# THE INFLUENCE OF GOVERNMENT AGENCIES ON ACCOUNTING PRINCIPLES WITH PARTICULAR REFERENCE TO THE SECURITIES AND EXCHANGE COMMISSION

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The influence of government agencies on accounting, at least in my experience at the Securities and Exchange Commission, is a popular subject for undergraduate students as well as for candidates for master's and doctor's degrees in accounting.[1] It is with some misgivings, therefore, that I attempt to compete in this field. The scholars should produce a more unbiased appraisal of the situation than would an active participant in the continuing effort to narrow areas of differences in accounting.

The subject of our discussion usually is stated as though the government agencies are the principal forces at work with strong implications at times that this is not a good thing--that the adoption of rules, forms, and uniform classifications of accounts tends to create road blocks to progress. Those who participate in the rule-making process know that requests for and resistance to change can develop from either camp--the regulated or the regulator. Some examples of this will be in order later.

In this discussion I intend to deal primarily with SEC experience in its own activities and with the policies of other independent regulatory agencies which have an interest in the same questions. Percival Brundage, in discussing the government's influence on accounting in an article in <u>The Journal of Accountancy</u> in 1950 commented on such matters as income tax regulations, government contract cost principles, renegotiation and price redetermination regulations, cost studies of the Federal Trade Commission as well as the SEC's influence in

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

prescribing the financial data to be filed with it.[2] The impact of the tax laws is so generally recognized and has been the subject of so many treatises and studies by accounting committees that I see no need to attempt a summary here. Specific examples, however, will come up for exploration. It is well known that tax rulings do not necessarily reflect generally accepted accounting principles in some cases.[3]

Mr. Brundage cites as the first government regulation in the country relating to accounting practice an act passed by the Minnesota legislature in 1865. Then came accounting instructions for railroads issued in 1876 by the Railway Commissioners of Massachusetts. Next in line appears to be a classification of operating expenses issued in 1894 by the Interstate Commerce Commission, which had been established in 1887. This classification was revised in 1901 and 1907, the latter revision providing for depreciation for the first time.

The discussion of the last few years over the accounting policies of the ICC would lead the present generation to believe that that agency had not made its contribution to the advancement of accounting principles. However, a book entitled "American Railway Accounting, A Commentary,"[4] published in 1918 by Henry C. Adams, Ph.D., LL.D., then Professor of Political Economy and Finance at the University of Michigan and from 1887 to 1911 in charge of the statistical and accounting work at the ICC, is interesting reading today.

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[2] Brundage, Percival F., "Influence of Government Regulation on Development of Today's Accounting Practices," The Journal of Accountancy, November 1950 (pp. 384-391). See also Werntz, William W., "The Influence of Administrative Agencies on Accounting," Handbook of Modern Accounting Theory, Morton Backer, Ed., Ch. 4, Prentice-Hall, Inc., New York, N.Y. 1955.

[3] I take note here of William A. Paton's "Comment on The Incredible Schulde Decision" in The Michigan C.P.A., July-August, 1963.

[4] Henry Holt and Company, New York, N. Y., 1918.

The first uniform system of accounts issued in 1914 was discussed in this volume. Adams testifies to the influence of these pioneering efforts when he says in his preface that "The American system of railway accounts is known and consulted by accounting experts in many lands. Accountants in China, Japan, New Zealand, Canada, and some of the South American and South African states, desire to learn what this country is doing, as a help to the solution of their local problems." For these he included reprints of the classifications promulgated by the ICC. In a final paragraph of the preface addressed to university students he said that "all sound accounting rules reflect the nature of the self-determining laws of business life."

In his first chapter Adams elaborates on this point and discusses the compelling character of an accounting rule. He says that "established rules of accounting are generalizations for the guidance of business conduct, a disregard of which is a step in the direction of business disaster." He states that "It is an accepted rule of accounts that dividends should be paid out of current or past profits--a declaration which touches capital is not only a lie to the stockholders but it dissipates their assets and is an abuse of trust." Another accepted rule cited is that a net revenue or surplus arises only after the deduction of all forms of expense incurred in its production. He observes that "An accounting rule which requires that adequate repairs, replacements, and depreciation should be made a current charge against revenues, is a business law of self-preservation." Accrual accounting is supported in these words: "A balance in the bank is no proof that a business is in a prosperous condition, or that this cash may be safely withdrawn from the business or used for improvements and extensions. A bank balance fails to disclose outstanding liabilities. Many business disasters are traceable to a disregard of this simple distinction between accruals and cash."

