

University of Mississippi eGrove

Association Sections, Divisions, Boards, Teams

American Institute of Certified Public Accountants
(AICPA) Historical Collection

1-1-1964

Search for accounting principles, today's problems in perspective

Reed K. Storey

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_assoc

 Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

Storey, Reed K., "Search for accounting principles, today's problems in perspective" (1964). *Association Sections, Divisions, Boards, Teams*. 308.

https://egrove.olemiss.edu/aicpa_assoc/308

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Association Sections, Divisions, Boards, Teams by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

*The Search for
Accounting Principles*

TODAY'S PROBLEMS IN PERSPECTIVE

REED K. STOREY, PH.D., CPA

This book represents the views of the author. Its publication by the American Institute of CPAs does not constitute official endorsement or approval of the opinions expressed.

*Copyright 1964 by the
American Institute of Certified Public Accountants, Inc.
666 Fifth Ave., New York, N.Y. 10019*

*To my father Karl S. Storey, CPA, who
led me into the profession of accounting*

Preface

A perspective on the past is vital to charting a course for the future. As the accounting profession embarks on renewed efforts to improve financial accounting and reporting, it has much to gain from a careful study of its past efforts to develop and improve accounting principles.

The history of the development of accounting principles in the United States has not yet been written. It is still to be found scattered through a large number of books, articles, and other documents, many of which have disappeared or are disappearing from print. Anyone interested in acquiring an understanding of the events of the past thirty years in their historical context is faced with the prospect of working his way through this vast amount of literature. This paper is intended to be a brief beginning toward remedying this situation.

The study on which it is based grew from a research grant given to the University of Washington in the summer of 1960 by Edward P. Tremper, Durwood L. Alkire, and Gerald E. Gorans, partners of Touche, Ross, Bailey & Smart in Seattle. The reading and most of the writing took place while the author was a member of the accounting faculty at the university.

The complete manuscript has been read at various stages by John L. Carey, Paul Grady, Maurice Moonitz, Gerhard

G. Mueller, and Cecilia V. Tierney. All have made suggestions which have improved the manuscript. Typing and editorial assistance have been provided by Eleanor Foley, Margaret Breslin, and Carol Perfetto, and the manuscript was prepared for publication by Ann O'Rourke, Joan C. Lucas, Barbara Shildneck, Mary Anne Leone, and Gail L. Gans, all of the American Institute of CPAs.

The opinions expressed do not, of course, represent the positions of the American Institute of CPAs, the University of Washington, or of any of the individuals named. The author alone is responsible for the conclusions drawn and for errors of fact or reasoning.

R.K.S.

December 1963

Table of Contents

Introduction . . .	1
The Foundation . . .	9
A Change of Architect? . . .	16
Accepted and Rejected Building Blocks . . .	19
Principles: Philosophy or Practice? . . .	20
Terminology: Defined or Undefined? . . .	21
Approach: Logic or Experience? . . .	24
Sand in the Foundation? . . .	26
The First Block is Placed . . .	28
New Problems in Old Dress . . .	32
The Broad Picture . . .	34
Uniformity, Flexibility, and Comparability . . .	38
The Structure Rises . . .	39
The Institute and the Association . . .	40
Similarities and Differences . . .	43
The Result . . .	48
A Dilemma . . .	51
Old Problems in New Dress . . .	52
The Institute's New Research Program . . .	54
Accounting at the Crossroads . . .	59
Progress . . .	60
Building Blocks . . .	61
Approach . . .	64

Introduction

Probably no word appears more frequently in the literature of accounting than the word "principles." Likewise it appears in every audit certificate signed by members of the American Institute of Certified Public Accountants and in most of those signed by other CPAs. And yet the "principles of accounting" are, and have been, the subject of disagreement among accountants. The following three statements provide an interesting overview:

After a quarter of a 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 statements when no satisfactory criteria of correctness and adequacy have been agreed to.¹

. . . it is important that we examine critically into the reasons why corporate financial statements of today meet with such cynicism and distrust. What is wrong with accounting as the public sees it? Could it be the fact that there is still no broad authoritative code of accounting principles? Could it be that the two principal accounting organizations

¹ "A Statement of Objectives of the American Accounting Association," *Accounting Review*, Vol. XI (March 1936), p. 1.

take opposite positions on many basic issues? Could it be that there is no standardization of terminology and that many of the terms of accounting are technical jargon which the layman doesn't understand? Could it be that there are still no fixed standards of minimum disclosure for financial statements? Could it be that there is a great variety of form and content in financial statements, making it difficult to compare one company with another? Could it be that there is still a great range of accounting practice and that many identical transactions are treated in different ways in different companies? Could it be that the chief criterion of accounting procedures is their general acceptance which is a passive concept in which the acceptance is by the creators of the practices and not by the reader?²

The opinion paragraph of the standard form of certificate uniformly reads that the financial position and operating results are fairly presented "in accordance with generally accepted accounting principles." While practically every accounting firm uses this standard wording to express its opinion on corporate financial statements, there is no general agreement as to the exact meaning of the phrase or its applicability to the variety of situations in which it is used.³

Although these three statements appear to be contemporaneous, the first is separated from the last by more than twenty-two years, and the other was made at a time about half way between that of the first and that of the last. Inasmuch as all three seem to indicate the existence of about the same state of affairs, is it fair to assume that little or no progress in the formulation of accounting principles took place between 1936 and 1958 (or between 1911 and 1958, if the first statement is literally accepted)? This question must be answered in the negative since it would be both unfortunate and misleading to conclude that accounting principles were at a standstill during this period. Progress has indeed been made, and although the basic problem which existed in 1936, i.e., the absence of an authoritative code of generally accepted accounting principles, still exists today, it is a different problem than it was in 1936.

The three statements represent similar points of view, but

² Maurice Stans, "Accounting Weaknesses which Inhibit Understanding of Free Enterprise," *The Journal of Accountancy*, Vol. LXXXVIII (December 1949), pp. 468-69.

³ Leonard Spacek, "Challenges to Public Accounting," *Harvard Business Review*, Vol. XXXVI (May-June 1958), p. 116.

they characterize three separate periods during which accountants have been especially concerned with the absence of a code of accounting principles. If the number of books and articles in the literature of accounting can be taken as an index of interest in a given subject, concern with the formulation and statement of accounting principles has followed a cyclical pattern. Since 1930 three distinct interest peaks are easily discernible, as well as two clear troughs. The peaks have not been of equal height nor have the troughs been of equal depth. In each case, however, the stimulus for increased interest is apparent, and the two declines of interest came because accountants turned their attention to more pressing matters of the time.

The periods of increased interest have a common thread running through them. The literature in each gives the impression that (1) financial accounting and reporting needs to be improved, (2) too many alternative methods and procedures are being used, (3) some limitation of the number of accepted alternatives is desirable, and (4) at least part of the solution lies in more carefully specifying the "principles of accounting."

The first peak of interest in accounting principles was brief but productive. It began to appear around 1930 and began to blossom in late 1934 or early 1935. It was related to two landmark events in the history of accounting: the publication of the report of the special committee on co-operation with stock exchanges of the American Institute of Accountants (since 1957, the American Institute of Certified Public Accountants)⁴ and the establishment of the Securities and Exchange Commission with authority to prescribe accounting procedures.⁵ The upswing of interest during the late 1930's in the formulation of accounting principles ended rather abruptly with the beginning of World War II. During the war period, accountants became preoccupied with military duties, service in government agencies, or with the account-

⁴ *Audits of Corporate Accounts* (New York: American Institute of Certified Public Accountants, 1934).

⁵ The Securities and Exchange Commission was created by the Securities Exchange Act of 1934. The Securities Act of 1933 was originally administered by the Federal Trade Commission.

ing problems caused by the mobilization program, industrial production for war, and wartime controls.

In spite of its short duration, the period of the first peak in interest produced a volume of literature on the subject of accounting principles which is unmatched by that of any other period and is probably equally unmatched in terms of progress made. During this time the accounting profession and the SEC began their harmonious working relationship. It was also during this period that the American Accounting Association was reorganized.⁶ In keeping with the Association's new objective, "To develop accounting principles and standards, and to seek their endorsement or adoption by business enterprises, public and private accountants, and governmental bodies,"⁷ its Executive Committee published two statements of accounting principles.⁸ Furthermore, a monograph was published by two members of the Executive Committee who, as individuals, undertook to elaborate and expand the basic concepts on which the "Tentative Statement" was based.⁹ Finally, this period was host to the publication of the first more or less comprehensive codification of accepted accounting principles¹⁰ and to the birth of the expanded committee on accounting procedure of the American Institute of Certified Public Accountants which issued eleven Accounting Research Bulletins between September 1939 and September 1941.

Although the period did not produce the solution that accountants sought, i.e., a comprehensive list of "principles

⁶ At the annual convention in 1935 the teachers of accounting changed the name of their association from the more descriptive American Association of University Instructors in Accounting to the more manageable American Accounting Association and opened the membership to anyone interested in accounting.

⁷ "A Statement of Objectives of the American Accounting Association," *op. cit.*, p. 1.

⁸ "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements," *Accounting Review*, Vol. XI (June 1936), pp. 187-91; "Accounting Principles Underlying Corporate Financial Statements," *Accounting Review*, Vol. XVI (June 1941), pp. 133-39.

⁹ W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Ann Arbor, Michigan: American Accounting Association, 1940).

¹⁰ T. H. Sanders, H. R. Hatfield, and U. Moore, *A Statement of Accounting Principles* (New York: American Institute of Certified Public Accountants, 1938).

of accounting," two important results clearly stand out as major contributions to the development of accounting principles: (1) accounting practices did in fact improve over what they had been ten years earlier and (2) the pattern of accounting development for the next twenty-five years was firmly established.

The second cyclical increase in interest in defining and codifying accounting principles began shortly after World War II and was largely a result of some serious criticism leveled at accounting and accountants. Some of this criticism was leveled, probably justifiably, at certain practices which developed during the war, the most notable of which was the use by some companies of profit equalization reserves. Some critics, however, concentrated on the fact that reported income and taxable income were not always the same amount or upon other similar irrelevancies. Criticisms of the latter type were symptomatic, for at the heart of much of the criticism was the basic ignorance of the public about financial statements and business operations in general. As a result of this ignorance, financial statements and the businessmen and accountants who prepared them were widely mistrusted. The matter was worsened by the lack of sophistication demonstrated by a number of commentators on the subject. There was, nevertheless, a beneficial result from this criticism. It led to substantial self-examination by accountants, and this, in turn, produced constructive steps toward the improvement of accounting practices and some improvement in public confidence in the results of accounting.

The second "boom" in interest in accounting principles differed significantly from its predecessor, although the basic problems and questions appeared much the same. The output of books and articles on accounting principles and related subjects was much smaller than that of the period immediately before the war. In addition, the publications which did appear were more concerned with the place of accounting in the postwar world than directly with the formulation of accounting principles *per se*. Consequently, no statement or code of accounting principles resulted from the activities of the period. The second revision of the American Accounting Association statement appeared in 1948, but it was no longer

designated as a statement of principles.¹¹ Seventeen Accounting Research Bulletins (Nos. 26 through 42) were issued by the Institute's committee on accounting procedure between 1946 and 1953; the previously issued bulletins were revised and restated in 1953.¹² None of these, however, constituted the desired code of accounting principles.

