

WHAT ARE ACCOUNTING PRINCIPLES?

by

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WHAT ARE ACCOUNTING PRINCIPLES?

Every transaction involving the receipt, expenditure, utilization, exchange or distribution of things by a business concern – whether operated by an individual, a partnership or a corporation – must be recorded or the concern cannot long exist. The process of recording these data in dollars and cents we know as bookkeeping.

The gathering together periodically of the data so recorded in a form which will best serve the purpose of the many persons who are, or may become, interested in the concern may be referred to as financial statements presentation.

Since the accountant is responsible for both of these processes – and this responsibility is his alone – it follows that he must not only be well trained in the mechanics of bookkeeping but must also appreciate fully the significance and the use to be made of his ultimate product – the financial statements.

The users of these financial statements will comprise a great variety of persons and the purposes for which they are used will be equally numerous. The managers of business will utilize the statements of their respective companies as well as those of competitors and others to guide the destinies of their business; without complete and appropriate financial statements the banker cannot justify the making or continuance of loans; credit in any form cannot or should not be extended without the knowledge obtained from the debtor's financial statements of his ability to meet his obligations. Federal and state regulatory bodies must depend upon the financial statements of the companies coming under their jurisdiction as a basis for administering many of the statutory duties with which they are charged, including the determination of the necessity for or feasibility of rate changes; persons engaged in the reorganization and rehabilitation of companies in distress financially, and courts whose duty it is to protect all interests involved under such circumstances must have properly presented to them the financial status and potentialities of those companies; and persons contemplating investment, whether in an old or newly established enterprise, or considering the desirability of increasing, decreasing, or

disposing of present investments must obtain the data on which to base their decision from the financial statements.

Obviously, to accomplish their purpose financial statements must be clear and unequivocal. As between companies, especially those within the same industry, they must, above all, be comparable. The statement that the stockholders' equity per share in Company A is \$50.00 while that of Company B is \$150.00; or that Company A earned \$2.50 per share whereas Company B earned \$5.00; or that the net profits of Company A were 20% of its capital while the net profits of Company B were only 10%, can be an indication of the relative financial status or accomplishments of these companies only if the principles upon which these determinations are based are substantially the same.

Such a condition can only prevail to the extent that there has been established, with respect to each transaction reflected in the financial statements, a principle or "general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice."¹

If we are to place dependence upon the usual final or opinion paragraph of the standard short form of accountant's certificate found appended to most financial statements today, we must conclude that there has been established a body of accounting principles; for this opinion paragraph invariably (unless, of course, the accountant finds need to take exception to some specific practice or transaction) reads as follows:

"In our opinion the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at _____ and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

But where are we to find a comprehensive and authoritative statement of these "generally accepted accounting principles"? Is there such a statement which establishes unequivocally

¹ A.I.A. Accounting Research Bulletin No. 7 (Special); November 1940.

those accounting procedures and practices which are accepted and those which are not; those which are right and those which are wrong?

While many books have been written which have sought to recite in one place a body of accounting principles, and many more articles have been written setting down certain specific principles, vast areas of disagreement exist concerning many practices and procedures vital to the production of useful and understandable financial statements. Furthermore, many of the authors of our ever-increasing stock of accounting literature purposely have avoided the designation of certain practices or procedures as definite principles. Instead they have discussed the pros and cons of various situations and have left to the reader the determination of what is to be considered the “generally accepted accounting principle” under a given set of circumstances.

It would seem, therefore, that the following statement made by F. P. Byerly in 1937 was then, and still is, quite appropriate:

“First, what has frequently been spoken of as accounting principles includes a conglomeration of accounting practices, procedures, policies, methods and conventions relating both to the construction of accounts and their presentation; and second, there seems to be a general agreement among the commentators that the difficulty of any attempt to formulate so-called principles or prescribed rules and regulations on accounting matters is that the field is so large and the conditions encountered so diverse that few, if any, sweeping generalizations can safely be adopted.”²

Likewise, the American Accounting Association had previously expressed the opinion in 1936 that:

“After a quarter-century and more of active discussion and experimentation in this country, many of the simplest and most fundamental problems of accounting remain without an accepted solution. There is still no authoritative statement of essential principles available on which accounting records and statements may be based. Public accountants . . . have been asked to certify to the correctness and adequacy of accounting

² “Formulation of Accounting Principles or Conventions,” The Journal of Accountancy, August 1937.

statements, when no satisfactory criteria of correctness and adequacy have been agreed to.”³

The authors of Montgomery’s Auditing, Seventh Edition (1949) express the opinion (at page 67) that “there will never be compiled one body of authoritative, exhaustive, and permanent accounting principles which the auditor may consult and compare with the practices of the company he is auditing.”

And even now, after almost three years of deliberations, a Study Group on Concepts of Business Income initiated in 1948 by the American Institute of Accountants, with a matching grant from the Rockefeller foundation,⁴ is still striving to determine the most useful concept of one term having accounting significance – income. Indicative of the difficulties encountered by this study group is the fact that its members have not been able to agree upon the desirability of adhering to cost for financial statement purposes.

Although it would appear that the “generally accepted accounting principles” upon which certifying accountants rely are not to be found in one place, it is not, however, because organized efforts have not been made to establish a unified and coordinated body of principles.