These three rules have not lost any of their vigor by passage of time. But a more convenient support for these rules may be found in Professor Paten's article in the April 1963 issue of The Accounting Review entitled "The 'Cash-Flow' Illusion." Having injected the "Cash-Flow" matter at this point, I will quote one more passage from Adams to emphasize the importance of proper accrual accounting and that "Cash-Flow" is not an antidote for bad accounting. Concluding a section on the theory of depreciation accounting is the following paragraph:

> "It is the function of accounting to ensure that current statements are true, and this can be done with greater certainty by means of formal depreciation charges than by relying upon the more or less arbitrary instructions of the general manager. The temptation to influence the market by 'skinning' the property ought to be removed from those whom the stockholders have appointed as trustees of their investment, and this can be done, in part at least, by the rule that regular monthly charges be made for the creation of a depreciation reserve."

The early work at the ICC certainly was a contribution to the development of accounting principles.[5] But times do change and in recent years the ICC has found itself in the position of defending against charges of not keeping up with the times. During the last six or seven years it might be said that the accounting profession and certain allies, including the New York Stock Exchange, have had more impact on the ICC than it has had on accounting principles. In any event, a committee was appointed by the American Institute of Certified Public Accountants to work with the ICC in an effort to bring railroad accounting into agreement with generally accepted accounting principles. A number of the Committee's suggestions were adopted but in one major area of difference, that of deferred tax accounting, no change was made in the Commission's accounting requirements except that full disclosure was required to be made in

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[5] See Brundage, Percival F., "Milestones on the Path of Accounting," Harvard Business Review, July 1951, p. 73, and "Influence of Government Regulation on Development of Today's Accounting Practices," which was referred to previously.

reports to the Commission of what the effect would have been had deferred tax accounting been followed. The majority of the Committee did not recommend a proposal to change from replacement accounting to depreciation accounting for track structures as urged by a prominent accountant in speeches and in testimony before the House Committee on Government Operations which held hearings in the spring of 1957 on this point, deferred tax accounting and other matters.[6]

Another significant current development which demonstrates that the ICC can meet the needs of the investing public and still retain all the advantages which a uniform system of accounts provides for its regulatory needs resulted from a rule-making proceeding in response to a petition filed by Arthur Andersen & Co. The petition requested a rule or decision that would permit carriers to publish financial statements prepared in accordance with generally accepted accounting principles in annual reports to stockholders or otherwise released to the public. The ICC proposed a rule which would have required the financial statements to be consistent with the Commission's accounting regulations. The rule-making proceeding[7] was held and the resulting order, issued effective July 1, 1962, stated;

> "Carriers desiring to do so may prepare and publish financial statements in reports to stockholders and others, except in reports to this Commission [ICC], based on generally accepted accounting principles for which there is authoritative support, provided that any variance from this Commission's prescribed accounting rules contained in such statements is clearly disclosed in foot-notes to the statements."

The principal variance discussed in the release was deferred tax accounting as to which considerable difference of opinion was recognized. But the ICC squarely faced the full issue as

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6 See <u>The Journal of Accountancy</u>, May and November 1957 and March 1958, for releases and editorial comment; also <u>The Federal Accountant</u>, June 1958, pp. 55-56.

7 ICC No. 33581 (49 CFR 25), decided January 25, 1962.

to all variances rather than giving a fragmentary opinion on the point which caused the controversy.

It should be noted here that the railroads are not subject to the Securities Act of 1933 and that the Securities Exchange Act of 1934 provides that duplicate copies of reports filed with the ICC of the same general character may be filed with the SEC in satisfaction of the annual reporting requirement of the Act.

We have observed that, pursuant to the option provided in the ICC's new rule, some companies have revised their financial statements in reports to stockholders and in three instances in prospectuses under the Securities Act. These filings were made by new holding companies offering shares in exchange for railroad company shares, and thus certified financial statements of the railroads were required to be included in the prospectus.