The discussions about formulating accounting principles into a generally accepted code stopped as abruptly as it had begun. Although the Korean conflict may have been a factor in the decline of interest in accounting principles, another matter loomed larger in accounting thought. Accountants became concerned with a particular reporting problem, namely, accounting under conditions of changing price levels. They turned their attention almost entirely in that direction.¹³ The new trough in concern with accounting principles was neither as long nor as deep as the one during the war. A small number of articles on accounting principles appeared during the height of the price-level debate, and attention returned to accounting principles within three or four years.

In late 1957 a number of events occurred which returned accountants' attention to the problem of formulating accounting principles. Three of these events should be noted in particular. In August, at the annual convention of the American Accounting Association, Leonard Spacek made a proposal which was revolutionary in the view of most accountants. He suggested that an accounting court be established to hear and decide issues relating to accounting principles.¹⁴ The second significant event was that the newly installed president of the American Institute of CPAs, Alvin R. Jennings, set account-

¹¹ "Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948 Revision," *Accounting Review*, Vol. XXXIII (October 1948), pp. 339-44.

¹² Accounting Research Bulletin No. 43, "Restatement and Revision of Accounting Research Bulletins"; Accounting Terminology Bulletin No. 1, "Review and Resume" (New York: American Institute of Certified Public Accountants, 1953).

¹³ The decrease in the number of articles dealing with accounting principles is so sudden that it immediately strikes anyone working through the literature of the period. This happened about the time the Study Group on Business Income published its report, *Changing Concepts of Business Income* (New York: Macmillan Company, 1952).

¹⁴ Leonard Spacek, "The Need for an Accounting Court," *Accounting Review*, Vol. XXXIII (July 1958), pp. 368-79.

ing research as the keynote of his administration in his acceptance speech at the Institute's annual meeting in October. He called for the establishment of an expanded and independent Institute research program based on the premise that the development of accounting principles was more in the nature of basic rather than applied research.¹⁵ Lastly, the 1957 revision of the American Accounting Association statement, which had been in progress since 1955, was published in December.¹⁶ Although each of these events had developed independently of the others, they supported each other. The result was another burst of activity in the area of accounting principles. Much of the discussion centered on the same issues that had been the focal point of discussion in earlier periods — the need for an “authoritative, comprehensive code of accounting principles.”

The suggestion which really caught the imagination of accountants at this time was Mr. Jennings' proposal for an increased research effort to re-examine the basic assumptions of accounting, to develop authoritative statements to guide accountants, and to aid in improving understanding of financial statements by those who relied upon them. This suggestion, after study by a special committee, led to the Institute's present research program and to the establishment of the Accounting Principles Board.

Where this latest flurry of interest in accounting principles will lead is still uncertain for it has not yet ended and gives no evidence of doing so. The elusive authoritative statement of accounting principles has not yet been formulated. The literature still reflects the thoughts that (1) financial accounting and reporting need to be improved, (2) too many alternative accounting procedures are being used in a number of areas, (3) some limitation of the number of accepted alternatives is desirable, and (4) at least part of the solution lies in the direction of more carefully specifying the “principles of accounting.”

But accounting has neither remained where it was thirty

¹⁵ “Present-Day Challenges in Financial Reporting,” *The Journal of Accountancy*, Vol. CV (January 1958), pp. 28-34.

¹⁶ *Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision and Preceding Statements and Supplements* (Columbus, O.: American Accounting Association, 1957), pp. 1-12.

years ago nor has it come a full circle. A foundation of accounting principles has been laid, certain building blocks have been chosen, and a structure has been built. But the structure has proven inadequate, and the present criticism is directed toward the inadequacy of this structure rather than at the absence of a structure, as was the case in the thirties.

The foundation, the building blocks, and the structure of accounting principles which has been built with them all deserve careful scrutiny.

The Foundation

The most important single event in the early efforts to formulate principles of accounting was the work of the special committee on co-operation with stock exchanges, with George O. May as chairman. This committee laid the foundation on which subsequent work on accounting principles has been based. Most of the structure of accounting principles is dependent in one way or another on the report of this committee.¹⁷ This report consisted of correspondence between the Institute's special committee and the committee on stock list of the New York Stock Exchange. The major recommendations resulting from this correspondence were contained in a letter dated September 22, 1932 from the Institute committee to the Exchange committee.

The basic problem that had attracted the concern of the Stock Exchange was the fact that the listed companies were using a large variety of accounting and reporting methods. The Institute committee felt that the solution to this problem lay in two directions: (1) the education of the public regarding the nature and limitations of accounting reports and (2) the improvement of the published reports themselves to make them more informative to those who used them. The com-

¹⁷ *Audits of Corporate Accounts* (New York: American Institute of Certified Public Accountants, 1934). This booklet has recently been reissued by the AICPA.

mittee proposed to implement the first of these solutions by emphasizing the necessarily conventional and tentative nature of accounting. It thought that the public had to be made aware of the impossibility of formulating accounting principles in the way used to discover principles of the physical sciences. Accounting was, in the committee's view, dependent upon a body of conventions based partly on theory and partly on practice. The necessarily conventional nature of accounting left considerable room for differences of opinion with regard to the application of accounting principles even though they were generally accepted in broad outline. In other words, the committee wished to emphasize that some variety of methods was inevitable because of the nature of the accounting process.

The committee recognized that the problem of improving accounting and reporting practices would be more formidable. It first considered having some competent authority select a detailed set of rules to be made binding upon all listed corporations of a given class. However, the unhappy experiences of the railroads and other regulated utilities, which were generally subject to this type of accounting regulation, convinced the members of the committee that, in the case of industrial corporations, such a solution was impractical and unacceptable.

The heart of the solution finally proposed by the Institute committee and accepted by the Exchange committee was as follows:

The more practical alternative would be to leave every corporation free to choose its own methods of accounting within the very broad limits to which reference has been made, but require disclosure of the methods employed and consistency in their application from year to year. . . .

Within quite wide limits, it is relatively unimportant to the investor which precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year. . . .¹⁸

The key step in the proposed solution was to have been the formulation of a statement of certain broad principles or

¹⁸ *Ibid.*, p. 9.

standards (already generally accepted and probably few in number) which were to be adopted by listed corporations. Within the framework of these broad and accepted standards, each corporation was to be free to choose the detailed accounting methods and procedures which best suited its own needs. Improvement in financial reporting would then have been brought about by a threefold requirement involving desired standards of disclosure and consistency and dependent considerably upon the pressure of public opinion for the elimination of the less desirable practices. First, each listed company would have had to prepare a statement of the methods of accounting and reporting used in its own financial statements. The statement of methods would have been adopted by the board of directors to make it binding upon the company, would have been filed with the Exchange, and would have been made available to any shareholder on request. Second, listed corporations would assure the Stock Exchange that the methods listed in this statement would be consistently followed from year to year and that the Exchange and the shareholders would be informed whenever material changes in the methods or their application occurred. Finally, the audit certificate would be changed to require auditors to inform shareholders whether the methods adopted by the company were in actual use, whether the methods were consonant with the broad, generally accepted standards of accounting, and whether they had been consistently applied.

The Institute committee, in formulating the proposed audit certificate, chose the phrase "accepted principles of accounting." This was the first use of the term. It proved popular and its usage was soon widespread. Although the committee did not specify what it meant by the term, the general tone of the report and the type of "principles" used as examples left no doubt that it had in mind the broad standards (which were few in number) against which the individual company's procedures were to be compared and which, in the committee's opinion, formed the basis of accounting.

The committee suggested that an authoritative statement of the broad accounting principles or standards, which would serve as a guide to individual corporations in making up lists

of their own methods and procedures should be prepared by a small group of interested and qualified persons including accountants, lawyers, and corporate officials. They suggested five principles which would presumably be included. These principles were given as examples, however, and not as the committee's complete statement of "accepted principles of accounting."

In spite of the fact that the committee was the first to use the term "accepted principles of accounting" and the first to attempt a formal statement of accounting principles, its most important contribution was more basic. The fundamental framework of accounting which the committee established has guided the development of accounting for thirty years. The recommendations were not fully implemented, but the basic concept which permitted each corporation to choose those methods and procedures which were most appropriate for its own financial statements within the basic framework of "accepted accounting principles" became the focal point of the development of principles in the United States.

The idea that the phrase "accepted principles of accounting" applied only to listed companies which had specified the methods and procedures used in their accounting and reporting might sound strange to the accountant of today who has seen the term applied to all companies. This was, nevertheless, the clear intent of the committee. George O. May commented on this point shortly before his death:

It must be remembered that the plan called for a fairly full disclosure of the methods of accounting adopted by each listed company. It is often forgotten that this was a part of the program and that the certificate was designed for use only by listed companies which furnished the required details. It is, I think, widely used today in cases in which it is not appropriate because there is no source from which even a general idea of the principles adopted can be gained.¹⁹

George O. May was the guiding spirit of the Institute committee, and its proposals were undoubtedly basically his work. Good reasons for the form which the proposed solution took

¹⁹ George O. May, "Generally Accepted Principles of Accounting," *The Journal of Accountancy*, Vol. CV (January 1959), p. 24.

may be found in his outlook, his background, and his experience.

First of all, Mr. May was firmly convinced that most corporation reporting was generally satisfactory, and that the questionable practices which had attracted the attention of the Stock Exchange and the public involved relatively few companies. Moreover, he had confidence in the honesty of most corporate officials and in the ability, integrity, and judgment of the public accounting profession.²⁰

Mr. May's British background was also clearly reflected in the committee's proposal — the committee's proposal was essentially English practice modified to fit the American situation.

Although the investor in the United States in 1930 had no effective legal protection,²¹ his counterpart in England had long been recognized in English Company Law. The price that joint-stock companies paid under the Companies Acts for the privileges of free transferability of shares and of limited liability of shareholders was not restricted, as in the U.S., to creditor-oriented rules governing the reduction of legal capital. This price in England included publicity. The principle of compulsory disclosure was introduced in the first Companies Act of 1844, and subsequent Acts strengthened disclosure requirements. Companies were required to file copies of the articles of association and provide the government annually with statements of capital, shareholders, and directors. They were required to use "Limited" as part of the company name. And they were required to publish audited balance sheets.²²

²⁰ This philosophy permeates Mr. May's writing. For example, see "Improvement in Financial Accounts," *Dickinson Lectures in Accounting* (Cambridge: Harvard University Press, 1943), especially pp. 15-17, 33-34, 47-48.

²¹ The investor had no recourse to Federal statutes at this time unless the mails had been used to defraud him. State protection was minimal. The most important restriction on corporations found in the state corporation statutes—i.e., restrictions on the reduction of legal capital—was intended primarily for the protection of creditors, not investors. What little legal protection investors had was found in the generally ineffective "Blue Sky" laws of the various states.

²² Brief summaries of the important events in the development of joint-stock companies and the Companies Acts are found in Herbert Heaton, *Economic History of Europe* (Rev. Ed., New York: Harper & Brothers, 1948), pp. 571-78; and in Edward T. McCormick, *Understanding the Securities Act and the S.E.C.* (New York: American Book Company, 1948), pp. 3-9.

The Acts did not, however, spell out the accounting methods and procedures to be used in the preparation of the published balance sheets. Stockholders had the same latitude as partners in the adoption of whatever accounting methods they saw fit for the determination of profit and dividends so long as the rights of creditors were not impaired. Instead of establishing accounting rules, the Acts contained specific requirements regarding disclosure and placed heavy responsibilities on management and auditors for the accuracy of the accounting statements.