American Institute of Accountants – In January 1936 the American Institute of Accountants published the bulletin “Examination of Financial Statements by Independent Public Accountants”. This bulletin represented the last of a series the first of which, entitled “Uniform Accounting,” was prepared by a committee of the Institute in cooperation with the Federal Reserve Board in 1917. Upon the first reprinting of the original bulletin in 1918 the title was changed to “Approved Methods for the Preparation of Balance-Sheet Statements”. A revised bulletin (the revision was begun in 1925) was prepared by a committee⁵ of the Institute and

³ “A Statement of Objectives of the American Accounting Association,” The Accounting Review, March 1936.

⁴ See “Three Year Study of Business Income, Its Concepts and Terminology,” The Journal of Accountancy, August 1947.

⁵ The Committee consisted of Arthur W. Teele (chairman), William B. Campbell, W. Sanders

published by the Federal Reserve Board in 1929 under the title “Verification of Financial Statements”. This was superseded by the present bulletin in 1936. A discussion of the reasons for and purpose of the bulletin is contained in the May 1929 Journal of Accountancy, wherein are recounted the painstaking efforts of many eminent accountants to produce what was described editorially in the same issue of the Journal as “the most representative pronouncement upon the vital question of accounting procedure which has been made in this country.”

The 1929 bulletin, like the 1917 and 1918 versions, dealt principally with examination procedures and financial statement presentation but contained several pronouncements, some of which were so definite as to establish them as statements of principle, and others which indicated a preference for, or recommended against, a specific practice or procedure. For example, it was indicated that:

- 1) Reserves should be provided for notes and accounts receivable, the collection of which was doubtful, for diminution in value of securities and for depreciation of plant, property and equipment;
- 2) Inventories should be valued at the lower of cost or market; should not contain unsalable or obsolete items; should not include selling expenses, interest charges or administrative expenses; and should not anticipate profits;
- 3) Items of unusual profit or loss which were not the result of ordinary transactions of the concern and items which were due to operations of prior periods should be shown as special credits or special charges to profit and loss;
- 4) If property was stated on the basis of an appraisal at a given date that fact should be mentioned in the balance-sheet;
- 5) Any credit reflecting appreciation based on an appraisal of assets should be shown, where possible, on the balance-sheet above capital and surplus as “Unrealized appreciation resulting from revaluation of capital assets”;
- 6) “When corporations have temporarily invested funds in the purchase of their own stocks and bonds these securities technically should be deducted from the corporation’s outstanding securities. Custom, however, has sanctioned the inclusion of such temporary holdings as investments, but where they are so held the fact should be clearly indicated on the balance-sheet. Investments of this kind are not usually regarded as current assets.”

The bulletin made no specific reference to the manner to which assets should be recorded and the use of appraisals was neither recommended nor condemned, although, as indicated by item 4 and 5 above, apparently they were not considered out of place.

The revised bulletin, issued in 1936, like its predecessors was, as indicated by its title, “Examination of Financial Statements”, concerned principally with audit procedures. It did contain, however, substantially all of the pronouncements – although in some instances worded differently and, on the whole, more definitely stated – that were in the 1929 bulletin except that it veered away from the “all-inclusive” type of income determination; instead of stating, as did the 1929 bulletin, that “Items of unusual profit or loss which are not the result of ordinary transactions of the concern and items which are due to operations of prior periods should be shown as special credits or special charges to profit and loss,” it stated that “Minor surplus adjustments affecting prior periods are preferably included under this caption [other income or other charges] since it is impossible to close the accounts of any one period without continual overlapping of miscellaneous income and expense items.”

With respect to the basis for recording assets it was stated that “Plant assets, permanent investments and intangibles are usually stated at cost or on some other historical basis without regard to present realizable or replacement value,” and “It is a generally accepted principle. . . that the investment in an industrial plant should be charged against operations over the useful life of the plant.”

Like the 1929 bulletin the 1936 bulletin neither recommended nor objected to restatements of assets based upon appraisals but contained the statement “The balance sheet should show as ‘surplus arising from revaluation,’ or some similar title, any credit resulting from increasing the book value of capital or other assets by revaluation, whether on the basis of independent appraisal or otherwise.”

The bulletin, however, contained the following new pronouncements:

- 1) “Unrealized profits should not be credited to income account either directly or indirectly, by charging against such unrealized profits amounts which would ordinarily be

chargeable against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in the case of inventories in industries (such as the packing-house industry) in which it is a trade custom to take inventories at net selling prices which may exceed cost.”

2) “Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise require to be made against income. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the stockholders as in reorganization.”

3) “Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.”

4) “Each class of stock should be stated separately on the balance sheet, with the amount authorized, issued and outstanding and the par value per share. If the stock is of no par value the stated or assigned value per share, if any, should be shown and the redemption price or the amount of preference upon liquidation. If any stock of the company is held in the treasury it should preferably be shown as a deduction from capital stock or from surplus or from the total of the two, at either par or cost, as the laws of the state of incorporation and other relevant circumstances require. If it is included on the asset side of the balance sheet the circumstances justifying such treatment should be indicated in the caption or in a footnote to the balance sheet.”