Time does not permit a historical discussion of the accounting policies prescribed by all of the principal independent agencies, but those prescribed by the Federal Power Commission do require consideration as some of their policies have been the subject of critical comment and, to a considerable extent, accounting policies established in FPC cases have a direct bearing on opinions of the SEC under the Public Utility Holding Company Act of 1935 and on financial statements filed under the securities acts. Uniform systems of accounts were made effective by both Commissions as of January 1, 1937. The first opinions of the FPC, and parallel opinions of the SEC, to arouse the interest of accountants generally were published in the early 1940's. George O. May, in a book published in 1943,[8] discussed the Northwestern Electric Company case in which common stock was found by the FPC to have been issued without consideration and ordered that the debit amount created equal to the par value of the stock be amortized. Mr.

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[8] May, George O., Financial Accounting, The Macmillan Company, New York, N. Y., 1943, pp. 261-265.

May pointed out that the FPC's Chief Accountant testified it was policy rather than accounting principle which led to the order to amortize the amount rather than to dispose of it at once or to reclassify the debit as discount on stock.

William A. Paton a year later referred to May's discussion and the intervention of the American Institute of Accountants by way of filing an amicus curiae brief with the Supreme Court in the Northwestern Electric Company case as signs of an awakened interest of the accounting profession in the control of business activity by governmental agencies through accounting means.[9] The article was written as a criticism of the accounting policies prescribed by the FPC as explained by its Chief Accountant in his testimony in the Arkansas Power and Light Co. case. Professor Paton questioned the value of the distinction required between "original cost" (the cost of property to the person first devoting it to public service) and "acquisition adjustments" (the difference between total actual cost of property purchased as an operating unit and "original cost" -- "aboriginal cost" to some people). Accounting for intangibles, writeups, intercompany profits, transactions between affiliates, consolidations and depreciation all get Professor Paton's attention with very little praise. His concluding paragraph is:

"I, for one, would like to see the Commission direct its accounting effort primarily toward the constructive task of improving utility accounting practice of the future, and abandon the present program of wiping out a substantial portion of the investment in utility property as it now stands on the books."

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9 Paton, William A., "Accounting Policies of the Federal Power Commission – a Critique," The Journal of Accountancy, June 1944, p. 432.

The program was not abandoned and new problems have developed in the ensuing twenty years. Professor Paton received from the Institute an award in recognition of distinguished services to the accounting profession for his article which was described in the citation as "the most significant and valuable article on an accounting subject" published during the twelve months ended August 31, 1944.[10]

The Committee on Accounting Procedure of the Institute, with both May and Paton as members, considered the trend of the utility cases and issued a report in 1946 to the Executive Committee which pursuant to resolution of council forwarded the report to the membership. In its covering letter the executive committee said:

> "The significance of the report lies in the indication which it affords of differences in the rules and principles which are applied in different fields. The existence of such differences between regulatory and general accounting is a fact that should be of interest to all concerned with accounting. Recognition of this fact may influence the development of accounting in either or both of these fields."

The implications of this statement have been the subject of considerable debate among accountants, so much so that on request from the Committee on Auditing Procedure the Accounting Principles Board ruled in 1962 that:

> ". . the basic postulates and the broad principles of accounting comprehended in the term 'generally accepted accounting principles' pertain to business enterprises in general. These include public utilities, common carriers, insurance companies, financial institutions, and the like that are subject to regulation by government, usually through commissions or other similar agencies."

[10] The Certified Public Accountant, October 31, 1944, p. 3.

However, the Board observed that differences in the application of generally accepted accounting principles between regulated and non-regulated businesses could arise because of the effect of the rate-making process in regulated businesses.[11]

It is not for me to evaluate the influence of the SEC on the development of accounting principles--such an evaluation should come from unbiased sources. Unbiased sources may be hard to find because those who do not agree may be overly critical while those who approve may remain silent to avoid the appearance of self-seeking. It would be expected that college professors would provide unbiased testimony but I have noticed on a number of occasions that in making well-meant suggestions they sometimes disregard pertinent facts, including the clear-cut provisions of the laws we are required to enforce.