The solution for the protection of investors proposed by Mr. May and his committee, and adopted by both the Institute and the Exchange, was a simple and logical extension of the established practice which had proved successful under English Company Law. The essential features derived from British practice were: (1) each company was to choose its own accounting methods, (2) the companies were to disclose clearly the nature of the methods and procedures used, (3) the statements were to be put forth as representations of management, and (4) the public accountant would certify whether the methods used were acceptable, whether they had been consistently followed, and whether the methods used were properly reflected in the statements. In the absence of legal requirements, the success of such a program in the United States depended upon the integrity of corporate officials and the professional competence of public accountants.

The principal deviation from British practice in the proposal was the recommendation that a statement of "accepted accounting principles" be formulated by a qualified group of accountants, lawyers, and corporate officials. The concept of a generally accepted body of principles to serve as a guide to corporate accounting practice and as a standard for public auditors was completely unknown in the United Kingdom. Unmodified British practice would, however, probably have been impractical for the American situation.

The U.S. business and financial community lacked the centralizing tendency which characterized that of the United Kingdom. The size of the British Isles and the class structure of her society contributed to the formation of a closely knit managerial and banking fraternity based on mutual acquaint-

anceship and respect. In the United States, on the other hand, regional rather than national groupings were the rule, and antitrust laws hampered co-operation both within and between industries.

In addition, British practice with respect to corporate accounting was built upon a concept of the corporation not applicable in the U.S. The "private company" was viewed essentially as an extension of the partnership²³—an association of individuals with rights of free transferability of shares of ownership and limited liability and with an obligation to maintain legal capital and to disclose certain information. Hence the proposition followed easily that the owners, through their elected representatives, should be permitted to choose the methods of accounting which regulated interests among themselves, as long as creditors were protected. By 1930, however, corporate development in the U.S. had attained a degree of separation of ownership and management in which the interests of management were generally considered inimical to those of shareholders.²⁴ Adoption of British accounting practice in its pure form was probably politically unfeasible in the United States in the early 1930's.

²³ See George O. May, *Financial Accounting* (New York: Macmillan Company, 1943), p. 52.

²⁴ A. A. Berle, Jr. and Gardner C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, Inc., 1932) is the classic work on the development of the modern business corporation. The opening sentence is significant: "Corporations have ceased to be merely legal devices through which *the private business transactions of individuals* may be carried on." (Emphasis supplied.)

A Change of Architect?

By the mid-1930's the accounting profession, in co-operation with the New York Stock Exchange, had thus laid the foundation for the development of accounting principles. Whether it would be allowed to erect a structure upon that foundation was for a time in doubt. The catastrophic losses suffered in the rapid decline in securities prices beginning in 1929 had touched people in all walks of life. Those who had been financially damaged by the market disaster demanded government protection in the form of control over dealings in corporate securities. The hue and cry eventually resulted in the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934.

The basic intent of the Securities Act as stated in its preamble was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent fraud in the sale thereof."²⁵ The Act applied only to the original issue of securities and was administered at first by the Federal Trade Commission. The Securities Exchange Act²⁶ established the Securities and Exchange Commission and extended the coverage of securi-

²⁵ Public Act. No. 22, Seventy-third Congress (1933), *United States Statutes at Large*, Vol. 48, Part 1, p. 74.

²⁶ Public Act No. 291, Seventy-third Congress (1934), *United States Statutes at Large*, Vol. 48, Part 1, pp. 881-909.

ties legislation to include trading of securities. The provisions of the Acts most affecting the development of accounting principles were those requiring periodic submission of audited balance sheets and income statements by companies registered with the Commission. In addition, the Commission had the authority to prescribe "The items or details to be shown in the balance sheet and earnings statement, and the methods 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. . . ." ²⁷

The purpose of the full disclosure provisions of the Acts was to remedy the situation in which insiders had substantially complete and reasonably accurate pictures of operating results and financial position while outsiders had to be content with incomplete and sometimes erroneous information.²⁸ This was clearly the same goal as that which had been sought by the Institute and the Stock Exchange in their co-operative effort at raising accounting and reporting standards.

Whether or not the co-operative arrangement of the program of the Institute and the Stock Exchange would have been more effective than the mandatory disclosure involved in the Securities Acts became an academic question with the passage of the Acts. In actual practice, the results of the SEC efforts at improving financial statements were not unlike those expected by the special committee on co-operation with stock exchanges. The similarity between the results produced by the statutory requirements and those that probably would have resulted from the voluntary program was at least partly due to the fact that the Commission chose not to exercise its power to prescribe accounting rules. Instead, it sought co-operation from the accounting profession rather than subservience. It endeavored to rely on accepted corporate accounting practice and on the competence of the independent

²⁷ *Securities Act*, Section 19 (a). Similar language is found in the *Securities Exchange Act*, Section 13 (b).

²⁸ Carman Blough, "The Relationship of the Securities and Exchange Commission to the Accountant," *The Journal of Accountancy*, Vol. LXIII (April 1937), p. 193. Mr. Blough was at the time Chief Accountant of the SEC.

accountants. Consultations between the Commission and the Institute were frequent and the actual principles subsequently developed were more the work of the accounting profession than of the Commission. The profession had survived its first major crisis in its endeavors to formulate accounting principles.

Accepted and Rejected Building Blocks

The late 1930's was a period of unparalleled activity in the development of accounting principles. Much of the improvement in financial accounting and reporting that has been associated with the twentieth century took place at that time, and the basis for further improvement was also established. Important issues were highlighted, and battle lines were drawn which have persisted. Developments of the previous decade reached a climax during the period, and accounting achieved new heights of eminence as well as usefulness.

Accounting, as it is practiced today, probably owes more to the decade of the thirties than to any other period after the development of double-entry bookkeeping. During this period both the American Institute of CPAs and the American Accounting Association formalized their respective machinery for the promulgation of accounting principles. The great names of the period—Kohler, Littleton, May, Montgomery, Paton (to name but a few)—stand out not only because of the influence of their individual writings but because of the parts they played during the formative years in the efforts of the two most important accounting associations of the day to formulate accounting principles. The basic form of financial

accounting as a process of cost allocation based on the matching of revenues and expenses crystalized during this period. The concept of accounting principles developed in the late thirties has dominated accounting thinking for more than twenty years. So have the prevailing ideas as to how principles are formulated. During the period accountants considered a number of definitions of "accounting principles" and a number of approaches to their formulation; some were rejected and some became the basis of future development.

Principles: Philosophy or Practice?

One interpretation of what the term "accepted principles of accounting" ought to mean was proposed by Gilbert Byrne in an award winning paper.²⁹ Mr. Byrne took the position that the use of the term "accepted principles of accounting" presumed that such principles in fact existed, and that accountants in general knew what they were. He argued that the failure to agree on what they were came about "in large part because there is no clear distinction, in the minds of many, between that body of fundamental truths underlying the philosophy of accounts which are properly thought of as *principles*, and the larger body of accounting rules, practices and conventions which derive from principles, but which are not of themselves principles."³⁰ The definition which most nearly conformed to the concept Mr. Byrne had in mind was the one he found in *Webster's New International Dictionary*:

A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which others are founded; a general truth; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate.

Mr. Byrne's paper drew an immediate comment from

²⁹ "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" *The Journal of Accountancy*, Vol. LXIV (November 1937), pp. 364-79. This essay won the first prize in the contest for the best answer to the question chosen for the title as a part of the fiftieth anniversary celebration of the Institute in October 1937. Mr. Byrne was associated with the firm of Lybrand, Ross Brothers and Montgomery.

³⁰ *Ibid.*, p. 368. Italics in the original.

George O. May.³¹ Mr. May remembered the discussion and searching of dictionaries in the committee "before the perhaps rather magniloquent word 'principle' was adopted in preference to the humbler 'rule.'"³² The committee, according to Mr. May, had relied on the *Oxford Dictionary* for the expression of the concept it wished to adopt:

A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice.

An alternative definition in the same dictionary which was similar to Mr. Byrne's definition had been rejected by the committee.

Mr. May's definition of "principles of accounting" was the one which was adopted by the profession and the one on which auditors' certificates have in fact been based. It was incorporated word for word in the pronouncements of the Institute.³³

Terminology: Defined or Undefined?

One important weakness of the formative period of the late thirties was the failure to develop a precise terminology. Few of the writings of the period were concerned with accounting terminology. There was a tendency (which unfortunately has persisted) for each writer or group to use terms as he saw fit; sometimes the usage was explained, and sometimes it was taken for granted that it would be understood. Such terms as principle, rule, convention, procedure, method, etc., were sometimes used interchangeably and sometimes to express entirely different concepts. This imprecise and inconsistent usage undoubtedly hampered the development of accounting principles. The period was not entirely devoid of work on terminology, of course, but these efforts received little attention.

The major terminological work of the immediate prewar

³¹ George O. May, "Principles of Accounting," *The Journal of Accountancy*, Vol. LXIV (December 1937), pp. 423-25.

³² *Ibid.*, p. 423.

³³ Accounting Research Bulletin No. 7, "Reports of Committee on Terminology" (New York: American Institute of Certified Public Accountants, 1940), p. 60.

period was largely ignored. It appeared in five chapters of a book published in 1939 by Stephen Gilman.⁸⁴ Mr. Gilman used great care and went to great lengths to define and differentiate the terms and related concepts of principles, conventions, rules, doctrines, precepts, procedures, practices and methods. For better or worse, he relied, as had Messrs. Byrne and May, on dictionary definitions to describe his terms and concepts.

Mr. Gilman found that four terms—convention, rule, doctrine, and principle—were used almost interchangeably in accounting practice. Thus he set out to define the terms in such a way as to make them mutually exclusive and then to classify the concepts which had been masquerading as “principles” according to these four classifications.

Mr. Gilman defined *convention* as follows (all of his definitions were taken from *Webster's New International Dictionary*):

A rule or usage based upon general agreement; a rule or practice generally adhered to; an arbitrary or inflexible rule, form, principle, etc., as in an art; a conventionalism.

He recognized that there were numerous accounting conventions and gave illustrations of three to indicate what he had in mind: the entity convention, the valuation convention, and the period convention. In his vocabulary, conventions were “the foundations upon which the superstructure of accounting doctrine, principle, and rule is raised.”⁸⁵ In other words, conventions were the basic assumptions underlying accounting theory.

Mr. Gilman found four *doctrines* — i.e., those accounting practices that were taught or held forth as articles of faith of

⁸⁴ Stephen Gilman, *Accounting Concepts of Profit* (New York: The Ronald Press Company, 1939), Chapters 12 through 16. Mr. Gilman's book was the most ambitious of the period. He undertook to combine in a single place all significant work on accounting of the previous decade. Much of the book was dedicated to emphasizing the increased importance of the income statement over the balance sheet, the nature of income determination problems caused by the accounting period convention, and to specialized income determination problems resulting from the valuation of inventories and the accounting for fixed assets.

⁸⁵ *Ibid.*, p. 245.

accounting. These dogmatically propounded concepts were conservatism, consistency, disclosure, and materiality, and should be considered as doctrines of reporting rather than as doctrines of accounting. Mr. Gilman's implication was that these doctrines constituted what might be called "reporting policy," in the sense that "The Monroe Doctrine" is a statement of foreign policy.

Of all the terms discussed, *rule* was, in Mr. Gilman's opinion, the one most properly used in existing practice:

A prescribed guide for conduct or action; a governing direction; as, the *rules* governing a school; a *rule* of etiquette or propriety; the *rules* of cricket.

No enumeration of rules of accounting appeared in the book, but by segregating the principles, doctrines, and conventions, Mr. Gilman implied that everything else belonged in the category of rules.