5) “‘Notes’ [and] accounts receivable from stockholders, directors, officers and employees and . . . from affiliated concerns. . . should be shown separately on the balance sheet.”

6) “If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of the property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.”

Another significant step toward the establishment of a body of generally accepted accounting principles was taken by the Institute at their annual meeting in 1934 when the membership approved the adoption of a “Statement of Rules or Principles Recommended for

Adoption by the Institute” contained in a report of a Special Committee on Development of Accounting Principles.

In this report the Committee stated that:

“Since principles of accounting can not be arrived at by pure reasoning, but must find their justification in practical wisdom, the committee believes that the Institute should proceed with caution in selecting from the methods more or less commonly employed those which should be accorded the standing of principles or accepted rules of accounting. Further, when the Institute lays down rules or principles, they are apt to be regarded as self-serving declarations when they would operate to protect its members, though they will be given full weight when they affect the position of a member adversely. It is therefore highly desirable to secure the acceptance of any rules or principles laid down, not only by the Institute but also by the courts or by independent bodies having some regulatory powers or authority. The committee believes that the policy of the Institute should be to act with care and deliberation, and to endeavor whenever possible to secure the concurrence of some body possessing high authority in the rules or principles which it lays down.”

“Under the act creating the Securities and Exchange Commission as passed at the last session of Congress, that Commission has wide powers to prescribe methods of accounting and your committee believes that a close cooperation with the Commission is desirable and should permit of the formulation of accounting rules or principles in accordance with the policy which has been outlined. Obviously, the Institute desires to keep in close touch with the work of the Commission for the purpose, first, of assuring that the methods prescribed by that body conform to the best accounting opinion and shall not be prejudicial to the welfare of the profession or the community; and, secondly, to enable it to bring rulings made by the Commission to the attention of members of the Institute and to secure their cooperation in all measures designed for the protection of investors and benefit of the community.”

“Your committee desires, also, to submit the following report on specific recommendations:

“In September, 1932, the special committee of the Institute on cooperation with stock exchanges, in a communication addressed to the New York stock exchange, set forth in five paragraphs certain principles which it thought would find general acceptance. Subsequently, the stock exchange asked all corporations whose securities were listed to secure from their auditors information on certain points, one of which was whether the accounting of the corporation conformed to accepted accounting practice,

and particularly whether it was in any respect inconsistent with any of the principles put forward by the Institute. In a report to the governing committee of the exchange dated October 24, 1933, the committee on stock list stated that the replies had indicated very general acceptance of those principles, and added: ‘The committee feels that all these principles should be regarded by the exchange as so generally accepted that they should be followed by all listed companies – certainly, that any departure therefrom should be brought expressly to the attention of shareholders and the exchange.’ The committee feels that these rules or principles. . . should be adopted by the Institute.”

The “rules or principles” recommended by the committee and adopted by the membership were six in number and were substantially the same, and in some instances were word-for-word the same, as those quoted previously⁶ from the bulletin “Examination of Financial Statements” issued by the Institute in 1936.

In September 1939 the Institute’s Committee on Accounting Procedure issued the first three of a series of Accounting Research Bulletins. In Bulletin No. 1 the six “rules or principles” just referred to were reprinted under the caption “Rules Formerly Adopted” by the membership of the Institute. In addition there was included in the bulletin, described as a “rule already adopted by its committee on accounting procedure” the report of that committee relating to “Profits or Losses on Treasury Stock”, which was prefaced by the statement “The executive committee. . . directed that. . . [it] be published, without approval or disapproval of the committee, for the information of members of the Institute.” This report concluded with the following statements of the special committee on cooperation with stock exchanges and the committee on accounting procedure (which apparently comprise the “rule” referred to):

“Accordingly, although your [special] committee [on cooperation with stock exchanges] recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account).’

⁶ Pages 10 – 11, supra.

“This committee [on accounting procedure] agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.”

Although these seven pronouncements are referred to as “rules” the bulletin also contained the following paragraph under the caption “Exceptions to General Pronouncements”:

“The committee recognizes that its general rules may be subject to exception and that in extraordinary cases truthful presentation and justice to all parties at interest may require exceptional treatment. But the burden of proof is upon the accountant clearly to bring out the exceptional procedure and the circumstances which render it necessary.”

Bulletin No. 2, captioned “Unamortized Discount and Redemption Premium on Bonds Refunded” was not characterized as a rule. In it three optional treatments were cited and discussed; one was stated to be “permissible” but “open to objection”; another, “has in the opinion of the committee, considerable support in accounting theory” and “perhaps conforms more closely than either of the other methods to the current trend of development of accounting opinion” although “the committee is not prepared at this time to express a preference for this method so definite as to call for a qualification of the certificate if any other method is employed”; and the third method was described as “not adequately supported by accounting theory, but to run counter to generally accepted accounting rules”.

Bulletin No. 3 amplified, but did not change, Rule No. 2 contained in Bulletin No. 1.