The work of the SEC and other governmental agencies attracted considerable attention at the fiftieth anniversary meeting of the AIA in 1937. In an address at that meeting Andrew Stewart listed six important developments emanating from regulatory bodies which had affected the practice of accountancy in the last fifty years. These were (1) the development of uniform classifications of accounts for common carriers and other regulated industries; (2) the support given the profession by the Federal Reserve Board and the securities exchanges in the development of sound accounting procedures and principles; (3) the unsuccessful attempts to control prices through costs under the Clayton Act of 1914, the National Industrial Recovery Act of 1933, and the Robinson-Patman Act of 1936; (4) the impact of the early income tax laws; (5) the retarding influence of state corporation laws; and (6) "the effect of the administration of the Securities Act of 1933 and the Securities Exchange Act of 1934, which, together, constitute

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[11] The Journal of Accountancy, December 1962, p. 67.

the greatest single aid to the development of sound accounting principles and forms of presentation of financial statements in the history of our profession in the United States."[12]

The basis for this overall opinion may be found in the following passage:

> "It is obvious that with the close harmony which has existed between the Commission and the profession, the influence of the Commission, backed by the effective powers which it possesses, has been in the direction of insisting on the presentation of financial statements prepared in accordance with sound accounting principles. An effective weapon has been the Commission's insistence that the accountant express his opinion of the propriety of the principles employed in cases where the accountant has expressed a qualification in his certificate, or where disclosures in the statements indicate accounting principles of doubtful validity. The ultimate effect of such a policy, supported by the powers conferred on the Commission by the Act, must be to enforce on all registrants of securities a sound code of accounting principles."[13]

In the preceding December, Carman G. Blough, the SEC's first Chief Accountant, delivered an address before the American Accounting Association in which he praised its efforts in developing the "Tentative Statement of Accounting Principles," cited examples from experience of the difficulty in determining what was generally accepted at that time, and said:

> "What the future policy of the Commission will have to be, I am not prepared to say, but we are reluctant to undertake the prescription of principles to be followed except as a last resort. It is hoped the profession will itself develop greater consistency in the many places where uniformity appears essential to avoid confusion in the presentation of financial data. I feel this Association can do much to improve the general tone of accounting and you may be assured the Commission stands ready in whatever way it can to assist the profession in accomplishing this purpose."[14]

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[12] "Accountancy and Regulatory Bodies in the United States," The American Institute of Accountants, Fiftieth Anniversary Celebration, 1937, pp. 133-34.

[13] Ibid., pp. 137-38.

[14] Blough, Carman G., "The Need for Accounting Principles," The Accounting Review, March 1937, p. 37.

It was only a few years after this statement was made that the SEC published a report on its investigation of the McKesson & Robbins case which was concluded with the following paragraph:

> "We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made. Further, the adoption of the specific recommendations made in this report as to the type of disclosure to be made in the accountant's certificate and as to the election of accountants by stockholders should insure that acceptable standards of auditing procedure will be observed, that specific deviations therefrom may be considered in the particular instances in which they arise, and that accountants will be more independent of management. Until experience should prove the contrary, we feel that this program is preferable to its alternative--the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us--and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers."[15]

The Commission's influence on the development of accounting principles is exerted through its support of the profession as indicated above and through the daily review of financial statements filed under the various acts administered by it. Guidelines as to the form and content of the financial statements are given in Regulation S-X and the statements to be filed are specified in the instructions to the forms. These guidelines are supported, supplemented or interpreted in letters of comment, conferences, accounting series releases and opinions of the Commission.

Accounting Series Release No. 1, published April 1, 1937, announced "a program for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform

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15 Accounting Series Release No. 19, December 5, 1940.

8. When long-term receivables are included in current assets in accordance with trade practices, Rule 3-13 of Regulation S-X requires the showing of the estimated amount, if practicable, not due within one year.

9. Fixed assets acquired from predecessors or promoters in tax free exchanges are required to be shown at cost to the transferors and any "write-ups" are eliminated.

10. The caption required on the balance sheet reading "Contingent Liabilities and Commitments" with a direct reference to the related footnote disclosure is frequently omitted and correction requested.

11. When disclosure in the text under remuneration of officers clearly discloses deferred compensation arrangements upon retirement, provision for such accrued liability to retirement date is required rather than the cash pay-out method prescribed by tax regulations.

12. Notes stating restrictions which limit the availability of surplus for dividend purposes have required revision when there are a number of restrictions in the debt indenture or other loan agreement and the amount of retained earnings restricted under the most restrictive covenant is not disclosed.