Mr. Gilman's definition of *principle* was the same as Mr. Byrne's (both used the same dictionary):

A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which others are founded; a general truth; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate.

In addition Mr. Gilman applied three tests to determine whether or not a given proposition qualified as a principle: (1) a principle must not be subject to modification by law, legal decisions, or rulings of government bodies, (2) a principle must not vary between industries, and (3) a principle must not be changed by the form of proprietorship. Not surprisingly, Mr. Gilman found no principles of accounting.

Mr. Gilman, in fact, thought that the term "principles" had already been overworked, and that this had resulted in much wasted effort on the part of accountants quarreling over its meaning. He proposed to substitute other terms in its place, namely rules, doctrines, and conventions. He was also sympathetic to Mr. Littleton's proposal³⁶ to substitute the

³⁶ "High Standards for Accounting," *The Journal of Accountancy*, Vol. LXVI (August 1938), pp. 99-100.

word “standard” for the more inflexible “principle” in those instances in which the term was required.

Whether or not acceptance of Mr. Gilman’s proposals would have led to more progress in the formulation of accounting “principles” than actually resulted is a moot question. Perhaps dictionary searching is a fruitless pastime as far as real development in accounting is concerned. Mr. Gilman’s terminological work had, however, at least two characteristics which were missing from the structure of accounting principles that eventually developed, the absence of which weakened the structure. First, Mr. Gilman expected accounting usage of terms to conform to general usage. This usage avoids the weakness inherent in accountants’ use of a generally understood term in a specific, technical, and often obscure sense, a sense almost always misunderstood by non-accountants. Mr. May’s (and the Institute’s) use of “principle,” as well as numerous other accounting terms, are subject to this criticism. Accountants have recognized this limitation in such cases as “reserve” and “surplus” but not in the case of “principle.” Second, and perhaps more important, Mr. Gilman’s proposed usage, although perhaps not the most useful (e.g., his use of the word “convention”), had the advantage of being precise. The rejection of precise terminology as a building stone of the structure of accounting principles hindered the entire effort.³⁷

Approach: Logic or Experience?

Another possible building block which did not form a part of the structure of accounting principles actually built was the use of formal, logical methods. Such recognized

³⁷ Accountants’ interest in precise terminology did not noticeably increase during the next twenty-two years. One section of Accounting Research Study No. 1, “The Basic Postulates of Accounting,” by Maurice Moonitz (New York: American Institute of Certified Public Accountants, 1961) drawing significant criticism was the author’s attempt to tighten up the terminology with regard to one of the most imprecise terms in the accountant’s vocabulary—“income.” See “A Summary of Comments on ‘The Basic Postulates of Accounting,’” *The Journal of Accountancy*, Vol. CXV (January 1963), pp. 52-54.

authorities as Messrs. Sprague,³⁸ Scott,³⁹ and Littleton⁴⁰ had long supported the view that accounting was more than “distillation of practice” and was subject to rigorous analysis. Mr. Sprague emphasized that accounting was a “branch of mathematical and classificatory science . . . [the principles of which might] be determined by *a priori* reasoning.”⁴¹ Mr. Scott saw accounting, not merely as a management tool, but as the primary adjuster of conflicts in economic interests, replacing the market in this function as the latter declined in importance as a regulator of economic affairs. He related accounting to statistics and classified the combination as a social science and held that “present promise for advancement in the social sciences lies in an application to social phenomena of the viewpoint or philosophy which underlies scientific work in the physical and biological sciences,”⁴² i.e., the habit of thinking in objective terms. Mr. Littleton proposed the use of deductive reasoning (the syllogism) to test principles inductively derived from accounting practice.⁴³

In spite of this eminent sponsorship, the use of formal logic did not play a significant part in the formulation of accounting principles. Accounting development has been essentially practice-oriented. The phrase “logically follows” which appears often in the literature to support some point of view is usually not used in its formal sense. Accounting is described as an art,⁴⁴ and accounting principles are referred to as “generally accepted” rather than as “logically consistent.”

³⁸ Charles Ezra Sprague, *The Philosophy of Accounts* (New York: The Ronald Press Company, 1913).

³⁹ DR Scott, *The Cultural Significance of Accounts* (New York: Henry Holt and Company, 1931).

⁴⁰ A. C. Littleton, “Tests for Principles,” *Accounting Review*, Vol. XIII (March 1938), pp. 16-24.

⁴¹ Sprague, *op. cit.*, p. iii.

⁴² Scott, *op. cit.*, p. 32-33. See also pp. 218, 261.

⁴³ Mr. Littleton also worked with inductive reasoning: “Inductive Reasoning in Accounting,” *New York Certified Public Accountant*, Vol. XX (August and November 1950), pp. 449-55, 460, and pp. 641-51. Both the 1938 work and the 1950 work were combined in *Structure of Accounting Theory* (Menasha, Wis.: American Accounting Association, 1953).

⁴⁴ “Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and the results thereof,” *Accounting Research Bulletin No. 7*, *op. cit.*, p. 58.

Sand in the Foundation?

Only some of the recommendations of the special committee on co-operation with stock exchanges became part of the effort to find and formulate accounting principles. Several of the key proposals were, in fact, cast by the wayside as the development proceeded. An early casualty was "accepted principles of accounting," which was replaced by "generally accepted accounting principles," but why the "generally" was added is not known.⁴⁵ In addition, only the second of the special committee's three basic recommendations became part of the framework of accounting. A few companies prepared lists of the accounting methods they followed in the preparation of reports to shareholders and filed them with the New York Stock Exchange, but there is little evidence that they were made available to shareholders generally. Nonaccountants were not invited to participate in the formulation of a statement of accounting principles; in fact, the Institute attempted no such formulation because the committee on accounting procedure early decided against such an approach in favor of a problem-by-problem treatment of accounting principles. Practically, all that remained of the special committee's program was that individual companies should be left relatively free to choose accounting methods thought appropriate for each case by their respective managements. The independent auditor judged whether the practices used had the authoritative support necessary to make them "generally accepted."

In the absence of the limits that would have been imposed by the preparation of a list of broad, accepted accounting principles and the requirement that companies disclose their accounting methods, the impact of the special committee's recommendation was quite different from the result which might have been anticipated if the full program of the com-

⁴⁵ Although the Institute's own publication, *Examination of Financial Statements by Independent Public Accountants*, published in January 1936, retained the earlier phrase in its model audit certificate (p. 41), the chief accountant of the SEC stated at the AAA convention in December of that year that "The term 'generally accepted accounting principles' has been widely used in accounting literature, particularly by the American Institute of Accountants and the Securities and Exchange Commission . . ." Carman G. Blough, "The Need for Accounting Principles," *Accounting Review*, Vol. XII (March 1937), p. 31.

mittee had been adopted. The second recommendation therefore became a program in itself instead of a part of a more extensive program with built-in safeguards. The only safeguard in what actually developed was the judgment of the independent accountant in each individual case. Inasmuch as no statement of accepted principles existed on which he could rely, the independent accountant was placed in a difficult, if not intolerable, position. The failure to adopt the limitations recommended by the special committee to accompany the freedom given management in the choice of accounting methods sowed the seeds of the subsequent proliferation of accepted methods.

The reasons for the adoption of only a part of the recommended program have remained obscure. Perhaps Mr. May himself had changed his mind between 1934 and 1939—between the report of the special committee and the issuance of Accounting Research Bulletin No. 1. The definition of “accounting principles” given by him in 1937⁴⁶ (adopted in Accounting Research Bulletin No. 7 by the committee on terminology of which he was chairman) differed from the concept implied by the report of the special committee. It tended more toward the identification of principle with rule or procedure than did the 1934 report which implied the idea that principles were broad standards rather than specific rules or methods. There is, however, no evidence that he changed his mind about the need for disclosure of the methods used by companies and about who should formulate accounting principles. In 1958 he expressed his disappointment that the proposal for disclosure of accounting methods by individual companies had not been implemented.⁴⁷ During the late 1940’s, Mr. May became the guiding spirit of the Study Group on Business Income. This group was formed following the prescription of the 1934 special committee, i.e., a group of accountants, lawyers, economists, corporate officials, and others were brought together to study a basic accounting problem.

There are a number of possible explanations for the turn of

⁴⁶ George O. May, “Principles of Accounting,” *op. cit.*, p. 423.

⁴⁷ George O. May, “Generally Accepted Principles of Accounting,” *op. cit.*, p. 24.

events described above. Perhaps Mr. May did change his mind. There is considerable evidence that he saw the problem-by-problem approach as a method which would lead later to a more integrated approach. He approved the Institute's change of emphasis from the piecemeal method to the integrated method in 1959. Perhaps he was overruled by members of the committee on accounting procedure or by officials of the Institute. Perhaps the establishment of the SEC with its emphasis on disclosure had changed the situation. At any rate, the fact that the program proposed by the special committee on co-operation with stock exchanges (George O. May, chairman) was essentially eviscerated by the committee on accounting procedure (George O. May, the active head)⁴⁸ remains one of the intriguing puzzles of the period.

The First Block is Placed

Thus the work of the special committee, while forming the foundation for the structure of accounting principles, did not contribute substantially to the form of the structure itself. The work of Messrs. Sanders, Hatfield, and Moore under the sponsorship of the Haskins and Sells Foundation⁴⁹ was more in keeping with the form of later developments. The authors, all prominent educators, were requested by the Foundation to form a committee to undertake "to formulate a code of accounting principles which would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public."⁵⁰ In carrying out its commission, the group traveled widely and interviewed interested persons from several groups preparing or using accounting data. In addition, they reviewed the literature of accounting,

⁴⁸ Mr. May was vice chairman of the committee on accounting procedure of the Institute during the years immediately following its expansion and its designation as the committee with authority to issue pronouncements on accounting principles. The president of the Institute was the chairman, but as this office rotated to a new man every year or two, Mr. May was the dominant influence in the committee.

⁴⁹ Sanders, Hatfield, and Moore, *op. cit.*

⁵⁰ *Ibid.*, p. xiii. This is an excerpt from the letter of invitation to the three professors. Sanders and Hatfield were professors of accounting, Moore a professor of law.

the statutes and court decisions referring to accounting, and numerous current corporation reports.

The statement of principles resulting from this effort was largely a set of generalizations derived from accounting practice. The authors tied principles firmly to the uses to which accounting data were put, tempered, of course, by such factors as statutory provisions and legal considerations,⁵¹ the necessarily conventional nature of accounting, and the fact that accountants did not pass judgment on the companies they reviewed but only on the way the companies reported about themselves. Experience formed the basis for principles:

The answer must be based upon experience . . . illuminated by criticism. A statement of generally followed accounting practices expresses that experience in detail. Reflection upon the whole body of that experience is the basis of criticism. The principles of accounting are, therefore, the more general propositions describing the procedure which should be followed in the making of records and the preparation of financial statements. . . .⁵²

The authors apparently interpreted their mission as one of reporting on the weight of opinion and authority. At least their emphasis was on codification of accounting practice rather than on re-examination of individual practices. The result was largely uncritical acceptance of existing methods. The committee took the position that it was the duty of management to decide what information should be given in the financial statements and how it was to be shown. The role of the accountant was restricted to indicating whether appropriate disclosure had been made. In other words, the judgment of "sound business management" determined appropriate accounting principles.

The report was severely criticized,⁵³ especially for the attitudes described in the preceding paragraphs. The general

⁵¹ The influence of legal considerations on the conclusions of the study was indicated not only by the presence of a lawyer on the committee but also by the large number of case citations found throughout the report.

