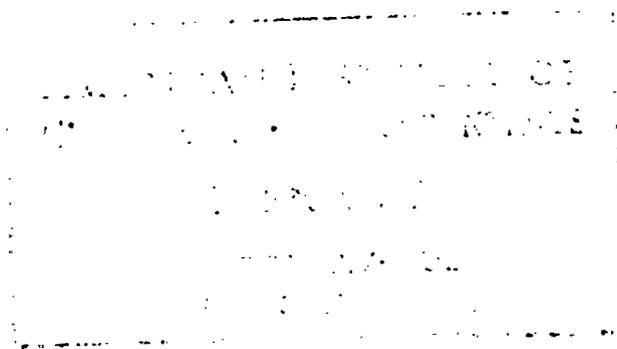


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Report of Special Committee on
**OPINIONS OF THE
ACCOUNTING PRINCIPLES BOARD**



Presented to Council of the
American Institute of Certified Public Accountants

Spring 1965

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666 Fifth Avenue, New York, N. Y. 10019

Message from President Flynn

TO MEMBERS OF THE AMERICAN INSTITUTE
OF CERTIFIED PUBLIC ACCOUNTANTS

The report of the Special Committee on Opinions of Accounting Principles Board, presented in full in this booklet, sets forth a general statement of the philosophy, purpose, and aims which the Special Committee believes should guide the Board in the development of accounting principles and practices for financial reporting. It was submitted to Council last month, and was warmly received as an outstanding contribution to a better understanding of the problems involved in improving financial reporting and to a clear definition of the means by which that might be accomplished.

Because of the significance of the report, and its immediate interest to the accounting profession, the executive committee has directed that it be distributed to all members of the Institute for their information and to provide an opportunity for obtaining their comments on the Special Committee's recommendations while the report is being studied by the Accounting Principles Board and the Executive Committee.

May 1964 Action

By way of historical background, you will recall that Council in May 1964 adopted the following resolution with

respect to disclosure of departures from Opinions of the Accounting Principles Board:

RESOLVED -- That it is the sense of this Council that reports of members should disclose material departures from Opinions of the Accounting Principles Board, and that the President is hereby authorized to appoint a special committee to recommend to Council appropriate methods of implementing the substance of this resolution.

Acting upon this resolution and the discussion which preceded it, the then President Heimbucher appointed a Special Committee on Opinions of the Accounting Principles Board and instructed it to:

1. Propose specific implementation as called for by the resolution.
2. Review the entire matter of the status of Opinions of the Accounting Principles Board and the development of accounting principles and practices for reporting purposes. From this review, develop, and recommend to Council a general statement of philosophy, purpose, and aims in this area, together with proposals for further implementation of that general statement, if considered appropriate.

By later direction from Council, the Special Committee was also instructed to:

3. Give further study to whether the Code of Professional Ethics should be amended to cover infractions of the requirements adopted by Council of the Institute at the Fall 1964 meeting regarding disclosure of departures from Opinions of the Accounting Principles Board.

October 1964 Action

The Special Committee reported to Council on the first of these assignments in October 1964, and a report of the recommendations adopted by Council was distributed the same month to all Institute members in a Special Bulletin, entitled "Disclosure of Departures from Opinions of the Accounting Principles Board."

Briefly, the recommendations adopted by Council provide that members should see to it that departures from Opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, with respect to financial statements for fiscal periods beginning after December 31, 1965, either in footnotes to financial statements or in the audit reports of members in their capacity as independent auditors. If in the reporting member's judgment an accounting principle applied in financial statements lacks substantial authoritative support, he should either qualify his opinion or express an adverse opinion, as appropriate, in accordance with generally accepted auditing standards and the Code of Professional Ethics.

May 1965 Action

The report in this booklet covers the remainder of the Special Committee's assignments, and was considered by Council at its May 1965 meeting. Upon recommendation by the Executive Committee, Council adopted the following resolution:

RESOLVED -- (1) That the report of the Special Committee be received with appreciation;

(2) That with respect to Recommendation #3 (a) dealing with the size of the Accounting Principles Board, the Council now approve the proposal for the gradual limitation of the APB to 18 members, to be accomplished by reducing the number of members elected annually, to six, commencing with the Council meeting in the Spring of 1966.

(3) That the report be referred to the APB and the Executive Committee with instructions to render their initial reports to Council at the 1965 Fall meeting covering the actions taken or planned to be taken on the remaining recommendations; and

(4) That the Special Committee be discharged with

the gratitude of Council for the prompt and effective completion of its difficult task.

You will note that, by this action taken at the suggestion of the Special Committee, most of the recommendations have been referred either to the Accounting Principles Board or to the Executive Committee for consideration. Each of these bodies has been instructed to render an initial report to Council at the September 1965 meeting on action taken or planned to be taken with respect to the recommendations referred to it.

In the meantime, the Accounting Principles Board and the Executive Committee will welcome the views of Institute members regarding the Special Committee's recommendations.

Yours truly,

THOMAS D. FLYNN, *President*

May 1965

Report of Special Committee on Opinions of Accounting Principles Board

TO THE COUNCIL OF THE AMERICAN INSTITUTE
OF CERTIFIED PUBLIC ACCOUNTANTS

This Special Committee was appointed by the then President Heimbucher on May 21, 1964 and reported on the first part of its assignment at the Fall 1964 meeting of Council of the Institute. At that meeting Council unanimously adopted recommendations that members should see to it that departures from Opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, either in footnotes to financial statements or in their reports as independent auditors.

Since that meeting the accounting profession and this Committee sustained a great loss through the untimely death of William W. Wernitz, the first chairman of the Committee. The members of the Committee express their profound sorrow and acknowledge a deep sense of loss because of his absence from its deliberations on the matters covered by this last installment of its report.