Bulletin No. 1 also listed twelve additional matters which were receiving attention and would be the subject of future bulletins. These were:

- “1. A more exact determination of the basis of inventory valuation.
2. Definition of ‘cost’ of fixed assets under varying conditions as to payment or consideration for them.
3. Should accounting recognize a classification of losses other than revenue losses (the so-called capital losses)? If so, what are the distinguishing characteristics of the classification, having regard to the nature of surplus, and of its subdivisions?

4. The possibility of combining the income statement with the statement of surplus, or alternatives to emphasize their related character.
5. An apparent trend toward viewing the annual corporation report to stockholders as being in the nature of a prospectus to investors.
6. The accounting treatment: (1) of options issued to officers and employees of a corporation for services rendered or to be rendered, and (2) of capital stock issued or issuable under these options.
7. Depreciation on appreciation.
8. Comparative statements.
9. Accounting for the purchase and retirement of bonds other than through refunding operations.
10. The proper recording of capital-stock dividends in the books of the issuing company, and of the recipient.
11. The treatment of voluntary payments made by corporations under pension plans.
12. Accounting for cash in foreign banks.”

Forty Accounting Research Bulletins have now been issued, seven of which have dealt with subjects included in the twelve listed for future action. These were:

Bulletin No. 5 – Depreciation on Appreciation.

Issued April 1940. (Item 7 above);

Bulletin No. 6 – Comparative Statements.

Issued April 1940. (Item 8 above);

Bulletin No. 8 – Combined Statements of Income and Earned Surplus.

Issued February 1941. (Item 4 above);

Bulletin No. 11 – Corporate Accounting for Ordinary Stock Dividends.

Issued September 1941. (Item 10 above);

Bulletin No. 29 – Inventory Pricing.

Issued July 1947. (Item 1 above);

Bulletin No. 36 – Pension Plans – Accounting for Annuity Costs Based on Past Services.

Issued November 1948. (Item 11 above); and

Bulletin No. 37 – Accounting for Compensation in the Form of Stock Options.

Issued November 1948. (Item 6 above).

None of the thirty-seven bulletins issued subsequent to the first three is described as a rule, and not more than one-third of them appear to be unequivocal statements of principle or procedure. Most of them contain statements so qualified as to allow for a variety of practices (e.g.: “should ordinarily be included”; “is usually combined with”; “it is not generally necessary”; “it may be desirable”; “might well be adopted”; “is obviously proper”; “is good accounting practice”).

All thirty-seven of the subsequent bulletins, except eight which are captioned “Reports (or Recommendation) of Committee on Terminology”, contain the admonition “Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached”, and “It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment.”

In addition to these bulletins the Institute issued in November 1949 through its Research Department a timely memorandum entitled “Accounting Problems Arising From Devaluation of Foreign Currencies”.

The American Accounting Association – Another effort toward the establishment of a coordinated body of basic accounting principles is found in “A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements”, which was issued by the Executive Committee of the American Accounting Association in 1936.

The purpose of this statement was described as an attempt “to set forth some of the bases upon which accounting statements rest; it has not tried to establish the postulates of all accounting theory and procedure. . . any complete statement of fundamental principles must include suitable explanations, extensions, and qualifications in order to provide for special circumstances. With this understanding, however, it should still be possible to agree upon a

foundation of underlying considerations which will tend to eliminate random variations in accounting procedure resulting not from the peculiarities of individual enterprises, but rather from the varying ideas of financiers and corporate executives as to what will be expedient, plausible, or persuasive to investors at any given point of time. A solution of this problem has been sought by attempting a tentative statement of certain basic propositions of accounting which embody standards of adequacy and reasonableness in the presentation of corporate financial statements. In most instances these principles represent levels of accounting practice departures from which now are viewed with concern by many practitioners and financial analysts.”

The principal features of this statement may be summarized briefly. It recognized original cost as the proper basis of recording, and accounting for depreciation of, assets; periodic revaluation of assets, up or down, whether in accordance with price levels or for other reasons, was condemned, as was the use of any values other than unamortized cost except insofar as furnished only as collateral notations for informative purposes; the income statement should be “all-inclusive”, that is, should reflect all revenues and all costs recognized during the period whether or not strictly applicable to the current period; as an aid to proper comprehension of the results for the period it was provided that a section of the income statement which would include all items resulting from normally recurring transactions would be followed by a second section showing all other items including, specifically, so-called capital gains and losses, prior year adjustments, difference upon settlement of liabilities and extraordinary items; the income statements should exclude any item arising from transactions or adjustments affecting the capital accounts, including dividends; a warning was expressed as to the use of reserves created to artificially stabilize profits; and the prescription was laid down that “Surplus set aside for contingencies or for other purposes does not lose its identity and should ultimately be restored intact to surplus account.”

The propositions were advanced (the general objective of which was to make an effective distinction between capital and income) that capital should be divided into two main classes,

namely paid-in capital and earned surplus; that paid-in capital should be further sub-divided into capital stock, paid-in surplus, gains from the sale and from retirement of reacquired shares and capitalizations of earned surplus; that reductions of paid-in capital should be limited specifically to stock redemptions and retirements and to liquidating dividends; that upon retirement of reacquired shares any excess of cost over the prorata portion of capital stock and paid-in surplus applicable to the shares should be charged to earned surplus; that no credits to earned surplus might arise from transactions in the company's own stock; that no transfers should be made from paid-in surplus to earned surplus; and that, following the elimination of a deficit by utilization of paid-in capital, earned surplus should be dated.