⁵² Sanders, Hatfield, and Moore, *op. cit.*, p. 5.

⁵³ See four articles entitled, "Comments on 'A Statement of Accounting Principles,'" *The Journal of Accountancy*, Vol. LXV (1938) by W. A. Paton, pp. 196-207; Wyman P. Fiske, pp. 308-16; James L. Dohr, pp. 316-18; and Andrew Barr, pp. 318-23.

approach taken led the authors to condone certain extremely questionable practices. The report contained statements to the effect that (1) impairments of net worth in the form of catastrophic losses might be listed on the asset side,⁵⁴ (2) deficits of new companies might be shown as assets,⁵⁵ (3) capital losses might be carried as deferred charges if charging them against the income of a single period would distort profit,⁵⁶ etc.

In spite of the fact that the authors frowned on such practices, their failure to condemn these and other equally dubious practices constituted a serious defect in the report. The failure of the report to exert aggressive leadership in the improvement of accounting practices was, of course, inherent in the position taken with respect to the accountant's relation to management. The report was also therefore justly criticized because it gave the impression throughout that whatever management wished to do with its accounting was acceptable as long as it was legal. At a time when investors and governmental agencies, as well as management, were beginning to recognize and understand the concept of accountants' independence, the committee threw the yoke of management domination onto the accountants' necks once more.

The report seems to have had little direct impact at the time; perhaps the criticisms leveled at it were partly responsible for this result. The recognition of the independence of accountants steadily increased; the questionable methods condoned in the report have long since vanished entirely from accepted accounting practice. Although a subcommittee of the committee on accounting procedure of the Institute recommended that the report be revised and reissued,⁵⁷ such a revision was never made. The report was allowed to remain out of print for many years and has only recently (1959) been reissued by the American Accounting Association as part of its project to make available items of historical interest.

After twenty-five years, the report may be seen for what it

⁵⁴ Sanders, Hatfield, and Moore, *op cit.*, p. 57.

⁵⁵ *Ibid.*, p. 41-42.

⁵⁶ *Ibid.*, pp. 76-78.

⁵⁷ "Report of the Subcommittee Appointed to Study 'A Statement of Accounting Principles,' by T. H. Sanders, H. R. Hatfield, and U. Moore," *The Journal of Accountancy*, Vol. LXXI (January 1941), pp. 58-62.

was: the first relatively complete statement of accounting principles and the only complete statement reflecting the school of thought that accounting principles are found in what accountants do — the school which emphasizes the *accepted* part of “generally accepted accounting principles.” In the sense that the report was meant to codify as principles those methods and procedures then currently in use, it was almost completely successful; it was in fact a “distillation of practice.” Because some critics of the report failed to recognize this objective, much of the criticism of the work was irrelevant. The committee undoubtedly performed a distinct service to those interested in accounting by cataloging the accounting methods then in use, and a similar feat would prove invaluable today. This work was the first major building block in the structure of accounting principles, and it determined the form which this structure was to assume to a significant extent.

New Problems in Old Dress

The second “boom” in interest in accounting principles was different from the first. Naturally, many of the discussions from the late thirties carried over into the late forties as accountants were released from the distractions of war. But the problems of the thirties had been largely solved. Most of the poorest practices had been eradicated, and although a new crop crept into accounting during the war, they were mostly short-lived. The accountant in the immediate postwar period was not faced with an array of bad practice, and he did not yet fully recognize the problem that was to plague him in the near future — i.e., a superabundance of accepted alternative practices. The leaders of the profession were concerned with broader issues than they had been before the war, and if the contributions of the period toward the development of accounting principles were less spectacular than those of the earlier period, that which occurred was scarcely less important in its impact on the development of accounting.

The period began on the sour note of extreme criticism of accountants and accounting by nonaccountants. Critics of all descriptions — informed and ignorant, responsible and otherwise — turned their attention to financial reporting. Accountants were taken to task for failure to develop uniform accounting principles, for failure to conform accounting more closely to income tax rules, for aiding management in obscur-

ing the truth. The ghost of McKesson & Robbins was occasionally brought forth to haunt them.

The cruelest blow of all, however, was the results of a survey carried out for the Controllershship Foundation⁵⁸ which disclosed that the public's general reaction toward financial statements was misunderstanding and distrust based predominantly on almost complete ignorance. More than one-half of those interviewed who had an opinion on the subject thought that companies lied about the amount of profits they made and that reports were deliberately made difficult to read. The belief was widespread that business was making too much profit — estimates varied from 10 to 30 per cent of sales — often wrung from exploited workers. Only about one-third of those interviewed, however, had actually seen a profit-and-loss statement. Clearly, financial statements themselves constituted an unimportant source of information about business as far as the public was concerned, but the data they contained were widely disseminated, probably mostly by rumor and hearsay, in a highly distorted fashion.

Accountants tended to look upon these comments and criticisms as reflections upon their personal integrity and competence. Yet it was not really the procedures of accounting which were under fire as had been the case before the war. The criticisms were leveled primarily at corporate reporting rather than at accounting itself.

Accountants undoubtedly deserved some of the criticisms leveled at annual reports. There were no generally accepted standards of minimum disclosure.⁵⁹ Some statements were either completely missing or so condensed that information was actually concealed rather than disclosed.⁶⁰ In spite of the public relations men, who often had more to do with the form and content of annual reports (except for the financial statements themselves) than accountants, reports were often

⁵⁸ *The Public's Acceptance of the Facts and Figures of Business Accounting* (New York: Controllershship Foundation, 1947). The results were briefly summarized and analyzed by the staff of the *Journal of Accountancy*, "What the Public Thinks About Financial Statements," Vol. LXXXIII (June 1947), pp. 487-89.

⁵⁹ Editorial, "The Need for Agreement on Basic Accounting Procedures," *The Journal of Accountancy*, Vol. LXXXIII (June 1947), p. 455.

⁶⁰ William Werntz, "Recent Developments in Accounting," *Accounting Review*, Vol. XXII (April 1947), pp. 137-38.

couched in the technical jargon of the profession making them all but unintelligible to those for whom they were intended. But the criticism was even broader.

The primary targets of the critics were management and public relations. The fact that much of the public thought that profits were two to ten times what they actually were was sufficient indication that companies had failed to do the job of explaining profits to the public. And this failing contributed to a more serious problem from the standpoint of the companies themselves.

The Broad Picture

In the immediate postwar period, the business community as a whole was greatly concerned that the people of the United States were in the process of abandoning the American system of "competitive enterprise" or "free enterprise" in favor of increased government participation in business affairs. This apprehension resulted from a number of factors such as the observed tendency in the years shortly preceding the war of the U. S. Government to inject itself into areas relating to business from which it had previously refrained, the obvious relish with which some bureaucrats had enforced government controls of business during the war, and the unrest among organized labor immediately following the war (sometimes coupled with unrealistic demands for increased wages). The most potent factor in this concern, however, was probably the immediate postwar experience in Great Britain—the country with which the citizens of the United States have historically identified themselves commercially. The accession to power of the socialist Labor Government with the subsequent nationalization of significant sectors of British industry was enough to disquiet the American businessman.

The U. S. public, including union members and shareholders, was to a large extent ignorant regarding economic and business matters. Management, aided by public relations, had not succeeded in explaining free enterprise to the workers, perhaps for the very reason that they spent their time and effort extolling the virtues of "free private enterprise" and harping on the dangers of "collectivism," "controlled economies," "government interference," etc., instead of explaining

what they were talking about.⁶¹ Quite likely, more could have been accomplished by providing information of immediate interest to workers—information that affected not only their pocketbooks but their feelings toward management. Paradoxically, these were also the matters which management knew most about, i.e., wages and profits, but they became so involved in the theory of free enterprise that they failed to explain profits—their source, their necessity, their relation to productivity and to the economies of capacity output, their residual nature, etc.⁶² Clearly, management had a story to tell, but they did not tell it effectively, probably partly at least because they chose to ignore accounting information in favor of more abstract concepts.

In spite of the fact that accountants were extremely self-conscious about the criticisms, their reaction was, on the whole, sensible. There was no wholesale condemnation of the critics, nor did most accountants try to make excuses. For the most part, they recognized that there were many unsolved problems in financial accounting and reporting. Editorials in *The Journal of Accountancy* reflected the attitude of self-appraisal that the profession adopted:

Uniform accounting, in the sense of detailed prescriptions, would be . . . a tragedy of the first magnitude. But accounting as the language in which the results of business operations are interpreted cannot be spoken in a multitude of dialects if it is to serve society well.⁶³

. . . there is a great deal of unnecessary variation in financial reporting. . . .

The main point, however, is that instead of lamenting the lack of uniformity and comparability in financial statements, it might be worth while to try to eliminate as much of the variation as could reasonably be expected to disappear under persuasion or agreement. Complete uniformity may not now be attainable, but unnecessary and inconsequential

⁶¹ See, for example, *The American Competitive Enterprise System* (Washington, D.C.: Chamber of Commerce of the United States, 1946) or *The Drive for a Controlled Economy via Pale Pink Pills* (Washington, D.C.: Chamber of Commerce of the United States, 1949).

⁶² This point was well expressed by Harold Fleming, "Facts on Earnings Better than Theory," *Christian Science Monitor*, Vol. XXXIX, No. 136 (May 6, 1947), p. 10. Mr. Fleming wrote a number of columns on accounting and financial reporting for the *Monitor* about this time. All of them must be classified as informed and responsible criticism.

⁶³ "The Need for Agreement on Basic Accounting Procedures," *The Journal of Accountancy*, Vol. LXXXIII (June 1947), p. 456.

differences should be pruned forthwith. The public would surely applaud the effort.⁶⁴

Many accountants were, in spite of the progress that had been made since before the war, still unsatisfied with the way accounting had performed, and a surprising amount of the discussion turned on the question of whether accounting was doing an effective job of explaining "free enterprise."⁶⁵

Accountants, as well as others in the business community, were worried about the increasing clamor from certain sectors of the public, often based on varying degrees of ignorance, for basic changes in the American enterprise system. Many accounting writers of the period recognized that the accounting profession, by virtue of the fact that accounting was the most important medium of expression of economic facts, was in a unique position to take the lead in dispelling the ignorance surrounding the operations of business under the private enterprise system. There was almost unanimity of opinion among these writers that accountants were not fully exploiting this opportunity and that serious consequences, both to the system and to the accounting profession, might result from continued inaction.

In general, the accountants who commented on the problem of informing the American public on the nature of free enterprise during this period divided into two groups. One group saw the major problem as the tendency of certain accepted accounting concepts and procedures to overstate the profits of American business, thereby contributing to the widespread fallacy that business was, as a rule, making too much

⁶⁴ "Uniformity and Comparability in Financial Statements," *The Journal of Accountancy*, Vol. XC (July 1950), pp. 1-2.

⁶⁵ An indication of the extent to which accountants were concerned with this problem can be obtained by thumbing through *The Journal of Accountancy* for the 1946-1950 period and noting the number of articles with the words "private enterprise," "freedom," "competition," etc. as part of the title. Some of the most important were: E. B. Wilcox, "The Role of Accountancy in Prosperity and Peace," Vol. LXXXIV (October 1947), pp. 274-81; George D. Bailey, "Institute's New President Sees Freedom as Accountancy's Goal," Vol. LXXXIV (December 1947), pp. 451-52; W. A. Paton, "The Accountant and Private Enterprise," Vol. LXXXV (January 1948), pp. 44-58; W. A. Paton, "Accounting Procedures and Private Enterprise," Vol. LXXXV (April 1948), pp. 278-91; Maurice H. Stans, "How New Standards of Financial Reporting Grow from Social Responsibility of Accountants," Vol. LXXXVI (August 1948), pp. 98-106; Maurice H. Stans, "Weaknesses in Present Accounting which Inhibit Understanding of Free Enterprise," Vol. LXXXVIII (December 1949), pp. 466-71.

profit. Another group emphasized the narrowness of the approach of accountants—they feared that independent accountants were, at best, investor-oriented and, at worst, client-oriented—and held that this narrow point of view, coupled with the absence of an accepted code of accounting principles, restricted the usefulness of accounting in explaining the profit system.