Rule 4-04(a) of Regulation S-X requires a statement as to the principle adopted in determining the inclusion and exclusion of subsidiaries in the consolidated balance sheet. Generally speaking, the burden of proof is on the registrant to justify the exclusion of majority-owned subsidiaries. We have accepted the practice that finance companies may be excluded from consolidation and that world-wide generally accepted accounting principles and therefore the financial statements need not be amended. This continued controversy led the Commission in 1938 to issue Accounting Series Release No. 4 stating its administrative policy on financial statements. This has not stopped the debate. The policy was elaborated on in Accounting Series Release No. 96 as follows:

> "Accounting Series Release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant's certificate and footnotes will be accepted in lieu of conformance to, the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance."[16]

I have indicated that the Commission has supported the profession in its efforts to narrow the areas of difference in accounting principles. This is accomplished in part by citing the Institute's accounting research bulletins, when we agree with them, as evidence of the authoritative support required by Release Nos. 4 and 96. There have been very few instances when we have disagreed with a bulletin. This may be accounted for in part because we have had an opportunity to comment on the content of most of them prior to publication in much the same manner as the public may comment on our rule-making proposals under the Administrative Procedure Act.

Nevertheless, we are aware that some critics of the present state of accounting point to governmental agencies (including the SEC) as a barrier to progress rather than as a stimulant to the profession in the development of greater unanimity of opinion on accounting principles. I have cited Mr. Brundage and Mr. Stewart on the positive side of this question. Mr. Brundage

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16 Published January 10, 1963. Accounting Series Release No. 4 was published April 25, 1938.

has also written on the negative side in an article entitled "Roadblocks in the Path of Accounting."[17] Let me comment briefly on the five roadblocks cited in that article which were (1) the monetary obstacle, (2) the overwhelming effect of taxation on accounting and business decisions, (3) the misconception that financial statements are true and accurate in an absolute sense, (4) governmental regulation, and (5) the natural conservatism of accountants. Conservatism, he states, is not limited to our profession--lawyers have it, too.

The problem of coping with the effect of the changing price level on financial reporting has been under serious study for at least thirty years. I have reported elsewhere on the Commission's awareness of the problem[18] so I need not repeat here. This is an important problem for management and investors and as such it rightfully held a prominent place on the program of this year's meeting of the American Accounting Association. Ralph C. Jones, who has studied the problem for many years, noted a long term trend toward recognition of the problem. He proposed that the traditional monetary postulate, "Fluctuations in the value of the monetary unit, which is an accounting symbol, may properly be ignored," be changed to read "Fluctuations in the value of the monetary unit during a single accounting period may properly be ignored" or "No accounting period should be longer than the time during which fluctuations in the value of the monetary unit under the existing conditions may properly be ignored."[19]

The Commission has noted that the practice of giving recognition in the accounts to the effect of the changing value of money is followed by some foreign corporations with the

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[17] Harvard Business Review, September 1951, p. 110.

[18] "Financial Reporting for Regulatory Agencies," The Journal of Accountancy, February 1958, p. 26.

[19] From a paper presented by Mr. Jones at the Price Level Panel discussion on August 28, 1963, at Palo Alto, California.

approval of their independent accountants. We are also aware of limited acceptance of this practice in the United States. The subject is referred to in a pamphlet, "Accounting and other requirements for the sale of foreign securities in The U. S. Capital Market," which was first published in 1959 and revised in 1962 by the AICPA for the assistance of its members. The pertinent passage is:

> "Another common area of difference between American and foreign accounting principles relates to property accounts and the provision for depreciation. The accepted American basis of carrying property in the balance sheet is at historical cost. The provision for depreciation charged in the income account should represent amortization, by a recognized method, of the actual cost of the properties over their economic lives. Although there has been some pressure in the United States to adopt economic depreciation, based on current replacement cost or current price levels rather than on actual cost, the business community and the accounting profession have not accepted this theory and the SEC has not recognized it as proper accounting in financial statements filed with the Commission."