The bulletin has been revised twice; first in 1941 under the title "Accounting Principles Underlying Corporate Financial Statements" and again in 1948 under the title "Accounting Concepts and Standards Underlying Corporate Financial Statements".

The 1941 revision embodied a number of desirable changes and additions. For the most part, however, they were clarifying in nature or served to add emphasis at selected points. Among the new features the following were most significant: 1) upon retirement of a debt any related discount, premium or expense should be written off immediately; 2) discovery value, timber growth, and other forms of accretion are generally not to be recognized as realized revenue; absorption of a deficit by transfer to paid-in capital should be approved by the stockholders; and 4) the treatment of reacquired shares was expanded to deal with the reissuance of such shares.

The 1948 revision was perhaps more extensive than the first. Its new features included (1) recognition of the necessity for disposing of intangibles in respect of which it was stated that "the cost of an intangible asset which has a limited-term significance should be assigned to expense by systematic timely charges"; (2) indicated as acceptable the assumption of "a flow of the cost of inventoriable items, for example 'first in, first out'"; and (3) in connection with the accounting treatment for the reacquisition of shares of a corporation's own stock, a complete cut-off is now effected as between such reacquisition and any subsequent events with the results that

the reissue of reacquired shares “should be accounted for in the same manner as the original issue of corporate shares.”

In 1949 and again in 1950 a Committee on Accounting Concepts and Standards was appointed by the American Accounting Association for the purpose of continuing a systematic study of accounting principles in order that ultimate further revisions of the Association’s Statement of Accounting Concepts and Standards might be developed as logically as possible. Several matters affecting the preparation of financial statements were considered in both years⁷ but no revision of the 1948 Statement of Accounting Concepts and Standards was made.

Haskins & Sells Foundation – In November 1937 “A Statement of Accounting Principles” formulated by Professors Sanders, Hatfield and Moore under the auspices of the Haskins & Sells Foundation was published by the American Institute of Accountants. The avowed purpose of this statement was to evolve “a reasonable number of accounting principles, based on practical business concepts of capital and income, which will merit the approval of those competent to judge of their soundness, and thus attain to general acceptance.” Such a statement was highly desirable in the opinion of the Foundation because “Accounting practices at present are based, in a large measure, upon the ethics and opinions of reputable accountants, and to some extent upon the accounting provisions of the various laws, but wide variations of opinion often exist among equally reputable practitioners. There is no unified body of opinion, nor is there any official tribunal for the final determination of technical differences of opinion.”

The statement was a very comprehensive one replete with discussion and notes. It covered directly, or by inference, all of the items referred to in the 1929 bulletin, “Verification of Financial Statements”, the Institute’s 1934 “rules” and the Association’s 1936 statement, and many more. Whether or not it accomplished its stated purpose, or the attempt of its authors as

⁷ See “Accounting Concepts and Standards – A Report for the 1949 Committee,” Ralph Coughenour Jones, Chairman (Accounting Review, April 1950, p. 139), and “Report of the 1950 President,” Perry Mason, (Accounting Review, April 1951, p. 248).

stated in their letter of transmittal to the Foundation “to set forth the principles and rules of accounting which dictate what should appear in a balance-sheet and an income statement and in the accounts from which they are compiled” may best be judged from some of the pronouncements contained in the statement, of which the following are representative:

1. “Since the income statement is prepared for the information of owners, managers, creditors, and taxing authorities, and for regulatory and other purposes, those accounting practices are best which serve those purposes in the most reliable and helpful manner. It sometimes becomes necessary to prepare separate statements to serve the several purposes. The different statements should be reconcilable with one another, and the purpose of each should be always to afford a substantially sound view of the facts to those to whom it is addressed.”
2. “The non-operating section [of the income statement]. . . should include. . . unrealized gain from appreciation (if shown at all. . .) . . .”
3. “One of the few topics relating to accounting on which there is general agreement is that depreciation involves a charge against the earnings of the period.”
4. “Reserves to equalize maintenance. . . even over successive fiscal years, may properly be employed, so long as the practice is clearly disclosed.”
5. “So-called ‘capital gains’ and ‘capital losses’ are conspicuous examples of occurrences affecting the asset values of a business enterprise for which accounting practice discloses no generally followed or standard method of accounting. . . Whether such gains or losses should be wholly included in the current income statement, wholly excluded from all income statements, or apportioned among the current and succeeding income statements is a matter to be determined by sound business judgment, made upon all the facts of the particular case, guided by the principle of conservatism. . . In cases of doubt the tendency should be to include such items in the income statement.”
6. “In the case of some commodities, such as grain or cotton, regularly quoted and readily realizable on an organized exchange, it may be the most convenient thing to value inventories on the basis of the current quotations. . . No great harm can result from taking up the resulting profits or losses in such cases, provided (a) a consistent policy is followed, (b) the practice is clearly disclosed, including the possible effects on dividends.”

7. “When unusual declines of large amounts have taken place and are likely to be permanent, the assets may be written down against capital, or capital surplus, or earned surplus. . . write-downs recording catastrophic physical or economic destruction of capital may be proper charges against capital or capital surplus. No such step should be taken without full consideration of its effect in reducing subsequent charges against income.”