The first group specifically singled out the so-called “cost principle,” and conservatism for condemnation.⁶⁶ Adherence to cost when prices changed and overemphasis on conservatism, with its inherent omission or premature amortization of asset values, both resulted in general understatement of asset values and overstatement of profit figures with the natural consequence of overstated rates of return on sales and greatly inflated rates of return on assets. Implicit in this argument were the recommendations that conservatism be rejected as “the most objectionable and obstructive tradition of accounting,”⁶⁷ and that cost should be abandoned in favor of current values when it was completely out of line with them. This aspect of the reporting problem developed into a full-scale controversy among those interested in accounting which has raged and waned and raged again without yet producing a generally accepted definitive solution to the problems of changing prices and changing price levels.

The second group emphasized the social responsibility of accountants. Their recommendations went in three interrelated directions: (1) the expansion of the accounting service to meet the needs of employees, consumers, and the general public more fully, as well as those of investors, management, and creditors, (2) the sharpening of the concept of independence to make the accountant the protector of the public interest rather than merely of the investor’s interest, and (3) the improvement of the understandability and comparability of financial statements by decreasing the discretionary differences in handling similar items through agreement on a statement of accounting principles.

In the end, interest in the narrower problem dominated in-

⁶⁶ See for example, W. A. Paton, “Accounting Procedures and Private Enterprise,” *The Journal of Accountancy*, Vol. LXXXV (April 1948), pp. 278-91, for a good statement of this position.

⁶⁷ *Ibid.*, p. 279.

terest in the broader, and the literature on the price-level problem constitutes the most obvious result of the discussions of the second period of increased interest in accounting principles. In spite of the call to "the sacrifice by accountants and businessmen of some of their reluctance toward standardization, for the sake of the common good,"⁶⁸ no authoritative, comprehensive code of accounting principles was forthcoming. From the standpoint of the development of accounting principles, the immediate postwar period was one of gradually changing attitudes rather than one of great leaps forward in identifying and codifying accounting principles.

Uniformity, Flexibility, and Comparability

One significant change in attitude took place almost imperceptibly. The arguments for a code of accounting principles changed between the first and second "boom" in interest in statements of accounting principles. This change was not one that can be pinpointed to specific articles or even to a specific brief period (rather, a reader proceeding through the literature becomes increasingly conscious of it), but by the mid-fifties accountants were talking about *comparability* of accounting *statements* rather than *uniformity* of accounting *principles*. The writers of the thirties had been vague about why "uniformity" of accounting principles was desirable and were often wont to defend or condemn uniformity *per se*. In the postwar period, accountants were quite specific in identifying comparability of statements as the major factor requiring standardized principles, terminology, methods, etc. This was, of course, another manifestation of the increased concern that many accountants were showing for so-called "outsiders," not only shareholders, but prospective investors, employees, customers, and the public itself. A more recent manifestation has been the insistence that accounting statements must be "fair" to all parties.⁶⁹

⁶⁸ Maurice H. Stans, "Weaknesses in Present Accounting Which Inhibit Understanding of Free Enterprise," *The Journal of Accountancy*, Vol. LXXXVIII (December 1949), p. 470.

⁶⁹ See for example, *The Postulate of Accounting—What It Is, How It Is Determined, How It Should Be Used* (Chicago: Arthur Andersen & Co., 1960).

The Structure Rises

The foundation for the development of accounting principles had been laid by the special committee on co-operation with stock exchanges in 1932. By the late 1950's, a structure of accounting principles of discernible shape had appeared. This structure was to a large extent a product of the events of the intervening period, the most important of which have been described in the three preceding sections.

The documents which might qualify as statements of accounting principles produced in the United States during the twenty-five years following the report of the special committee on co-operation with stock exchanges have been principally the work of two bodies of professional accountants. Comprehensive work on principles by individuals or small private groups has been the exception rather than the rule. Three prominent exceptions, of course, were the statements of principles prepared by Sanders, Hatfield, and Moore;⁷⁰ by Gilman;⁷¹ and by Littleton.⁷² None of the three was particularly well-received at the time of publication, and only the Sanders,

⁷⁰ Sanders, Hatfield, and Moore, *op. cit.*

⁷¹ Stephen Gilman, *op. cit.*

⁷² A. C. Littleton, *Structure of Accounting Theory* (Menasha, Wis.: American Accounting Association, 1953). Parts of this work had appeared in article form as early as 1938; other sections had also appeared as articles.

Hatfield, and Moore work has had much impact on the development of accounting. The credit or blame, as the case may be, for the structure of accounting principles which has developed must fall on the American Institute of Accountants (now the American Institute of Certified Public Accountants) and the American Accounting Association.

The Institute and the Association

During the twenty-year period, 1939-1959, the committee on accounting procedure of the AICPA issued fifty-one Accounting Research Bulletins on a variety of subjects, including ARB No. 43 which was a revision and restatement of the previous forty-two bulletins.

Between 1936 and 1957, the Association, first through the efforts of its Executive Committee and later through the work of the Committee on Accounting Concepts and Standards, published four statements on accounting principles with important matters elaborated upon in eight supplementary statements.

The pronouncements by the accounting societies have been extensively commented upon, explained, and analyzed. Much of this commentary and criticism has made valuable contributions to the literature by summarizing the positions of the two associations and by highlighting their points of similarity and difference with respect to recommendations in specific areas of accounting and reporting. The general nature of the recommendations made by each group is widely understood by all but the novice in accounting, and such differences in position as the clean-surplus or all-inclusive income position of the Association's committees as contrasted with the current-operating income concept of the Institute's committee have been well publicized.⁷³

More important, however, than similarities and differences in specific recommendations were the similarities and differ-

⁷³ This difference disappeared when the current-operating concept appeared in the 1957 Revision of "Accounting and Reporting Standards for Corporate Financial Statements," *Accounting Review*, Vol. XXXII (October 1957), pp. 536-46.

ences in the philosophies underlying the two programs and in the basic concepts and methods of approach chosen to carry them out. In fact, concern with the detail of the recommendations has tended to obscure the extent to which the work of the Institute and of the Association had important similarities which, on the whole, probably outweighed the difference on specific points.

Three basic similarities in the programs of the two associations stand out: (1) the two societies had exactly the same objective, i.e., the improvement of financial accounting and reporting practice by reducing the number of acceptable alternative procedures, (2) both saw financial accounting as essentially a process of cost and revenue allocation rather than as a process of asset and liability valuation, and (3) both looked upon accounting principles as being derived from accounting practice. These similarities provided a common ground for discussion and a basis for co-operation between the two groups that contributed to mutual progress. Furthermore, accounting as taught in colleges and universities has not been totally different from accounting as practiced in the business world.

Yet in spite of the fact that there was substantial agreement on basic matters between the two societies, important differences developed. Basic agreement involving the goal to be achieved did not result in agreement regarding the method of reaching it. Acceptance of matching as the basis of income determination did not result in a single theory for its application. Joint recognition that accounting principles were to be derived from practice did not result in agreement as to what the term "principles" meant or who was to be responsible for their derivation. In short, the two societies started at essentially the same place, traveled quite different routes because of their points of view and the backgrounds and personalities of the men who guided their efforts, but arrived substantially at the same destination at about the same time.

The Executive Committee of the American Accounting Association believed that improvement in accounting and reporting practices could best be achieved by strengthening the over-all framework which supported accounting practice. The Association's research program was initiated as an attempt to formulate and obtain general acceptance for a group of inter-

related, consistent, and comprehensive principles of accounting. These principles were not to be descriptions of procedures but standards against which procedures might be judged. Such principles might often be in conflict with existing practice but hopefully would set a level toward which practice could be raised. The methodology of the program was to start with a group of principles which *might* be adopted as fundamental to sound accounting and to continuously rework, revise, and improve them.⁷⁴ The first step, therefore, was the preparation and publication of "A Tentative Statement of Accounting Principles."⁷⁵ This statement, as its name implied, was intended to be somewhat experimental in nature and attempted to formulate some of the principles related to some of the most important parts of accounting. Criticism and comment were invited with the hope that wide discussion would, in turn, lead to a more comprehensive and improved formulation. The Executive Committee expected gradual improvement in financial accounting and reporting generally rather than immediate results in specific areas.

Three revisions of the original statement and eight supplementary statements amplified the coverage and elaborated on the principles enunciated but did not change the basic approach and objective. Between 1936 and 1957 the Association's pronouncement gradually evolved from a fairly general statement about a few items into a more or less comprehensive statement covering most of the important areas of accounting. Changes in successive statements introduced principles in areas not previously dealt with or de-emphasized or removed matters no longer important enough to command the space formerly devoted to them. The Association's leadership has given no indication that it thinks the task completed, and further development of the statement may presumably be expected.

⁷⁴ The foregoing is a digest of the sense conveyed by many sources. Particularly relevant are the following: "A Statement of Objectives of the American Accounting Association," *Accounting Review*, Vol. XI (March 1936), pp. 1-3; "Convention Report of the 1936 Convention," *Accounting Review*, Vol. XII (March 1937), pp. 68-75, especially "Report of the President" (E. L. Kohler), pp. 70-71 and "Report of the Director of Research" (Assistant Director A. C. Littleton reporting in the absence of Director W. A. Paton), pp 72-74.

⁷⁵ "A Tentative Statement of Accounting Principles," *Accounting Review*, Vol. XI (June 1936), pp. 187-91.

In contrast to the comprehensive, over-all approach of the Association, the Institute adopted what has been appropriately called the "piecemeal" approach to accounting principles. This approach was primarily practical; the objective was to give immediate help to the practicing accountant faced with a problem. Lengthy discussion of an over-all set of principles would merely delay the service the committee on accounting procedure could provide in reducing controversies, and there was considerable doubt that a comprehensive program could be carried to a successful conclusion. The committee therefore decided to consider specific topics as the need arose and, if possible, to recommend one or more alternative treatments as definitely superior to other recognized procedures.⁷⁶

The result of this approach was that the Accounting Research Bulletins were not arranged in any related order nor was the position adopted in any given bulletin necessarily consistent with that taken in an earlier bulletin. In 1953, the bulletins were revised and grouped according to subject matter in Accounting Research Bulletin No. 43, but even this collection retained the original flavor of the bulletins, i.e., a group of separate opinions on different subjects. The revision and restatement had begun in 1949 as a renewed effort to formulate a comprehensive statement of principles, but the project was soon abandoned in favor of the approach that the committee had followed since its inception.