The remainder of the tasks assigned the Committee were to:

- a. Review the entire matter of the status of Opinions of the Accounting Principles Board and the development of accounting principles and practices for reporting purposes. From this review, develop and recommend to Council a general statement of philosophy, purpose and aims in this area.
- b. Give further study to whether the Code of Professional Ethics should be amended to cover infractions of the requirements adopted by Council of the Institute at the Fall 1964 meeting

regarding disclosure of departures from Opinions of the Accounting Principles Board.

As a forerunner to its deliberations, the Committee examined all basic documents pertaining to the establishment of the Board and the related research program, and a mass of details as to the operations of the Board and the related Research Division. Letters from over 300 practitioners, industrialists, educators, and government representatives, relative to the Board's role, composition, operations, and Opinions were received and reviewed. The Committee itself had four meetings of at least two days each.

The Committee believes the members of Council may want, before considering the recommendations and conclusions in this report, to reorient themselves on the history, composition, activities, and cost of the Board. To this end, an appendix to this report sets forth a comprehensive background statement.

Summary of Recommendations

The Committee believes that the idea of an Accounting Principles Board, and the Board's objectives, structure, and procedures as originally conceived are essentially sound. It is perfectly natural that in actual operation occasions for adjustment will arise, and opportunities for improvement and strengthening will develop. Time accords perspective for appraising areas calling for priority attention or for new, repeated, or modified emphasis. It is with that background and spirit that the Committee makes these recommendations:

1. At the earliest possible time, the Board should:
 - a. Set forth its views as to the purposes and limitations of published financial statements and of the independent auditor's attest function.
 - b. Enumerate and describe the basic concepts to which accounting principles should be oriented.
 - c. State the accounting principles to which practices and procedures should conform.

- d. Define such phrases in the auditor's report as "present fairly" and "generally accepted accounting principles."

- e. Consider, with the Committee on Auditing Procedure, the possibility of improving the terminology of the auditor's report, and in particular the words "generally accepted" in the expression "generally accepted accounting principles."

- f. Define the words of art employed by the profession, such as "substantial authoritative support," "concepts," "principles," "practices," "procedures," "assets," "liabilities," "income," and "materiality."

2. The Board should move toward the reduction of alternative practices in accounting by adopting policies under which it will:

- a. Recognize the objective that variations in treatment of accounting items generally should be confined to those justified by substantial differences in factual circumstances.

- b. Set forth in its Opinions the criteria for application of such acceptable variations.

- c. In an Opinion dealing with a situation which the Board believes justifies alternatives even though there is no significant difference in factual circumstances, set forth the treatment to be preferred, and require disclosure of the treatment followed.

3. With respect to the composition and tenure of Board membership, Council should:

- a. Gradually reduce the membership of the Board to eighteen, the number recommended originally in 1958 by the Special Committee on Research Program, and in time consider reducing the number still further.

- b. Continue the present requirement that Board members be drawn solely from the Institute membership.

And the Executive Committee should:

- c. Provide for careful advance screening of candidates for Board membership by creating a special subcommittee for the selection of nominees, with particular reference to their contribution potential, time availability, and ability to work effectively with a group.

- d. Continue the present three-year term for Board members, but adopt a policy that members be limited to two successive full terms, with no presumption of automatic renomination at the end of the first term.

4. In its operation, the Board should:
 - a. Establish a long-range program to deal with the whole accounting and reporting spectrum, and in furtherance of the program assign priorities and target dates.
 - b. In the assignment of priorities, give major attention to the fundamentals described under Recommendation 1, at the same time recognizing the necessity of dealing from time to time with matters which require current attention.
 - c. To accomplish these objectives, designate subcommittees for long-range planning and for consideration of fundamental matters distinct from those dealing with current issues.
5. In the development and evolution of its Opinions, the Board should:
 - a. Set forth in its Opinions a comprehensive background of the subject, the problem areas likely to need attention, the conclusions and the reasoning supporting them, and illustrative applications.
 - b. Except where otherwise specifically indicated, make its Opinions applicable to financial statements for fiscal periods starting after the dates of the Opinions.
 - c. Adopt a formal procedure to provide review, at regular intervals, of its issued Opinions, from the standpoint of acceptance, continued applicability, or changed conditions.
6. To facilitate understanding and acceptance of Board Opinions by the profession, the financial and business community, and the users of financial statements, the Institute should:
 - a. Adopt a continuing educational program directed to the membership and other appropriate groups regarding the operations and Opinions of the Board.
 - b. Encourage meetings, seminars, and other exchanges of viewpoints by Board members with industry groups and regulatory agencies.
7. A reasonable period of time having then elapsed for education and adaptation of the profession to Council's action in October 1964, regarding disclosure of departures from Opinions of the Board, Council in 1968 should approve, and propose to the membership of the Institute, an amendment to the Code of Professional Ethics to cover infractions of these disclosure requirements.
8. The Institute should continue the policy of financing Board and research costs from within the profession exclusively.

Of these recommendations, the only one calling for Council action at this time is 3 (a) relative to reduction in size of the Board. The others are for reference to the Board and the Executive Committee with report back to Council.

Discussion

The Accounting Principles Board is the only body within the Institute with authority to make or authorize public pronouncements on accounting principles. The need for such a body is obvious. A primary function of the independent CPA is to attest to conformance of financial statements with generally accepted accounting principles. That requires authoritative identification of those principles. The Institute, as the national organization of CPAs, is the logical entity to discharge that function. The Board was created as the vehicle within the Institute to perform this task.

The charter documents of the Board incorporate the substance of the report of the Special Committee on Research Program dated September 1958. The following is set forth therein:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues.

The voice of the Institute in this field, acting through the Board, carries much further than to Institute members. Financial statements play a key role to investors, credit grantors, government agencies, and others. The CPA's opinion adds credibility to the financial statements prepared by management. The CPA occupies this pivotal role not

merely because of his technical competence but, of far more significance, because independence, objectivity, and forthrightness are the foundation of his profession.

Through the soundness of the principles it propounds the Board can protect the public and guide the profession. In the technical field the Board should lead the evolving and dynamic accounting world. This in turn calls for far-sighted understanding and courageous leadership. It means avoiding expediency, timidity, or stagnation.