An example of the second roadblock--taxation--will be covered when I discuss the investment credit. I agree completely with Mr. Brundage that the misconceptions of the nature of financial statements is a road block--a primary purpose of the securities acts is to prevent the use of misleading information and to require disclosures necessary to prevent misleading inferences. Differences of opinion as to what is required in this area existed before the passage of the acts and from the looks of things may continue to exist for some time to come. Some improvement in understanding should come from efforts to apply Mr. Brundage's suggestion to "bore a hole straight through this roadblock by the use of judgment, full explanations, and wide publicity of the facts and their significance." In his brief discussion of governmental regulation--the fourth roadblock--Mr. Brundage mentions the ICC and the FPC as well as the SEC. His comment on the SEC is

> "Although SEC regulation has for the most part followed constructive lines, and the Commission in general has refrained from laying down restrictive

> accounting rules, there nevertheless has been a tendency to oppose innovation and new forms of reports. My suggestion for improvement in this field is to urge moee latitude in accounting treatment to meet changing conditions as they arise."

By his statement that there has been a tendency to oppose innovation and new forms of reports Mr. Brundage seems to indicate that we represent the fifth roadblock designated as "the natural conservatism of accountants." On some proposals we have opposed change. His suggestion that there be more latitude in accounting treatment to meet changing conditions has been heeded by us as indicated in our opinions and releases, and we were severely criticized recently when we issued Accounting Series Release No. 96 dealing with the investment credit, which is discussed later.

Despite efforts to solve the problems relating to the determination of periodic income and the presentation of meaningful statements of income, this subject continues to be a controversial one. It was one of the most widely debated post-World War II accounting problems and was the subject of Commission studies and conferences with representatives of the accounting profession and others. At one point the Commission's staff and Institute representatives were very close to agreement on the proposed content of Accounting Research Bulletin No. 32, now Chapter 8, "Income and Earned Surplus," of Accounting Research Bulletin No. 43. The relative merits of the all-inclusive income statement advocated by the Commission's staff and the current operating performance concept believed by its supporters to be more useful as an indication of future earning capacity of a company are discussed in this chapter and the latter concept is endorsed. We unfortunately reached an impasse on the classification as between income and earned surplus of a few items and parted company. Having objected to various aspects of the bulletin in the course of its preparation, the Chief Accountant of the Commission wrote the Director of Research of the Institute that "'the

Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32." This letter and the bulletin were published in the January 1948 issue of The Journal of Accountancy.

About this time we began working on a major revision of Regulation S-X, the first since its publication in 1940. First drafts of this revision included new terminology such as "retained earnings" and avoided the use of the term "reserves," but this approach proved too cumbersome and was abandoned. However, a thorough analysis was made of letters of comment on financial statements for a considerable period of time in order that recurring inadequacies could be taken into account in drafts of the revision exposed to cooperating committees. Some of the proposed revisions were culled out at this stage and a formal notice of rule-making was published in July 1950. Then, the fireworks began! The preliminary draft had been sent to approximately 600 persons on September 21, 1949, and more than 3,000 persons were sent copies of the second draft which was published in the Federal Register pursuant to the requirements of the Administrative Procedure Act. Approximately 175 persons commented on each draft. The principal attack was directed at the inclusion of the definition of a quasi-reorganization as previously published in Accounting Series Release No. 25; the inclusion of the statement of administrative policy of Accounting Series Release No. 4, to which I have referred; a requirement that, except as otherwise specifically provided, accounting for all assets shall be based on cost; and a requirement for the use of the all-inclusive income statement.[20]

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[20] A Summary by the Editorial Staff of Accountants' Dissents on many of SEC's proposed changes in Regulation S-X, The Journal of Accountancy, October 1950, p. 312.

The American Accounting Association at its 1950 annual meeting approved a resolution presented by the Chairman of its Committee on Accounting Concepts and Standards which stated:

> "Whereas the development of accounting principles and accounting practices is a process which is necessarily continuous in order that they may be kept current with changing economic conditions, and
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> "Whereas it is to the public interest that such development continue so that financial statements may serve as well as possible the needs of investors and other interested parties, and
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> "Whereas experience has shown that the establishment of accounting principles by rule or regulation in certain fields has retarded such development,
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> "Now therefore be it resolved by the members of the American Accounting Association in meeting assembled:
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> that the establishment by rule or regulation of accounting principles, however meritorious in themselves they may currently seem to be, would tend to hamper the development of accounting and prevent the free exercise of judgment, in accordance with accepted principles, as to the most useful presentation of financial data,
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> and that accordingly certain proposals of this nature contained in a draft of a proposed amendment of Regulation S-X of the Securities and Exchange Commission would not be in the long range public interest, and
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> "Be it further resolved that the contents of this resolution be made known to the Securities and Exchange Commission."[21]

And the American Institute of Accountants in a meeting about a month later in the same city ratified a similar resolution of its council as follows:

> "WHEREAS, The council of the American Institute of Accountants has considered the proposed revision of Regulation S-X by the Securities and Exchange Commission and has observed that rules establishing matters of accounting principle have been incorporated therein; and

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[21] The Accounting Review, April 1951, p. 254.