Similarities and Differences

The different approaches of the two professional societies in fact complemented each other. The ultimate conclusions were surprisingly alike. The broad areas of basic agreement were indicated by the subtitles used in a report prepared by the research department of the Institute in 1945 comparing

⁷⁶ See Carman G. Blough, "The Work of the Committee on Accounting Procedure," in *Accounting, Auditing, Taxes, 1953: Complete Text of Papers Presented at the 66th Annual Meeting* (New York: American Institute of Certified Public Accountants, 1954), pp. 125-26; "History of the Accounting Procedure Committee—from the Final Report," *The Journal of Accountancy*, Vol. CVIII (November 1959), pp. 70-71.

these pronouncements and those of the SEC:⁷⁷

The Nature of Income

Income Realization

Income Reporting

The Valuation of Assets

The Measurement of Cost

Asset Absorptions

Revaluations of Assets

The Nature of Capital

Capital Surplus

Treasury Stock

Substantial, if not complete, agreement was found in all of these areas between the positions of the Institute and the Association. The Institute and the Association differed in the approach to finding and formulating accounting principles, not in the recommendations themselves.

This basic agreement between the results of the work of the Institute and that of the Association stems from the fact that both held the same view regarding the nature of the accounting process. The best statement of the underlying proposition appeared in the 1936 statement of the AAA:

Accounting is thus not essentially a process of valuation, but the allocation of historical costs and revenues to the current and succeeding fiscal periods.⁷⁸

This firm rejection of accounting as a valuation process in favor of accounting as an allocation process was the “fundamental axiom” on which all Association statements, including the Paton and Littleton monograph,⁷⁹ were specifically based.

⁷⁷ “Corporate Accounting Principles,” *The Journal of Accountancy*, Vol. LXXX (October 1945), pp. 259-67.

⁷⁸ “A Tentative Statement of Accounting Principles,” *op. cit.*, p. 188.

⁷⁹ W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Ann Arbor, Mich.: American Accounting Association, 1940), especially pp. 24-45. Although this publication was not an official pronouncement of the Association, it was written by two of the authors of the “Tentative Statement” to explain the concepts underlying that official statement.

Not until the 1957 Revision⁸⁰ did the least glimmer of recognition of discounted net cash receipts appear in the statements. The special committee appointed to make the 1948 Revision had adopted the cost concept "in toto."⁸¹

A statement equivalent to the "fundamental axiom" of the AAA did not appear in the bulletins of the American Institute, but the concept was implied in almost all of them. A similar statement was made, however, by George O. May at the annual meeting of the Institute in October 1935, about six months before the publication of the AAA's "Tentative Statement":

At this point it seems desirable to emphasize the fact that accounting is not essentially a process of valuation. . . . Primarily, accounting is historical in its approach, with valuation entering into it at times as a safeguard. The emphasis is on cost. . . .⁸²

Inasmuch as both the Institute and the Association subscribed to the same basic philosophy regarding the nature of income determination, it was more or less inevitable that they should reach similar conclusions, even though they followed different paths. The differences in specific recommendations were relatively minor because all of the recommendations were built essentially upon the same basis. In fact, many of the differences that did result came from the differing degrees to which the two associations adhered to the basic proposition.

In general the Association clung more tenaciously to the cost concept than the Institute. For example, although the Institute adopted the cost or market rule,⁸³ which conflicts with a strict application of the cost basis, and described in detail how to apply it, the Association did not dignify the

⁸⁰ "Accounting and Reporting Standards for Corporate Financial Statements," *op. cit.*, p. 539.

⁸¹ Hale L. Newcomer, "Report of Committee on Revision of the Statement of Principles: Introductory Statement," *Accounting Review*, Vol. XXIII (January 1948), p. 11.

⁸² "The Influence of Accounting on the Development of an Economy," *The Journal of Accountancy*, Vol. LXI (January 1936), p. 15.

⁸³ Accounting Research Bulletin No. 29, "Inventory Pricing" (New York: American Institute of Certified Public Accountants, 1947), pp. 238-41. This section was included unchanged as part of Chapter 4 of Accounting Research Bulletin No. 43 in 1953.

method by discussing it. Similarly, the Association's solution to the price-level problem was consistent with the cost basis,⁸⁴ while the Institute at least tacitly recognized the propriety of writing up fixed assets on the basis of appraisals.⁸⁵ The Association considered the cost concept a "fundamental axiom" which it accepted (at least until the 1957 Revision) "in toto." The Institute, on the other hand, considered utilitarian factors to be as important as the cost concept. The cost basis was a convention which should be adhered to as the primary basis of accounting as long as it proved useful, but accountants should not hesitate to abandon this or any other convention when more useful results could be obtained by so doing.⁸⁶ Cost as a fundamental and inviolable axiom is not the same as cost in the role of a useful but sometimes expendable convention.

At least part of the cause for the difference between the Institute and the Association in the interpretation of the place of the cost basis in accounting stemmed from somewhat different concepts of "the principles of accounting." The Institute's concept was clearly that "principles" were essentially *conventions*. The key words were "generally accepted":

"A general law or rule adopted or professed as a guide to action; a settled ground of conduct or practice. . . ." Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting.⁸⁷

⁸⁴ See "Supplementary Statement No. 2," *Accounting Review*, Vol. XXVI (October 1951), pp. 468-74.

⁸⁵ Accounting Research Bulletin No. 5, "Depreciation on Appreciation" (New York: American Institute of Certified Public Accountants, 1940), pp. 37-38. In ARB No. 43, the original bulletin was reduced to a single page (Chapter 9B) but the tacit recognition of asset write-ups remained.

⁸⁶ For a full exposition of this philosophy, see George O. May, *Financial Accounting* (New York: Macmillan Co., 1943), pp. 2-6. Of special significance is the following: "First . . . there is a choice between the value and the cost approach, or perhaps rather a question how the two can best be combined" (p. 6).

⁸⁷ Accounting Research Bulletin No. 7, *op. cit.*, p. 60. Compare with the definition of a *convention* in *Webster's New International Dictionary—Unabridged*, 2nd ed.: "5. A rule or usage based upon general agreement; a rule or practice generally adhered to. . . ."

The committee on accounting procedure's elaboration of the dictionary definition which formed the basis of its pronouncement showed that the similarity between "principle" and "convention" was intended. The Institute's position from the beginning of the committee on accounting procedure was that accounting principles were "a distillation of experience." According to this view, accounting principles developed in essentially the same manner as the common law, on a case-by-case basis, and the ultimate test of their acceptability was their utility.

The Association's committee did not specifically define "principles of accounting" in its pronouncements. Its usage was consistent, however, and the meaning intended by the Association committee was that of *standard*:

A solution . . . has been sought by attempting a tentative statement of certain basic propositions of accountancy 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.⁸⁸

In the 1948 Revision, "concepts and standards" replaced "principles" in the title of the pronouncement. The Association statements had considerably more of the flavor of "this is how accounting should be" than did the Institute bulletins. In spite of this orientation, however, the early Association statements were a mixture of standards and procedural rules. Only as they developed through revisions did emphasis shift gradually toward a predominance of concepts and standards.

The different concepts of principles underlying the work of the two societies inevitably affected the approach each used in improving accounting and reporting. Because the Institute made principles equivalent to conventions and procedures, it ruled out the possibility of making a complete and comprehensive codification. The Association, on the other hand, attempted from the outset to formulate a complete and comprehensive set of standards by which to evaluate rules and procedures. Accordingly, it used a conceptual approach and

⁸⁸ "A Tentative Statement of Accounting Principles," *op. cit.*, p. 188.

was led to a consideration of some of the underlying assumptions of accounting practice. This method also inevitably led to some propositions which were in conflict with principles distilled from practice, that is, to standards which were not accepted by practicing accountants.

The Result

It is not surprising, then, that the Institute bulletins had more impact on the practice of accounting than did the pronouncements of the Association. The Association's influence was probably felt more indirectly through two principal avenues: (1) the majority of new members entering the profession over the period of increased activity in the area of accounting principles which began in the late 1930's were products of colleges and universities where they were at least exposed to the AAA statements and often indoctrinated in them, and (2) the leaders among the practitioners, i.e., those who actually influenced the accounting practices of major companies, were familiar with the Association statements and were influenced, at least to some extent, by them. From the point of view of the majority of practitioners, however, the statements of the Association had a vital defect: they provided little guidance in solving actual problems of accounting or reporting. In contrast, the Institute bulletins were intended primarily to help the practicing accountant with specific problems. They were widely used and generally followed.

The Institute, among those who attempted to bring more uniformity to accounting by formulating and stating accounting principles, was therefore most responsible for the improvement in accounting and reporting practice that undeniably occurred. The Institute, supported by the SEC, successfully eradicated numerous undesirable practices. Most of the questionable practices that were in evidence in the report of Sanders, Hatfield, and Moore had completely disappeared by the late 1940's or early 1950's. In some ways, the bulletins were too successful. Unwittingly, the Institute became responsible for some new problems in accounting and reporting.

While the bulletins were making obvious achievements in

bettering practice, they were also creating a situation, the full import of which did not become evident for many years. The bulletins were successful against the working of a sort of Gresham's law of accounting procedures in which "bad" practices threatened to drive out "good" ones. As a result, however, accountants increasingly found themselves with a superabundance of "good" practices. One development in accounting over the last three decades has been an increase in the number of important areas in which numerous alternative methods and procedures have been sanctioned. Although some of these alternatives have been clearly superior to others, even the poorest have often been able to squeeze past the minimum barriers and have been cloaked with the respectability inherent in "general acceptance." This development was apparently not anticipated by the leading accountants of the thirties, although it was probably inherent in an approach which emphasized disclosure and consistency rather than specific principles.

Two factors contributed to the increase in the number of accepted alternatives: (1) the committee on accounting procedure failed to make firm choices among alternative procedures, and (2) the committee was clearly reluctant to condemn widely used methods even though they were in conflict with its recommendations. For example, in its very first pronouncement on a specific problem — unamortized discount and redemption premium on refunded bonds — the committee considered three possible procedures, of which it rejected one and accepted two.⁸⁹

The committee had a clear preference — it praised the method of amortization of cost over the remaining life of the old bonds as consistent with good accounting thinking regarding the relative importance of the income statement and the balance sheet. It condemned immediate writeoff as a hold-over of balance-sheet conservatism which was of "dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant."⁹⁰ Never-

⁸⁹ Accounting Research Bulletin No. 2, "Unamortized Discount and Redemption Premium on Bonds Refunded" (New York: American Institute of Certified Public Accountants, 1939).

⁹⁰ *Ibid.*, p. 13

theless, the latter method had “too much support in accounting theory and practice and in the decisions of courts and commissions for the committee to recommend that it should be regarded as unacceptable or inferior.”⁹¹

Had the committee made a specific recommendation for one method or the other, the issue of the wisdom of its decision could have been fought out and perhaps resolved. As it was, the bulletin satisfied everyone (or no one). A company could use either method without danger of a qualified certificate. Thus, even if the company and its independent accountants disagreed with the primary recommendation of the committee (as many apparently did), there was really nothing to argue about. The solution turned out to be a “live-and-let-live” policy. The major thing accomplished by the bulletin was the elimination of a method which was not widely used anyway. And this type of solution was characteristic of the bulletins, rather than exceptional.

The extreme to which this attitude was sometimes carried is exemplified in the Institute’s inventory bulletin, a classic example of trying to please everyone. The committee accepted almost every conceivable inventory valuation procedure, except the discredited base-stock method.⁹² The committee therefore passed up the opportunity to narrow the range of acceptable alternative procedures in the area of inventory valuation by specifying the conditions appropriate to the use of each of these methods.⁹³ Instead, the individual practitioner was left with the high-sounding but useless admonition that the method chosen should be the one which most clearly reflected periodic income. The resulting muddle in inventory valuation is directly attributable to the committee’s vacillation.

⁹¹ *Ibid.*, p. 20.