This concept of the Board, in combination with the Research Division, can achieve and maintain the desired goals.

But some disappointments and disillusionments have been expressed about the Board. The Board has been at work for over five years, and there are doubts as to its accomplishments during that period. The opposite side of that coin is that the Board has been at work *only* five years. The Board undertook a great responsibility. CPAs above all know about starting-up time, organization planning, securing personnel, the time required for research and experimental starts — all inevitable in a pioneering effort of this magnitude and scope.

As the Committee appraises the situation, these difficulties are about over. What may now appear to be sluggishness during the past five years may in retrospect, five years from now, be rechristened as a careful feeling of its way by the Board to insure a solid foundation.

That is not to say that everything has been done as effectively as it could have been done. It is to say that the substance is there. The Committee sees no reason to turn away from the idea of the Board and the related research program, or to start from scratch with some brand new approach.

The founding fathers of the Board — The Special Committee on Research Program — foresaw the desirability of "review at more or less regular intervals, say every five years, so as to improve its organization and method of operation, and to reflect changing conditions in the Institute and in the profession." This Committee has undertaken such a review.

There are definitely some problems that need attention now. The Committee conceives its role to be to identify

these problems, and not to usurp the jurisdiction to attempt to solve them in detail. The Committee also thinks that the record of the past five years affords good perspective about things to be emphasized or re-emphasized, and priorities to be set. The Board on its own already has had under consideration some of the recommendations herein.

Each recommendation of the Committee is restated and discussed in the following pages.

RECOMMENDATION 1

At the earliest possible time, the Board should:

- (a) Set forth its views as to the purposes and limitations of published financial statements and of the independent auditor's attest function.
- (b) Enumerate and describe the basic concepts to which accounting principles should be oriented.
- (c) State the accounting principles to which practices and procedures should conform.
- (d) Define such phrases in the auditor's report as "present fairly" and "generally accepted accounting principles."
- (e) Consider, with the Committee on Auditing Procedure, the possibility of improving the terminology of the auditor's report, and in particular the words "generally accepted" in the expression "generally accepted accounting principles."
- (f) Define the words of art employed by the profession, such as "substantial authoritative support," "concepts," "principles," "practices," "procedures," "assets," "liabilities," "income," and "materiality."

1 (a) (b) (c): The focus of accounting principles is on their application to financial statements. The focus of the auditor is on his opinion regarding the financial statements. What purposes and limitations attach to financial statements and to the auditor's opinion? This question is of first importance to the public and the profession. Literature abounds on it, but the answer is cast in many different molds. Until the profession has an official utterance about it, there is no point in beginning.

The Committee believes that such an utterance should be given top priority. It would be the subsoil on which subsequent pronouncements could be grounded and understood.

There would be many questions to tackle: What are financial statements trying to present? Are they primarily an

account of management stewardship, or primarily for investor guidance? What role does comparability play, especially with industry studies a part of investment life? What assumptions are made about the user of financial statements — who is he, what information does he want, what analytical ability does he possess, how does he use statements? What are the limitations of financial statements? What bearing do footnotes have? What role does judgment play? What significance attaches to the auditor's opinion? What are the different types of conventional opinions?

The Special Committee on Research Program contemplated that the Board would first address itself to the basic concepts or postulates on which accounting rests. These would provide the orientation for accounting principles from which in turn would stem the rules or other guides for application in specific situations.

This planned course ran into difficulty because current problems commanded attention and could not be neglected. Nevertheless, it remains true that until the basic concepts and principles are formulated and promulgated, there is no official bench mark for the premises on which the audit attestation stands. Nor is an enduring base provided by which to judge the reasonableness and consistency of treatment of a particular subject. Instead, footing is given to controversy and confusion.

Accounting Research Study 7, issued March 1965, is a giant step forward. It provides the Board with a comprehensive statement of the accounting principles which appear to be generally accepted. It includes a discussion of the function of accounting and the basic concepts to which accounting is oriented. This is most of the raw material which the Board needs to fashion the type of document or documents the Committee here recommends.

1 (d): Accounting, like other professions, makes use of words of art. Since accounting talks to the public, the profession's meaning, as distinguished from the literal dictionary meaning, must be explained to the public.

For example, in the standard report of the auditor, he generally says that financial statements "present fairly" in

conformity with generally accepted accounting principles — and so on. What does the auditor mean by the quoted words? Is he saying: (1) that the statements are fair *and* in accordance with generally accepted accounting principles; or (2) that they are fair *because* they are in accordance with generally accepted accounting principles; or (3) that they are fair only *to the extent* that generally accepted accounting principles are fair; or (4) that whatever the generally accepted accounting principles may be, the *presentation* of them is fair?

What is meant by the expression “generally accepted accounting principles”? How is “generally” measured? What are “accounting principles”? Where are they inscribed, and by whom?

I (e): In a world of change, it behooves the accounting profession to be alert to occasions for change in the conventional wording of its report on financial statements. Precision in terminology makes statements more valuable. One word in particular that needs re-examination is the word “accepted” in the expression “generally accepted accounting principles.”

By “accepted,” is the profession aiming at what is popular or what is right? There may be a difference. The report of the Special Committee on Research Program said that “what constitutes generally accepted accounting principles . . . means more than a survey of existing practice.”

Then again, “accepted” by whom — the preparer of the financial statement, the profession, or the user? Is a practice useful that is accepted by some and widely opposed by others?

The word “accepted” at the time it was adopted may have had reference to the preparers of financial statements, and that may have then been appropriate. But with the evolution of financial reporting, a concept of acceptability to the profession may now be in order.

Whatever the connotation of the word, it is clear that the profession owes it to the public and itself to declare how the profession regards the term. This is necessary not only for reciprocal understanding but also for reciprocal confidence.

I (f): The profession has said that generally accepted accounting principles are those with “substantial authoritative support.” What does that expression mean? What yardstick is to be applied to the words “substantial” and “authoritative”? What are the guidelines to prevent mere declaration, or use by someone, somewhere, from becoming the standard?

