations should be clearly separate. The scope of applicability should be indicated for each principle. After this has been accomplished the Accounting Principles Board can proceed to reduce alternative procedures or to spell out situations in which alternative procedures may be applied. New principles may be added to cover new conditions or to cover situations not

yet treated by the accepted principles. The Board must proceed with revision no faster than it can obtain general acceptance for its changes.

Accounting statements must not conflict with the law. However, there are occasions in which accounting statements must reflect economic facts on a practical basis when a strictly legal interpretation might reflect form rather than substance. It is important to recognize two different relationships between law and accounting principles. The law may affect accounting directly by requiring certain facts to be reflected in a certain way. More commonly the law affects accounting indirectly when it has a direct effect on business. The law represents the rules of the game of business, while accounting is analagous to scorekeeping.

It is doubtful that uniformity is a useful term in accounting--its use hinders reconciliation of viewpoints. Rigidity is not to be desired--comparability is essential. Comparability must be extended by reduction of alternatives. In order to accomplish this reduction of alternatives it may be necessary to

alter the profession's attitude toward generally accepted accounting principles. Presently it seems to be somewhat dishonorable for a corporation not to prepare its statements in accordance with generally accepted principles. It would facilitate reduction of alternative practices if deviations from generally accepted accounting principles were viewed merely as something requiring explanation, justification, and quantification. The appropriate discussion of the deviation could appear in the president's letter to the stockholders or in the public accountant's report or both. For that matter, the statements could be prepared in accordance with generally accepted accounting principles(with alternatives drastically reduced), and if the corporation management considered this not to be a fair presentation, it could explain its position. A by-product of such a practice would be diminution of the popular notion that accounting is an exact science.

Organization.--The AICPA, being the organization of persons most directly concerned with the prac-

tice of accounting, should continue to assume primary responsibility for formulation of accounting principles. However, more consultation with other organizations will produce better results. Closer cooperation would result in a more meaningful set of principles as well as assuring a more ready general acceptance.

Heretofore, accounting principles (or rules, etc.) have been designed almost exclusively to apply to all businesses organized for profit with some exceptions spelled out for certain types of operations. Broad principles should have this broad scope. However, when the number of units to be covered is reduced, or when their variety is reduced, a more detailed set of principles can be devised without forcing the data of some business units into inappropriate patterns. When the proposition is accepted that there are certain principles that are applicable to financial statements of all widely held corporations and certain more detailed principles that are applicable to those widely held corporations in each industry, then the basic requirement for an

organization to formulate these principles is obvious. There must be an organization for each industry and another organization with unlimited latitude.

The present Accounting Principles Board approximates the required committee for formulation of broad principles. Appointment of a limited number of members by the American Accounting Association and by the Financial Executives Institute would add to its stature. The industry committees should be selected by the Financial Executives Institute. These committees should use the administrative machinery and accumulated knowledge of the various trade associations to the fullest extent. The industry committees should each have a member who is also a member of the Accounting Principles Board. The industry committees should be charged with the responsibility of extending industry wide comparability within the framework of broad principles set forth by the Accounting Principles Board. The practices selected by the industry committees should require approval by the Board in order to maintain compliance with broad principles and a degree of consistency and comparability

between industries. It should be understood that the industry committees will extend uniformity by compromise and sometimes by arbitrary decision eliminate a practice followed by a small minority and not justified by basically different conditions. Public accountants should give an opinion as to whether a corporation's statements are prepared in accordance with generally accepted practice within the industry as well as with generally accepted accounting principles.

One of the criticisms of the workings of the late committee on accounting procedure was its failure to publish its findings in tentative form in order to benefit from the reaction of the profession. In the current organization this fault was over-corrected. Publishing findings in tentative form is desirable, but the approval of the Board should be required even for tentative publication. The AICPA should not lend its prestige nor should it sponsor financially the propagandizing of the membership in favor of an individual's doctrinal beliefs.

It should be the function of a sub-committee

of the Board to consider problems in the application of accounting principles submitted to it by members of the profession. With regard to each case submitted to it the committee should recommend a procedure. From these cases the Board (or industry committees) should select examples and discussion to be added to that already offered along with the applicable principle. When it is appropriate the Board (or industry committee) should adopt new principles to fit the new situations that have been presented to it. These comments, opinions, and dicta would continue to build up a body of accounting principles analagous to the common law. With regard to accounting questions the committee would serve in a capacity analagous to that of a court. The machinery for adapting generally accepted accounting principles to new conditions is the most essential feature of the organization.

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