"WHEREAS, This proposal represents a change in policy from one which has proved highly successful in improving financial reporting during recent years and constitutes a move which the council believes is adverse to the public interest in that it would inevitably lead to inflexibility of accounting procedures and a stagnation of accounting development; and

"WHEREAS, The council is of the opinion that the orderly development of accounting in the past has been achieved by the combined and coordinated efforts of all concerned including the business world, the accounting profession and governmental agencies, and that this method has proven so successful in practice that it should in the public interest neither be minimized nor abandoned;

"NOW THEREFORE BE IT RESOLVED, That the council is opposed to the issuance of rules by the Securities and Exchange Commission establishing matters of accounting principle, and instructs the executive committee and the officers of the Institute to take such steps as they deem appropriate to convince the Securities and Exchange Commission that it should continue its past policy in this respect."[22]

At the request of the Institute its representatives were heard by the Commission and as a result new items relating to accounting principles were deleted, all accounting series releases were incorporated by reference, and the all-inclusive income statement controversy was compromised by including the now well-known Item 17 in Rule 5-03.[23] Thus a major effort to influence the development of uniform standards and practices was concluded.

But what have we done for you lately?

In recent years there have been some interesting rule-making proceedings involving accounting principles but none have aroused such violent differences of opinion, except perhaps stock options, as deferred tax accounting and the investment credit. The regulatory agencies have diverse solutions for both issues. The ICC has applied its original "flow-through" decision

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[22] American Institute of Accountants, Annual Reports for the Year 1949-1950, pp. 9-10. See also The Journal of Accountancy, November 1950, p. A-20, for an announcement of the passing of the resolution by the members attending the annual meeting.

[23] See articles in The Journal of Accountancy for February 1951 for a discussion of the revision.

to the investment credit but, as I noted earlier, requires disclosure in a note and permits recasting of the published statements. The FPC adopted rules on deferred tax accounting and these rules and the question of that Commission's authority over reports to stockholders are presently the subject of litigation. The FPC has rule-making in process on the investment credit and its staff has recommended that the Commission find for the "flow-through" method. As to the investment credit the Civil Aeronautics Board's rule-making is still in process but the present indications are for a 48-52% solution.

A rehearing has been requested on the Federal Communications Commission's decision[24] to continue the "flow-through" basis. The FCC's decision, with three dissents in a Commission of seven members, identified three basic ways to reflect the credits, namely: 100% flow-through, 48% flow-through with 52% normalized as deferred taxes (advocated by Western Union), and normalization by a credit to plant accounts with a charge to operating expenses (advocated by AT&T). The majority found that their solution reflected the intent of Congress. The opposite view is succinctly presented in Commissioner Hyde's dissenting statement:

> "The order which has been adopted is not consistent with accounting regulations previously approved by the Commission, is inconsistent with accounting principles supported by a preponderance of opinion in the accounting profession, is contrary to the legislative intent of the investment credit law, and results in accounts giving a substantial distortion of income for the initial year, as compared to the remaining years of the life of the property."

Since the legislation on the investment credit was passed near the end of the year, all the agencies were under pressure to announce rulings, temporary or otherwise, so that companies under their jurisdiction could close their books for 1962. The same pressure was felt at the SEC from non-regulated companies subject to the reporting requirements of the securities acts. In this connection it should be noted that the regulatory agencies which have uniform systems of

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[24] Report and Order in Docket No. 14850, (RM-377) (RM-381) adopted July 29, 1963.

accounts were faced with the problem of amending them or of issuing interpretations governing their application to the investment credit problem. The regulatory commissions of the states had the same problem.