Many other expressions in accounting need explanation and clarification for the public. They include such words as “concepts,” “principles,” “practices,” “procedures,” “assets,” “liabilities,” “income,” and “materiality.”

Until the profession deals with all these matters satisfactorily, first for itself and then for understanding by the consumer of its product, there will continue to be an awkward failure of communication in a field where clear communication is vital.

RECOMMENDATION 2

The Board should move toward the reduction of alternative practices in accounting by adopting policies under which it will:

- (a) Recognize the objective that variations in treatment of accounting items generally should be confined to those justified by substantial differences in factual circumstances.
- (b) Set forth in its Opinions the criteria for application of such acceptable variations.
- (c) In an Opinion dealing with a situation which the Board believes justifies alternatives even though there is no significant difference in factual circumstances, set forth the treatment to be preferred, and require disclosure of the treatment followed.

2 (a) (b) (c): Variations or alternatives in accounting treatment have been the subject of a great deal of misunderstanding and, at times, criticism. From the standpoint of the public, the problem is frequently crystallized by posing the question: How can the same auditors under the same facts certify to widely different practices? Behind this question is another one: How can an investor compare companies and know what to buy, sell, or hold, if all companies are not measured by the same yardstick? The profession must answer satisfactorily, or else public confidence wanes.

In part, this is a semantic difficulty. The Committee believes a distinction needs to be made between acceptable *variations* in accounting treatment, which rest on differences in circumstances, and *alternatives*, which represent free choices of method where circumstances are substantially uniform.

There can be ample justification for different accounting practices, when the underlying facts are different. Accounting cannot conform what is in truth unconformed. Circumstances still alter cases. Accounting must be adapted to

its environment, and divergence, creativity, and innovation are characteristics of the American scene. To eliminate this adaptation would force treatments or practices where they did not fit in.

The field of medicine provides an analogy. The doctor may encounter the same disease in patients, but a variation in treatment is applied where the attending circumstances are different. So also in accounting the circumstances surrounding the application of a given principle may be substantially different. That is what justifies and even necessitates variations.

Applied in this manner, public understanding and acceptance of variations can be expected, since they are not different ways of handling the same thing. Rather, each is custom-fitted to its own special circumstances. And in a dynamic economy the number of acceptable accounting variations is likely to increase rather than decrease.

Difficulty arises for the public and the profession when there is a free choice of permissible treatments under the same circumstances. These are truly alternatives. Sometimes they have come about when accounting followed the income tax laws. Sometimes they have come about because of difficulty in establishing criteria for one or another method deeply imbedded in practice and in the market place.

An illustration of the latter is the alternative costing of inventory on the basis of assuming arbitrarily that goods first in are the first sold (Fifo), or that the goods last in are the first sold (Lifo). So also with fixed assets; there are various recognized and accepted ways of spreading cost over the period of usefulness and arriving at the resulting depreciation amount. These include straight line, declining balance, sum-of-the-years digits, unit of production, and so on.

In light of the foregoing, the Committee is of the view that the objective of the Board in this area should be to confine variations in treatment of accounting items to those that are justified by substantial differences in circumstances. The criteria for this purpose should be clearly identified and spelled out in the Board's Opinions.

The Committee recognizes that there will be situations

where, even within this objective, the Board finds alternatives to be justified though there is no significant difference in circumstances. Hopefully, these situations will be few. Where they do exist, the Board should set forth which of the alternative treatments is to be preferred. Furthermore, where the item is significant, the Board should require disclosure of the alternative method used. Through such disclosure and year-to-year consistency, public awareness and confidence will be advanced.

Paul Grady believes that Recommendation 2 greatly oversimplifies the matter of alternative accounting practices and overstates the extent of change which the Board should be expected to bring about. Until it has been demonstrated that distinguishing criteria can be established for such common alternative methods as are now in use for the pricing of inventories and allocation of depreciation charges to fiscal periods, he believes it is unrealistic to hold out an objective that alternatives should be restricted to differences in circumstances.

RECOMMENDATION 3

With respect to the composition and tenure of Board membership, Council should:

- (a) Gradually reduce the membership of the Board to eighteen, the number recommended originally in 1958 by the Special Committee on Research Program, and in time consider reducing the number still further.
- (b) Continue the present requirement that Board members be drawn solely from the Institute membership.

And the Executive Committee should:

- (c) Provide for careful advance screening of candidates for Board membership by creating a special subcommittee for the selection of nominees, with particular reference to their contribution potential, time availability, and ability to work effectively with a group.
- (d) Continue the present three-year term for Board members, but adopt a policy that members be limited to two successive full terms, with no presumption of automatic renomination at the end of the first term.

3 (a): The number of people on a board or committee is really secondary to the ability of its members, its method of operation, and its purpose. The Board now has twenty-one members. Recommendations made to the Committee would range from the size of the Board, anywhere from three to fifty members. A large group can be slow and unwieldy, impairing both product and production. A small group can lack representativeness or breadth of view.

Considering all this, the Committee believes it would increase efficiency to revert to the number of Board members originally recommended by the Special Committee on Research Program, namely, eighteen. This could be accom-

plished by electing to the Board six members a year instead of the present seven, starting with elections held following the current meeting of Council. In other words, the reduction from twenty-one to eighteen would be accomplished in a transitional period of three years.

It may very well be that the Board will find that even further reduction in its size is desirable and possible, say to fifteen. In that event, Council will then be in a position to consider the subject again and continue the recommended phasing-down.

3 (b): The Board chairman, in his report to Council in the Spring of 1964, said that the Board had under consideration a proposal to permit a limited number of non-Institute members to be eligible for Board membership. The proposal was deferred pending opportunity for this Committee to consider it. The Committee recommended against the proposal.

The Institute has within its membership CPAs from all walks of accounting life. Over 25 per cent of the members are from industry, education, and government. There is no need to go outside membership ranks.