8. “. . . it may be justifiable to charge to Development (an asset account) some expenses which later may regularly be charged against income. Or it may be better to make all the charges to income and carry forward the resulting net deficit as an intangible asset. In any case the accounts should indicate what has been done.”

9. “If the management wishes to go further and adopt a still more conservative policy with respect to inventory valuation, calculated to reduce the fluctuations in profits, that should be regarded as well within its province.”

10. “The regular amortization of goodwill is not considered imperative, as is the amortization of wasting assets. Such a treatment, however, is not considered objectionable. Strictly speaking, the amortization is a charge against income for the period during which the goodwill is supposedly effective, but the practice of charging capital or surplus instead of current income is approved by accountants.”

11. “Reacquired shares of a company’s own stock. . . should not be included in the current assets section. Ordinarily the same rule will apply to the company’s own issue of bonds. But a few bonds of a well-secured issue, upon reacquisition, if readily salable may be carried as marketable securities.”

12. “It is a proper exercise of the functions of management to choose which of the three methods shall be followed, provided the method chosen is clearly shown in the annual statements affected.” (This statement was made in connection with the discussion of optional methods of accounting for unamortized discount and expense on bonds refunded.)

13. “It is, however, good practice to call attention to the existence of material contingencies either parenthetically or in a footnote.”

The Securities and Exchange Commission – Following the stock market crash in 1929 it was almost inevitable, regardless of the causes of this economic catastrophe, that Federal legislation designed to safeguard the interests of investors would ensue. And it did; first in 1933 in the form of the Securities Act, known as “The Truth in Securities Act”, which act was

administered by the Federal Trade Commission until 1934, and the Securities Exchange Act, enacted in 1934, which created the Securities and Exchange Commission.

The Securities Act has as its principal purpose the protection of the interests of investors and the public (1) through disclosure by companies whose securities are offered for public sale of such financial and other information as may be necessary to apprise prospective investors of the salient facts concerning the securities, and (2) by prohibiting misrepresentation, deceit and other fraudulent acts and practices in the sale of securities, under penalty of fine or imprisonment and subject to the risk of suit for damages by investors.

The Securities Exchange Act extended the ‘disclosure’ doctrine of investor protection to securities listed on national (registered) securities exchanges but did not so affect securities not listed on an exchange but which are traded exclusively in the “over-the-counter” markets.

The 1933 and 1934 Acts were followed (1) in 1935 by the Public Utility Holding Company Act which resulted from a nine-year study conducted by the Federal Trade Commission and which seeks to correct, and guard against the recurrence of, a variety of abuses in public-utility holding company finance and operations which resulted in serious detriment to the nation’s electric and gas utilities investors and consumers; (2) in 1939 by the Trust Indenture Act designed to safeguard the rights and interests of purchasers of bonds, debentures, notes and similar debt securities offered for public sale which are issued pursuant to trust indentures under which more than \$1,000,000 of securities may be outstanding at any one time; (3) in 1940 by the Investment Company Act, brought about by the tremendous losses experienced by investors in this type of company; and (4) also in 1940, the Investment Advisers Act which regulates the activities of persons offering, for compensation, advice to investors.

Inasmuch as we are presently concerned primarily with financial statements of industrial companies, the foregoing statutes enacted in 1935, 1939 and 1940 will be dealt with only incidentally herein.

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 require that certain financial statements be filed with the Securities and Exchange Commission. The

Congress, however, did not, in either of these statutes, indicate what specific principles or standards are to be followed in the preparation of financial statements filed pursuant thereto. However, it did not leave the way open for those responsible for the preparation of such statements to rely solely upon their own judgment as to the manner in which they should be presented; for in addition to requiring the Commission to obtain balance sheets, income statements and other data in certain circumstances, in most instances the nature and details of the items comprising these statements are specified by statute.

Furthermore, the 1933 Act provides that the required financial statements shall be certified by “an independent public or certified accountant” and the 1934 Act provides that the Commission may require that such statements be accompanied by a certificate of “independent public accountants”. The Commission’s rules require that statements filed pursuant to both Acts be so certified.

In addition to the foregoing statutory restrictions against the indiscriminate application of accounting concepts in financial statements made public through filings with the Commission, each of the statutes charges the Commission with making certain that such statements contain all information necessary or appropriate in the public interest or for the protection of investors; and in order that the Commission may be in a position to carry out this mandate both the Securities Act and the Securities Exchange Act authorize the Commission, among other things, to “prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the method to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts

of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. . .⁸

It will be seen from the foregoing that the Commission definitely is empowered to establish principles and standards to be followed in the preparation and presentation of financial statements filed with it.

In arriving at a solution to the accounting problems confronting it in connection with these two statutes, several lines of approach were open to the Commission. It might have attempted to promulgate definite rules and regulations relating to all accounting matters involved in financial statements filed with the Commission. Such procedure the Commission deemed both impracticable and undesirable; for the ramifications of accounting are so extensive that to have attempted to establish what would amount to a body of accounting principles would have constituted an almost impossible task and could not have resulted other than in the formulation of a series of rules which, in many instances, would have been premature or unsound.