If experience at the SEC is an indication of what happened at other agencies, all were deluged with memoranda, letters, statistics, newspaper clippings, and visits by interested parties urging various and conflicting interpretations of the intent of Congress and solutions to the problem. Two Columbia professors, for example, filed with the ICC a paper in which they supported the ICC's "flow-through" policy on deferred taxes and recommended it for the investment credit. They stated: "the simplest, clearest and most direct accounting treatment is to be recommended. This treatment will be to show the credit as a tax reduction in the year received. Notes can, and should, report to ICC and the public what the credit is and how it might affect the future.[25]

The most recent federal government ruling to come to my attention is that of the Comptroller General of the United States on August 15, 1963, in a letter to the Secretary of Defense. This ruling finds that the intent of Congress is properly reflected in the Accounting Principles Board's Opinion No. 2 and for reasons stated the Comptroller General does not favor, "for determination of costs under a Government contract, a depreciation basis for assets that does not reduce the acquisition cost by the tax credit taken."

Two well-known experts on utility accounting debated the accounting treatment of the investment credit at the Great Lakes Conference of Railroad and Utilities Commissioners in June of this year. Leonard Spacek analyzed the legislative record and concluded that unless his

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[25] Dean, Joel, and Harriss, C. Lowell, "Railroad Accounting Under the New Depreciation Guidelines and Investment Tax Credit," The Accounting Review, April 1963, pp. 229-242.

marshalling of the facts from the record is wrong "there is only one proper basis of accounting for the credit and that is to record it as a credit against property cost, either directly or in an account offsetting that cost."[26] Donald C. Cook, reviewing the same legislative record, said in opposition to Mr. Spacek's views that "The whole legislative history of the statute makes entirely clear that a tax reduction in each successive fiscal period ["flow-through"] was intended by the Treasury and by Congress."[27]

In recognition of the substantial diversity of opinion that existed in this matter, the SEC issued Accounting Series Release No. 96 on January 10. This release states that the Commission will accept, with certain limitations, the method endorsed by the Accounting Principles Board or the 48-52% method, or, in the case of regulated industries, the 100%, flow-through method when authorized or required by regulatory authorities. The release also specifies that the balance sheet credit should not be made directly to the asset account, that the current provision for income taxes should not be stated in excess of the amount payable for the year. It includes other comments regarding adequate disclosure and details of certain other accounts, and a statement that appropriately qualified certificates will be accepted in cases where an alternative accounting treatment acceptable to the Commission is followed by the registrant.

Before issuing Release No. 96 the Commission considered a substantial amount of written material in support of the alternative solutions to the problem and listened to informal oral arguments on the subject as well as on the question of whether the Accounting Principles

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[26] Spacek, Leonard, "Accounting Treatment of Investment Credit," Arthur Andersen & Co. Subject File – AD 7220, Item 36.

[27] From typewritten copy of the paper, "Accounting Treatment of Tax Reduction Resulting from the Investment Credit," by Donald C. Cook, President of American Electric Power Company, Inc.

Board majority opinion should be supported as the only solution or some exception should be permitted. The basic problem here was, as it is in so many situations, to reach agreement on the facts. As the following excerpts from Opinion No. 2 indicate, the difference of opinion ranged from a dissenting opinion that “the pertinent factors preponderantly support the view that the investment credit is in substance a reduction in income taxes” to the belief of the majority of the Board that the weight of pertinent factors supports their conclusion that the credit is a “reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods.”

What will be the next step in the effort to narrow areas of differences in accounting? The program of accounting research adopted by the Accounting Principles Board was recommended by a special committee of the Institute on which the SEC was represented. I was a member of the advisory committee on the study of broad accounting principles for business enterprises and found it necessary to comment that the tentative set of principles “must be recognized as a statement of what the authors believe generally accepted accounting principles should be rather than what they are today.” The Board has announced an extension of its research program to include a project “to identify and codify accounting principles which the Board believes have achieved general acceptance.”[28] The SEC is represented on the advisory committee for this project. Some critics say that the Board has failed. One states that the SEC should “take over” but then in the next breath says that the consequences could be quite unpleasant.[29] Some take the position that the profession should never give the Commission

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[28] The CPA, July-August 1963, p. 1.

[29] Anthony, Robert N., “Shutdown on Accounting Principles,” Harvard Business Review, May-June 1963, p. 105.

reason to exercise its authority to "take over."[30] The record I have recited, I believe, indicates that the Commission has supported the latter sentiment. I will let you draw your own conclusions as to the future.

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[30] Hall, William D., "The Need for Uniform Accounting Standards," The Michigan CPA, June 1963, p. 24.