The viewpoint of non-Institute members can be of great value in connection with their specialty areas. That viewpoint can and should be obtained. This can be done through hearings conducted by the Board with invitations extended to non-Institute members. It can be done by inviting selected non-Institute members to attend meetings of the Board when particular subjects are up for discussion. It can be done by joint meetings with other groups. Non-Institute members can be consulted in areas of their expertness just as did the Long-Range Objectives Committee of the Institute. The continued participation of non-Institute members on project advisory committees offers another opportunity to get the viewpoint of "outsiders" at close range.

Another proposal that was considered in the Committee's deliberations was whether to confine Board membership to practitioners. The idea behind that proposal was that it is only the practitioners who are really concerned, and they

should decide what practices they approve of and by which they are to be bound.

That proposal was rejected. The Committee thinks it is desirable to take advantage of all talents in a membership organization. Besides, accounting principles are not the sole property of practitioners. Industry, education, and government likewise have an interest, and, as has been mentioned, it is desirable that the Board get the benefit of their points of view through Institute members from those fields. To confine the Board to practitioners alone may be regarded as overly introspective. Broader composition is valuable from the standpoint of recognition and acceptance of Board Opinions by the public.

3 (c): The foregoing factors point up that, as in all human endeavor, the work of the Board is conditioned by the people composing it. That is why the charter rules of the Board wisely prescribed that members of the Board be "selected primarily because of their competence and interest, rather than as representatives of particular groups or geographical areas."

The Committee heartily endorses those criteria. It believes that additional considerations are: (1) time availability; (2) readiness to evaluate arguments presented in Board discussions and research studies, regardless of previously formulated positions; and (3) ability to work with a group.

The Executive Committee nominates the members of the Board. Comprehensive advance screening and careful weighing of all of these qualifications is, in the Committee's opinion, a "must" to proposal of a candidate for Board membership. Factors like time availability should be discussed fully and frankly with a candidate in advance, especially considering the large amount of "homework" that goes with Board membership. This important responsibility of the Executive Committee should be discharged through a special subcommittee to do all the screening.

3 (d): Members of the Board are elected for a three-year term. With the sort of advance screening by the Executive Committee that is here recommended, the three-year term

is appropriate, but a member should be limited in number of full successive terms to not more than two. There should, however, be no presumption that his renomination will automatically follow at the end of his first term. Advance screening for renomination is as important as in the case of an original nomination.

RECOMMENDATION 4

In its operation, the Board should:

- (a) Establish a long-range program to deal with the whole accounting and reporting spectrum, and in furtherance of the program assign priorities and target dates.
- (b) In the assignment of priorities, give major attention to the fundamentals described under Recommendation 1, at the same time recognizing the necessity of dealing from time to time with matters which require current attention.
- (c) To accomplish these objectives, designate subcommittees for long-range planning and for consideration of fundamental matters distinct from those dealing with current issues.

4 (a): The Special Committee on Research Program in 1958 emphasized the need for forward planning in the work of the Board, to the end that: (1) accounting procedures be evolved on a co-ordinated and consistent basis; and (2) pronouncements be made in an orderly and timely manner. This Committee re-emphasizes the need for forward planning of the Board's activities.

A comprehensive ten-year or longer plan should be prepared by a subcommittee of the Board to provide it with a road map and timetable to deal with the whole accounting and reporting spectrum. That plan should be reviewed each year for needed adjustment or changes. As part of the plan, a schedule of priorities should be established, and target dates provided for fulfillment of the respective parts.

In short, what is recommended is a well-defined, imaginative plan of future action buttressed by an informed order of priorities and a completion schedule. *Accounting Research Study 7*, previously referred to, whose inventories present generally accepted accounting principles, provides

an excellent checklist in getting such a comprehensive projection under way.

4 (b): It is especially important that the Board make the vital distinction in its workload between the fundamental needs described in Recommendation 1 and the occasional current developments on which the profession needs prompt guidance. The activities of the Board must proceed with determination in its attack on the fundamentals, or new pressures of the moment will continue to relegate the basics to the background of attention.

Nevertheless, every now and then some development looms or takes place, like a change in tax law, that calls for early determination by the profession as to its accounting treatment. The timing of its consideration by the Board then becomes an important element in the CPA's responsibility and responsiveness. The prompt issuance of an Opinion can prevent divergent or unacceptable practices from taking hold. The Board should be so organized that all these things will be expeditiously handled.

4 (c): Neither current problems nor long-range matters lend themselves to full Board handling in the first instance. In the interests of effective and timely product, the best approach is through subcommittees.

The Board has been making some use of subcommittees. That pattern of organization should not only be continued but also intensified. The Board's field is so vast that only through subcommittees can the work get the concentrated attention and timing so urgently needed.

Separate subcommittees should be created to deal with long-range planning, with the fundamental matters, and with current problems. Each subcommittee should function like a conventional task force. Each should be charged with providing the Board with a finished product or report on its assigned area. To reach this point, the subcommittee should have recourse to and work with the Research Division and project advisory committees as needed.

By this process completed and documented proposals for consideration and action can be served up to the full Board. This will not only expedite Board deliberations and conclu-

sions, but also relieve the Board of some of the inordinate investment in time and effort each member is now called upon to make.

The Committee reviewed the staffing history of the Research Division, which assists the Board's projects with preliminary research. Until recently, the Director of this Division also carried on part of the administrative work of the Board. This was not desirable because it diverted valuable time from active surveillance of research, while at the same time failing to relieve the Board chairman of a large amount of remaining administrative detail.

The Committee believes that this was a glaring deficiency in the Board's organization. It has recently been corrected by the engagement of a full-time Administrative Director for the Board. Beyond heartily endorsing this action, this Committee has no present recommendations with respect to staffing. It may well be that increased emphasis on long-range planning and fundamental concepts and principles will require some added research personnel, but this is a matter which the Fiscal Committee of the Board is well qualified to appraise from time to time.