The Commission could have considered each set of financial statements filed with a view to having such data presented in a manner deemed preferable in the individual case. This approach would have resulted in inconsistencies which would have detracted from the comparability of statements and could only have added to the lack of uniformity in accounting practice.

Still another approach was to study the individual statements as filed to determine whether the accounting principles reflected therein and the methods followed in their preparation were sound and generally recognized as such; if not, to require that the statements be amended. It is this latter course which the Commission chose to follow and, as a consequence, it has refrained, so far as practicable, from prescribing specific accounting rules; and statements may,

⁸ Securities Act, Section 19(a); Securities Exchange Act, Section 13(c).

generally speaking, to quote Rule 3-01 of the Commission's Regulation S-X,⁹ be filed "in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in light of the provisions applicable thereto."

In the early days of the Commission such rules and regulations pertaining to accounting matters as it was found necessary to promulgate were contained in the numerous forms prescribed for use under various circumstances or in the Commission's general rules and regulations applicable to each statute. Beginning in 1937 these rules and regulations were implemented by the issuance of the Accounting Series Releases. The first of these releases, of which there are now seventy (70), was dated April 1, 1937 and was announced as the beginning of "a program for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."

One of these Accounting Series Releases – No. 4, dated April 25, 1938 – announced as an administrative policy of the Commission that:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

⁹ This regulation (together with the Accounting Series Releases) governs the form and content of financial statements filed with the Commission.

In February of 1940 the Commission issued Regulation S-X, previously referred to, which gathered together the various rules, regulations and instructions pertaining to the form and content of financial statements which previously had been contained in the various forms and general rules and regulations of the Commission. While this regulation was amended from time to time no substantial change had been made in the section (Article 5) applicable to commercial and industrial companies, or in the sections (Article 1 through 4) having general applicability to all types of companies.

Many accounting and reporting problems arose during the ten years following the adoption of Regulation S-X, and their solution resulted in changed viewpoints, not only on the part of industry and the accounting profession, but also of the Commission. Furthermore, entirely new situations developed requiring the establishment of new procedures. For this reason the regulation was subjected to a thorough review and Articles 1 through 5 were revised substantially in December 1950.

The promulgation of the Commission's first forms and general rules and regulations, insofar as they pertained to financial statement requirements, was a joint project upon which accountants in public practice and in industry, and educators specializing in accounting and kindred subjects worked closely with the Commission's staff.

The first Accounting Series Release and all subsequent releases relating to matters involving accounting principles or the form and content of financial statements were submitted to representative individuals and groups who were identified with or directly interested in the preparation of financial statements for public use for their comments and recommendations. These included individual certified public accountants, controllers (some who were C.P.A.'s and some who were not) and teachers, the American Accounting Association, the American Institute of Accountants, the Controllers Institute, and the American Petroleum Institute. Many of the recommendations of these persons or groups are reflected in the releases as finally adopted. In addition several proposed releases were never issued because of meritorious objections received from those asked to comment upon them.

Regulation S-X was issued originally only after similar review, numerous conferences with interested persons and representatives of interested groups and many drafts. The 1950 revision was subjected to the same treatment. More than 600 copies of a preliminary staff proposal were sent out in September 1949, and approximately 3,000 persons received the formal proposed revision in July 1950. Comments were received from approximately 175 persons or representative groups in respect of each proposal and many of these comments are reflected in the final amendment.

It will be noted that this procedure whereby the interested public has always been invited – indeed expected – by the Commission to participate, through letters or by conference, in the promulgation of rules and regulations affecting the presentation of financial statements, is now required by the Administrative Procedure Act which was enacted by The Congress in 1946.

Nor has the Commission limited the participation of industry and accountants in such matters to formal rules and regulations. A Committee on Cooperation with the S.E.C., appointed by the American Institute of Accountants almost coincidental with the formation of the Commission, meets from time to time with members of the Commission's staff to discuss current mutual problems. And a similar committee of the Controllers Institute of America has been of considerable assistance to the Commission.

From the foregoing it will be seen that the Commission, in carrying out its responsibilities with respect to financial statements contained in registration statements and other reports filed with it, has depended in a large measure upon the accounting profession to establish and follow accounting principles which are sound and which, in the absence of a body of definite rules, may be considered to be the generally accepted accounting principles underlying the preparation and presentation of financial statements.

While it is clear that much serious effort has been directed by those most interested in the production of useful financial statements to the accomplishment of this purpose, and substantial progress has been made, much remains to be done; for we must continue to seek to obtain a unanimity of opinion as to the most appropriate manner in which a given transaction or series of

transactions is to be reflected in financial statements. This does not mean that once it is decided, in a given set of circumstances, that a particular treatment is indicated the applicable rule, principle or whatever you may choose to call it can, or need, never be changed. Abraham Lincoln once said that “Important principles may and must be flexible.” But I am sure that he did not have in mind flexibility such as Edward Young¹⁰ referred to when, in speaking of writers, he stated that “they oftener chang’d their principles than shirt.”