RECOMMENDATION 5

In the development and evolution of its Opinions, the Board should:

- (a) Set forth in its Opinions a comprehensive background of the subject, the problem areas likely to need attention, the conclusions and the reasoning supporting them, and illustrative applications.
- (b) Except where otherwise specifically indicated, make its Opinions applicable to financial statements for fiscal periods starting after the dates of the Opinions.
- (c) Adopt a formal procedure to provide review, at regular intervals, of its issued Opinions, from the standpoint of acceptance, continued applicability, or changed conditions.

5 (a): The charter rules of the Board anticipate that Board Opinions will be well and fully reasoned documents anchored to the basic concepts and general principles of accounting. So framed, Board Opinions can, by their very persuasiveness, gain acceptance. This is the desirable approach.

Therefore, a Board Opinion should be cast more in the form of a statement of philosophy than an edict. A clear exposition of the philosophy behind a conclusion helps the profession, the preparer of financial statements, and the public. It enables the CPA to have an effective tool with which to persuade clients, if needed.

To this end an Opinion of the Board should contain a complete background statement of the subject, the various problems involved, the conclusions regarding the areas likely to need attention, the reasons behind the conclusions, and illustrative applications of the Opinion.

Precision in the wording of an Opinion is also important because of the tendency of practitioners to interpret the

wording literally. In addition, the Board should discourage any narrow, legalistic interpretations.

5 (b): The charter rules of the Board provide for prospective application of Board Opinions unless the contrary is indicated. When in October 1964 Council adopted the new policy regarding disclosure of departures from Board Opinions, it made the requirement applicable to fiscal periods starting at a date more than a year ahead.

Forward timing of the application of a Board Opinion has, in the Committee's view, much to commend it. The fact that an Opinion will not apply forthwith to a current year minimizes natural resistance to a sudden and unanticipated accounting change that can affect corporate earnings and upset published forecasts of the year's results. It is ordinarily desirable that the preparer of financial statements be in a position to rely on the continued application of accounting practices and rules that governed at the beginning of the fiscal year. The Committee therefore recommends that, other than in special situations clearly calling for an exception, Board Opinions specifically be stated to apply to financial statements for fiscal periods that begin after the date of the Opinion.

5 (c): An Opinion of the Board necessarily deals with the problem and its environment as perceived or projected at the time of the Opinion. But conditions have a way of changing or deviating from anticipation. An Opinion may become anachronistic, or may turn out to be inappropriate. A conclusion of the Board may encounter severe resistance, partial acceptance, or even rejection in actual practice.

All of these things bespeak the desirability of continuing surveillance of Board Opinions. The Special Committee on Research Program likewise concluded that "the Board would be expected to review the past pronouncements from time to time." This calls for assignment of responsibility within the Board.

RECOMMENDATION 6

To facilitate understanding and acceptance of Board Opinions by the profession, the financial and business community, and the users of financial statements, the Institute should:

- (a) Adopt a continuing educational program directed to the membership and other appropriate groups regarding the operations and Opinions of the Board.
- (b) Encourage meetings, seminars, and other exchanges of viewpoints by Board members with industry groups and regulatory agencies.

6(a)(b): The Committee thinks the public should be made aware of the many problems and facets that enter into the formulation of accounting principles and practices. For example, in September 1964 the Board approved a statement of its objectives. It is desirable that there be wide distribution of this statement, and of each of the statements developed in response to Recommendation 1.

Beyond this, there is a great deal of co-ordinating work to be done among the profession, industry, and government regarding accounting principles. To this end, more meetings with representatives of these groups, including stock exchanges, trade associations, and the professional organizations, should be sought by members or representatives of the Board. Considering the impact of taxes on accounting, advance discussions with members of Congress and officials of the Treasury Department can be very useful.

Talking things out with all groups can lead to enhanced understanding of one another's views, problems, and limitations. It can be an effective way to bring about a "narrowing of differences" in accounting, and to get a consensus in some cases as to the preferred treatment. Meetings of this character may even help within the respective groups; for example, in

government these meetings may help to reduce the number of disparate accounting rules now prescribed by the different regulatory agencies.

The Board has already begun to work with some industry committees. This type of co-operation should be expanded. The Board, as the representative of the profession in this field, should take the initiative in arranging for these meetings. They can be conducted on either an industry-by-industry basis, agency-by-agency, or groups of either or both, as best suits the particular technical areas to be discussed. From this process, the Committee foresees closer harmonization among all, and wider acceptance of the results.

The membership of the profession needs, too, to be brought along with the thinking and Opinions of the Board. This means that increased explanation of its work in professional journals and in meetings at national, state, and chapter levels is important. Such exposure is an essential to the full understanding needed for compliance; and it must be a continuous process.

The Committee envisages that all these programs should be primarily of an educational nature as distinguished from the conventional public relations approach.

RECOMMENDATION 7

A reasonable period of time having then elapsed for education and adaptation of the profession to Council's action in October 1964, regarding disclosure of departures from Opinions of the Board, Council in 1968 should approve, and propose to the membership of the Institute, an amendment to the Code of Professional Ethics to cover infractions of these disclosure requirements.

Disclosure requirements are inseparable from requirements regarding the application of generally accepted accounting principles. Damage from failure to disclose may equal or exceed damage from failure to follow generally accepted accounting principles. There is a rule of professional ethics dealing with failure to observe generally accepted accounting principles. Likewise, there should eventually be a rule of professional ethics dealing with failure to disclose departures from Opinions of the Board.

Council, in October 1964, called for such disclosure even though the departure rested on substantial authoritative support. It also called for study as to the desirability of an amendment to the Code of Professional Ethics to deal with infractions of this disclosure rule. In the interim, Council stated that it deemed failure to make the disclosure to be sub-standard reporting, and instructed the Practice Review Committee to give its attention to this area and report to Council on the extent of violations.

The educational program of the Practice Review Committee is excellent, but for compliance with Council's resolution the discipline of an ethics rule is needed, just as in the case of all other accounting and reporting matters before the Practice Review Committee. It is inconceivable that there should be no recourse for dealing with deliberate, extreme, or repeated flaunting of Council's resolution.

The public posture of the profession should be supported by the highest ethical standards. Certainly, Council's resolution gains more authority with a corresponding ethics rule than without one. The effectiveness of the Practice Review Committee is also enhanced when refusal of a CPA to respond to education can be dealt with by discipline.

The disclosure requirement becomes effective with financial statements for fiscal periods beginning after December 31, 1965. A transitional period is desirable to allow time for the educational work of the Practice Review Committee to bring about understanding and observance of the rule. By 1968, the requirement will have been before the profession for over three years and will have been in effect for two years. Therefore, it is proposed that an appropriate amendment to the Code of Professional Ethics to deal with infractions should be readied in due course, for recommended approval by Council and submission to the Institute membership in 1968.

Carman G. Blough and Paul Grady object to the position set forth in Recommendation 7. In their opinion this is not the time to decide that an amendment to the Code of Professional Ethics should ever be submitted to the membership of the Institute, to say nothing about fixing a date for such action to be taken. They recommend that continued surveillance and reporting thereon by the Practice Review Committee, as provided in Council's resolution of October 1964, is appropriate.

RECOMMENDATION 8

The Institute should continue the policy of financing Board and research costs from within the profession exclusively.

The Board and the related research program are now financed by amounts received for this purpose from the American Institute of Certified Public Accountants Foundation. The funds of the Foundation have in turn come exclusively from voluntary contributions by members of the profession.

Some industrial organizations have generously indicated a willingness to contribute toward the Board and research costs. It is the Committee's opinion that the method of financing should continue as at present. It is important that the profession be unmistakably in a position of independence and objectivity. Outside financing may give a contrary appearance. That should be avoided, and will be, if the profession itself continues to be the sole source of funds for this important activity. The Special Committee on Research Program likewise concluded, in 1958, that the costs should be borne solely by the profession.

Proposals Rejected

The Committee in the course of its deliberations dealt with many additional topics. Since Council may be interested in knowing the proposals which the Committee rejected, they are listed here:

1. Substitute for the Board a joint Board composed of various financial and accounting groups and major regulatory bodies.
2. Have a small group of full-time paid Board members, with tenure, similar to judges of a court.
3. Eliminate research, and rely instead on the competence and interest of Institute and Board members.
4. Confine research to gathering information, leaving the development of conclusions to the Board.
5. Publish only Board Opinions and not research studies.
6. Do not include in Board Opinions individual statements of assent or dissent.
7. Issue Board Opinions first on a "proposal" basis.
8. Require Board Opinions to be approved by either the Executive Committee, Council, or Institute members.
9. Change the rule requiring approval of two-thirds of the Board members for the issuance of an Opinion.
10. Change the procedures for preliminary exposure of Board Opinions.
11. Change election procedures for Board membership.
12. Terminate the Fiscal Committee of the Board.
13. Change other Board rules, procedures, and relationships.

Conclusion

Only Recommendation 3 (a), calling for a reduction in the size of the Board to eighteen members, requires action by Council at this time. The chairman of the Committee will move the adoption of this recommendation.

The other recommendations of the Committee are for reference to the Board or the Executive Committee of the Institute, as indicated. The chairman of the Committee will move that the reference be made to those respective bodies for consideration of and action upon the Committee's recommendations, and that they be respectively requested to report to Council at its Fall 1965 meeting as to the actions taken or planned to be taken with respect to the recommendations.

With this report the assignment to this Committee is completed. Unless, therefore, in the course of Council's disposition of this report there be anything to further engage the Committee, its chairman will move that it be discharged.

In closing, the Committee repeats the view expressed at the outset of this report. The idea of an Accounting Principles Board is essentially sound. In fact, it can be one of the greatest achievements of the profession and the Institute. To bring this about calls for recognition by every member of the profession that the Board is merely an instrumentality, and that in the last analysis each member of the profession has the responsibility to share in the burden of shaping the rules and practices by which the profession and the economy will be judged. Obviously, no quarter must be given to inertia, indecision, or considerations of expediency. With a pooling of its intelligence, foresight, and courage, the profession should have no difficulty mastering the forces that test it.

Respectfully submitted,

J. S. SEIDMAN, *Chairman*
CARMAN G. BLOUGH
ALBERT J. BOWS
PAUL GRADY
JOHN R. RING
MAURICE H. STANS
GLENN A. WELSCH

April, 1965

Appendix

Background Regarding the Accounting Principles Board

The genesis of the Board may be traced to an address made by the then president-nominee Alvin R. Jennings at the Institute's annual meeting in October 1957. He urged a new approach to the promulgation of accounting principles, with particular emphasis on antecedent, independent research. In December 1957, a Special Committee on Research Program was appointed. That committee reported to Council in September 1958. Council acted on the report in April 1959, and voted the creation of an Accounting Principles Board, as well as a new Accounting Research Division of the Institute. On September 1, 1959, the Research Division came into existence. On September 11, 1959, the Board held its first meeting and adopted charter and procedural rules.

The Special Committee on Research Program recommended, and Council originally voted, that the Board consist of eighteen members. The membership was increased to twenty-one by authorization of Council in September 1960. Nomination of members is made by the Executive Committee; election is by Council.

The twenty-one now on the Board consist of fifteen practitioners, three industrialists, and three educators. The aggregate number to date who have served on the Board is thirty-eight, consisting of twenty-six practitioners, five industrialists, six educators, and one governmental employee.

The Board has had three chairmen — Weldon Powell to April 1963, followed by Alvin R. Jennings to September 1964, followed by Clifford V. Heimbucher, the present incumbent.