If and when changes in principles or practice appear called for to improve the quality of financial statements to the end that there can be no reasonable doubt as to their purport, they should be made only after exhaustive consideration which will leave no major argumentative point unsettled. And the desirability of reexamining some of our present standards seems evident if we are to pay attention to the doubts expressed by many persons experienced in analyzing financial statements as to the propriety of some of the basic accounting principles presently reflected in financial statements.

For example, in the August 11, 1947 issue of Barron’s National Business and Financial Weekly there appeared the statement by Arundel Cotter that “Phantom profits worry foresighted managements. Business executives today, contemplating the big black dollar figures that adorn the last lines of their income accounts, are giving more and more thought to informing their shareholders. . . that there is a strong tinge of red in the black. Too many profits are in what the late Al Smith termed baloney dollars. . . His reports, if they follow standard corporate accounting, give his stockholders a false picture of the results of the corporation’s current activities.” The article contends that insufficient depreciation charges are among the principal causes of the “phantom” profits and states “the money with which to replace a capital asset must come from the earnings of this asset, and nowhere else. Obviously, if the reserve from earnings for this replacement is less than the cost of replacement, capital is being depleted. Assuming that

¹⁰ Epistles to Mr. Pope concerning the Authors of the Age (1730).

replacement costs remain at their current high level, any corporation that allows for depreciation only on the basis of original cost of twenty or forty years ago is inviting eventual bankruptcy.”

In the New York Times on October 5, 1947 it was stated in an article by C. M. Reckert under the heading “Big Increase Seen in Industry Profits – Rate is Above Pre-War Years – One third of Profits Only on the Books”, that “while the enormous increase in earnings might indicate ‘excessive’ profits for many organizations, it should be understood that more than one-third of the reported profits are not real earnings but book profits. * * * Inventory profit appears on the books as a result of the higher value per unit placed on goods in the warehouse or in process of production. When the present inventory is sold at an enhanced value, it must be replaced with new stock bought or produced at higher costs.” The article characterizes these inventory profits as “unreal”.

The April 20, 1950 issue of The Commercial and Financial Chronicle contained an article by Alden R. Wells, entitled “Fantasy of Figures – Responsibility of Accountants”, wherein it was stated that “Accepted accounting practices rest on the delusion that the dollar is a true yardstick. As a unit of measurement, it will on this assumption measure the comparative value of different goods purchased at the same time and similar goods purchased at different times. All these goods can then be combined at stated intervals into an income statement and balance sheet expressed in the single unit of measurement – dollars. Casual readers of financial statements, and many not so casual, assume that the physical facts behind this dollar summation are truly represented. Or, looked at in another way, they assume all of those dollars are identical with the dollars at that point resting in their pocket. That, of course, is not. * * * Balance sheets reflect as much fantasy. At the top, cash is expressed in the same dollars as sales. Below this the inventory may be expressed in dollars three times as valuable as cash dollars. * * * Well informed students of accounting today agree that this accounting confusion exists, but the number who understand the implications are distinctly limited; * * *.”

The foregoing, which are representative of the many, many articles complaining about the lack of utility or dependability of present day financial statements, refer to only three of the

current accounting problems – depreciation, inventories and decreased purchasing power of the dollar – which, as we are all aware, have been or are being dealt with by the accounting profession. There are many others.

While to some extent, because of the hesitancy on the part of the accounting profession to take a definite stand on many debatable – or at least debated – matters, criticism is justified, it is by no means to be concluded that financial statements are of doubtful value. However, if they are so equivocal as to require explanation or clarification beyond that contained in the statements themselves, they fail to serve their purpose. For this reason the basic principles underlying their preparation should be firmly established and consistently applied.

It seems to me highly desirable that the accounting profession, which would include not only its members engaged in public practice but also those in the employ of industry, particularly controllers or those in similar positions, and teachers of accounting, should cooperate to the fullest extent in an all-out attempt to have adopted as definite rules those principles and practices which they can agree have in fact become generally accepted.

Nor should their efforts stop there. The principles or rules agreed upon should be the subject of constant review to determine the need for and nature of new or supplemental pronouncements necessary to keep pace with economic and financial developments, or the desirability of changing existing ones.

A foundation for such a program has been laid in the six rules contained in A.I.A. Accounting Research Bulletin No. 1 (referred to previously on pages 10 and 11). Seldom, if ever, do we find these rules violated. The recommendations contained in the subsequent Accounting Research Bulletins and the views expressed in the A.A.A. 1948 Statement of Accounting Concepts and Standards Underlying Corporate Financial Statements should be reexamined with a view to reconciling such differences – and they are relatively few – as now exist between the respective pronouncements of the Association and the Institute. This done, and a body of authoritative generally accepted accounting principles must emerge.

In such a program – in which all persons concerned with the production of useful financial statements would have a keen interest – it seems to me that the accounting staff of the Securities and Exchange Commission could be helpful. Certainly we would be glad to cooperate to the fullest extent, if for no other reason than that the successful conclusion of such a program would lighten the work-load involved in the examination of the many thousands of financial statements filed with us in that it would reduce to a minimum the many discussions we now become engaged in due to different points of view as to what accounting principle governs in a particular set of circumstances. But most important of all, I think, would be the advantages obtained by investors in that financial statements would be immeasurably improved.

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