The full Board has met eighteen times (most of them two-day meetings), as follows:

1959 — 2
1960 — 2
1961 — 3
1962 — 4
1963 — 3
1964 — 3
1965 — 1
<u>18</u>

There have been nineteen technical subcommittees set up by the Board, of which thirteen are still active. The following are the details:

- Nov. 1960 — *Communications
- Oct. 1962 — *Leases
- Oct. 1962 — Affiliated company report (a)
- Apr. 1963 — *Bank accounting principles
- May 1963 — *Carved-out oil and gas sales
- May 1963 — *Administrative committee
- June 1964 — *Statement of objectives
- June 1964 — Pensions
- Nov. 1964 — Declining-balance depreciation
- Nov. 1964 — Foreign operations
- Jan. 1965 — Affiliated company reports (a)
- Jan. 1965 — Review Accounting Research Bulletins
(7 subcommittees)
- Jan. 1965 — Nature and objectives of financial statements

* no longer active

(a) primary responsibility with Committee on Auditing Procedure

The present complement of full-time members of the Research Division consists of a director, two project managers, two assistant project managers, or a total of five technical peo-

ple (plus secretarial and stenographic assistance). There are also two paid outside consultants. The number of research personnel by years is as follows:

	<u>STAFF</u>	<u>PAID CONSULTANTS</u>
1959	1	1
1960	5	5
1961	6	6
1962	6	6
1963	5	3
1964	4	2
1965	5	2

The staff personnel have come from the fields of practice, education, or both. All the paid consultants have been from education.

There have been four Research Directors. Up to June 30, 1960 Perry Mason was Acting Director. Thereafter there were Maurice Moonitz to July 31, 1963, Paul Grady to August 31, 1964, and Reed K. Storey, the present incumbent.

To date, seventeen projects have been initiated for research study, of which seven have resulted in published reports, one has been discontinued, and nine are pending. The details are as follows:

	<u>INITIATED</u>	<u>STUDY PUBLISHED</u>
Basic postulates	Mar. 1960	Sept. 1961
Broad accounting principles	Mar. 1960	Apr. 1962
Business combinations	Mar. 1960	June 1963
Income taxes	Mar. 1960	
Leases	Mar. 1960	May 1962
Nonprofit organizations	May 1960	discont'd.
Pensions	Oct. 1960	
Cash flow and funds	Oct. 1960	Nov. 1961
Price-level	Aug. 1961	Oct. 1963
Foreign operations	Aug. 1961	
Intercorporate investments	Aug. 1961	
Inventory of generally accepted accounting principles	Sept. 1963	Mar. 1965

	<u>INITIATED</u>	<u>STUDY PUBLISHED</u>
Goodwill	Nov. 1963	
Research and development	June 1964	
Extractive industries	June 1964	
Materiality	Nov. 1964	
Income and retained earnings	Nov. 1964	

Project advisory committees have been created for each of the projects, except that in the case of the last two, preliminary studies are still in progress. To date, seventy-three individuals have served on the project advisory committees, and of these forty-four have been from practice, seventeen from education, two from government, and ten from other areas including law and security analysis.

Of the total of sixteen active projects, the research work was farmed out in nine cases, assigned to the Research Division staff in five cases, and a combination of both in two cases. Of the nine cases farmed out, five were to practitioners, and four to educators. Of the two cases, the participants in the research were educators. Of the seven published research studies, four were handled by the Institute's research staff, two by educators, and one by both. In the case of all research work that is farmed out, the Institute research staff renders some assistance.

To date, the Board has issued five Opinions. Of these, two were anteceded by research study. The details are as follows:

	<u>OPINION DATE</u>	<u>RESEARCH STUDY DATE</u>
1. Depreciation guidelines	Nov. 1962	
2. Investment credit	Dec. 1962	
3. Statement of funds	Oct. 1963	Nov. 1961
4. Investment credit (amended)	Mar. 1964	
5. Leases	Sept. 1964	May 1962

In the seven published research studies, there was an aggregate of twenty accompanying statements of comment

by members of the project advisory committees. The one on broad accounting principles had nine; the one on cash flow and funds had none.

In the Board Opinions there was a total of twenty-eight separate statements, of which thirteen were dissents and fifteen assents or qualified assents. The Opinion on depreciation guidelines was unanimous. The original Opinion on investment credit had six dissents; the amended Opinion had five dissents.

In the formulation of each Board Opinion, about 2,500 to 4,000 exposure drafts have been sent out, depending on the subject. The groups covered include Institute committees, state societies and their chapters, colleges and universities, government agencies, and industry organizations.

In the case of a published research study, about 1,500 copies are distributed for consideration and comment. The groups covered include Institute committees, state societies and their chapters, colleges and universities, and editors of business and economic publications.

The research study reports are also sold. The figures on these to November 30, 1964 are as follows:

	<u>QUANTITY</u>	<u>AMOUNT</u>	<u>NET INCOME*</u>
1. Basic postulates	39,000	\$ 48,000	\$11,000
2. Cash flow and funds	40,000	53,000	10,000
3. Broad accounting principles	32,000	38,000	7,000
4. Leases	26,000	33,000	1,000
5. Business combinations	16,000	20,000	(1,000)
6. Price-level	13,000	20,000	(7,000)
	<u>166,000</u>	<u>\$212,000</u>	<u>\$21,000</u>

* after deducting printing, promotion, and handling costs

The aggregate cost of the Board and the research program through the fiscal year ended August 31, 1964, was

\$635,000. The breakdown by years ended August 31 is as follows:

1960 —	\$ 64,000
1961 —	131,000
1962 —	165,000
1963 —	144,000
1964 —	131,000
	<hr/>
	<u>\$635,000</u>

The budgeted amount for the year ended August 31, 1965 is \$145,000. Approximately \$30,000 a year applies to direct Board costs, and the remainder is for research.

The Institute financed the costs from its budget for the first three years, and the American Institute of Certified Public Accountants Foundation has financed the subsequent years. The aggregate amount received to August 31, 1964, by the Foundation from Institute members and firms for the research program was \$867,000. Income on investments to that date aggregated \$47,000, making a gross fund of \$914,000. Deducting the \$275,000 financed by the Foundation left \$639,000 in the Foundation at August 31, 1964 earmarked for the research program. This will be reduced to about \$494,000 by August 31, 1965.