⁹² Accounting Research Bulletin No. 29, *op. cit.*, pp. 235-42. The committee may also have rejected specific identification (p. 237).

⁹³ The Institute’s Research Department had done some work on inventory valuation, but no evidence of it found its way into the bulletin. See “Inventories: A Tentative Statement by the Research Department of the American Institute of Accountants,” *The Journal of Accountancy*, Vol. LXX (October 1940), pp. 327-330. Although this tentative statement was apparently to have been the basis of a bulletin, it was not issued in that form. The actual bulletin six years later was much more condensed and contained little reasoning in defense of the positions taken.

In contrast, the Association's inventory statement⁹⁴ met the problem head on, analyzed it, and suggested a solution. This solution, although perhaps inadequate in some respects and undoubtedly unpopular, was superior to the Institute's for the simple reason that it proposed a solution rather than a perpetuation of the problem. The Institute bulletin essentially refused to acknowledge that a problem existed.

A Dilemma

Neither the conceptual nor the piecemeal approach has been fully capable of solving accounting and reporting problems nor has either of the professional bodies been able to completely dominate attempts at formulating accounting principles. The Association's efforts, with which the conceptual approach has been identified, although having considerable promise from a purely analytical standpoint, have had little immediate impact on accounting practice. In spite of the obvious long-run beneficial impact of the work of its committees, the Association has not yet discovered an effective way to make its members' influence felt significantly in current practice. This influence is largely indirect in its impact on large companies and their auditors who lead the way in the development of accounting practice. The influence of the Association may have been weakened to some degree by the fact that many of its recommendations have seemed impractical to the majority of practicing accountants and by the inherent distrust which the practical man feels toward proposals emanating from the academic world.

The Institute's efforts, with which the case-by-case approach has been identified, have made positive practical contributions to the improvement of accounting. But the method has demonstrated two important weaknesses which may well indicate that its contributions in the future will not equal those of the past. First, the method has been unable to lay a gen-

⁹⁴ "Inventory Pricing and Changes in Price Levels—Supplementary Statement No. 6," *Accounting Review*, Vol. XXIX (April 1954), pp. 188-93. See also "Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision," *op. cit.*, p. 541.

eral conceptual foundation for accounting practice. The *ad hoc* solutions resulting from the play-it-by-ear approach have rarely turned out to be lasting solutions (even taking into consideration the dynamic nature of accounting), and the Institute's committees have found themselves continually considering the same problems. Second, in solving some problems, the piecemeal approach has created others which it has been unable to solve. Furthermore, an association composed primarily of practicing accountants has an inherent weakness when it comes to the formulation of accounting principles: progress is inhibited because practitioners are understandably reluctant to condemn practices which are being used by their own clients and which they themselves have approved in the past. The Institute's experience reflects the fact that the compromises necessary to get the votes required for the issuance of a bulletin have often frustrated the original purpose of the pronouncement. Equally serious, bulletins on the most controversial subjects (and therefore bulletins most urgently needed) have sometimes not been forthcoming because the necessary votes for publication have been unobtainable.

The conceptual and the practical approaches to accounting principles seem to be complementary rather than antithetical. All the evidence points to this conclusion. Progress in the development of accounting principles has undoubtedly been hampered because the two approaches have been treated essentially as independent methods by the two professional bodies most responsible for the formulation of accounting principles. A marriage of the approaches is obviously called for. Such a union should be based on the interrelationship and essential equality of the two methods. Such a union does not exist.

Old Problems in New Dress

After more than twenty years' effort, no statement of accounting principles has been prepared on which accountants and users of financial statements can rely. Numerous pronouncements have been made but they do not form a codifica-

tion of generally accepted accounting principles either individually or collectively because (1) those of the American Institute of Certified Public Accountants are not and do not claim to be comprehensive or integrated, (2) those of the American Accounting Association have achieved little recognition in practice, and (3) those of individuals (i.e., those not originating with either of the professional bodies) have been largely ignored. In fact, the attempts at the promulgation of principles have quite possibly created as many problems as they have solved. Instead of being faced with a choice between "good" and "bad" practices, accountants now have a choice among a multiplicity of "accepted" practices, the use of which causes confusion among the readers of financial statements and prevents meaningful comparisons of statements of different companies.

Although some accountants have become increasingly concerned about the stature of the accounting profession in the public view and its responsibility to groups other than shareholders, many, if not most, accountants have remained primarily concerned with reporting to existing shareholders, and some have remained oblivious even to the needs of this group.

Although much of the discussion of comparability during the fifties was at a relatively high level, more recent arguments have had an unfortunate tendency to drift back into the pattern of the fruitless debates of the thirties on uniformity. The following statement accurately summarizes much of the literature of the late fifties and early sixties:

Some seem to believe that uniformity of accounting principles and procedures is what is most needed; that rules should be established in such detail that similar transactions would always be handled similarly in the accounts. Comparability is their goal. Others believe that such uniformity would be impossible but firmly believe that much more uniformity than we now have would not only be possible but highly desirable. Still others consider uniformity to be highly dangerous. To them, subjective judgment in each case should govern; they believe consistency, accompanied by disclosure, is of primary importance.⁹⁵

⁹⁵ Carman G. Blough, "Accounting Research for Better Financial Reporting," *Proceedings of the Twenty-second Annual Institute on Accounting, 1960* (Columbus: The Ohio State University, 1960), p. 6.

If this description carries just a hint of extremism, it accurately reflects the fact that extremism has almost always been a characteristic of accountants' discussions of uniformity. Even recently, many proponents of more comparability have charged their opponents with recommending complete and uninhibited freedom on the part of companies and their accountants to choose any procedure they please. Their opponents imply that comparability in accounting must be identified with the type of accounting and reporting systems prescribed for railroads, public utilities, and other regulated companies by various state and Federal regulatory agencies. The one group has been charged with being concerned only with the desires of the client company and the protection of the accountant; the other has been criticized for trying to encase accounting in a strait jacket of rules which would stifle all change and progress. Needless to say, the tendency of each group to characterize members of the other as fools or knaves has not provided a solid basis on which to establish a settlement of differences.

Although some accountants defended the *status quo*, increasing numbers of accountants, after contemplating the structure which had arisen, expressed the feeling that some renovation of the house of accounting principles was overdue.

It was into this state of affairs, with its somewhat charged atmosphere, that Alvin R. Jennings interjected his suggestion for reorganizing the efforts of the Institute in the area of accounting principles.⁹⁶ This is the environment in which the new program has been forced to operate. It is small wonder that the spectacular results apparently anticipated by some have not materialized.

The Institute's New Research Program

The Institute lost no time in following up Mr. Jennings' proposal. A special committee on research program was ap-

⁹⁶ "Present-day Challenges in Financial Reporting," *The Journal of Accountancy*, Vol. CV (January 1958), pp. 28-34.

pointed, and its report,⁹⁷ as amended and approved by the Institute's governing Council, became the basis of the "Charter Rules" which provided for the organization and operation of an Accounting Principles Board and an Accounting Research Division. The Council stated the objective of the program to be:

. . . to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its [the Institute's] members and of others. This means something more than a survey of existing practice. It means a continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice.⁹⁸

The essential features of the program involve the relationship between the Board and the Accounting Research Division:

1. The Accounting Principles Board is designated as the sole group within the Institute having authority to make or authorize public pronouncements on accounting principles.
2. The Board ordinarily does not act upon any matter until it has been thoroughly studied by a competent independent investigator from the research staff, who is advised in carrying out the research study by the Director of Accounting Research and a project advisory committee composed of recognized authorities in the field, but who is free to come to the conclusions to which his research leads him. Research studies are not, therefore, in any sense statements of the official position of the Institute, but are intended to be widely circulated with the hope that they will stimulate interest and discussion before the Board makes a pronouncement on the subject.

⁹⁷ "Report to Council of the Special Committee on Research Program," *The Journal of Accountancy*, Vol. CVI (December 1958), pp. 62-68.

⁹⁸ *Organization and Operation of the Accounting Research Program and Related Activities* (New York: American Institute of Certified Public Accountants, 1959), p. 9.

3. The completed research study is then considered by the Board which may defer action pending further study and exposure of the conclusions but will ordinarily issue a pronouncement either (a) accepting the conclusions of the research study in whole or in part or (b) rejecting the conclusions by stating conclusions of its own.

The Institute's reorganized effort to find and state accounting principles has at least three characteristics which make it more or less distinctive. First of all, the use of deduction to aid in the discovery of accounting principles — a method intentionally absent from earlier Institute efforts — is clearly intended to play a significant part in the new program. This fact is clearly expressed in both Mr. Jennings' proposal and the Charter Rules. The studies published to date (six by Dec. 1, 1963) bear out this intent; all of them have relied heavily on the use of deductive reasoning.

A second feature built into the Institute's new program is its emphasis on making available the reasoning underlying the positions taken by the Accounting Principles Board. The Accounting Research Bulletins, except for the first few, did not contain the reasoning used by the committee on accounting procedure in arriving at its conclusions. The pronouncements merely stated the conclusions without indicating what alternatives, if any, the committee had considered, why one method was preferred over another (or why no such preference was stated), or what the arguments were in favor of or against any method. This type of pronouncement resulted, at least in part, from the fact that the research connected with the committee's efforts was modest indeed and that the Institute's research department did not have the resources to probe any subject in real depth. The bulletins were based, therefore, primarily on the experience of the twenty-one men who sat on the committee at any one time and the opinions of at least two-thirds of them.

The new research program is based on the widest possible dissemination of a research study and of the Board's position before official issuance of a pronouncement. The wide distribution is to include not only the conclusions reached but

also the analysis and reasoning underlying them. Accordingly, anyone who reads a moderate amount on the subject under consideration can be well informed on the position taken by the independent researcher and on the position about to be taken by the Board.

A third feature of the Institute's program sets it apart from all previous organized efforts in the area of accounting principles. It is the first serious attempt to unite the practical experience of the practicing accountant and the research potential and the preoccupation with logical methods and conceptual matters of the university professor. The Board is composed primarily of prominent and influential accountants in public practice whose knowledge and competence of the practical aspects of financial accounting and reporting are unchallenged, with a minority of equally qualified members from industry, from government, and/or from the universities. The choice of research staff emphasizes expertise of a nature complementary to, rather than the same as that of the Board. Graduate education, research capability, writing ability, and creative thinking are the qualifications stressed, in addition to accounting experience.

Research effort of this type is inevitably long-run in its effect. The special committee on research program recognized that much, if not most, of the material resulting from the research studies will not be immediately applicable to the accounting practice:

There should be borne in mind the desirability of developing pronouncements on accounting matters in a coherent, consistent series rather than as unconnected articles on isolated matter. Effort should be made to avoid restricting research projects to matters upon which the Board would be expected to take action immediately by incorporating the results of an accounting research study in a statement of generally accepted accounting principles; encouragement should be given to the exploration of unsettled and controversial matters as to which the Board might not be expected to make a pronouncement for some time.⁹⁹

⁹⁹ "Report to Council of the Special Committee on Research Program," *op. cit.*, p. 67.

The quality of the research studies issued to date, each of which is undeniably a contribution to the literature of accounting, indicates the soundness of the Institute's new approach to research.

Accounting at the Crossroads

The period of the 1960's may hopefully be remembered by future generations of accountants as a time during which progress made earlier in the improvement of financial accounting and reporting was consolidated, continued, and even accelerated, a time during which real and lasting solutions became discernible for some of the major problems. Accountants of the future may, however, point to the present as the time in which it became clear that the accounting profession was unable to put its own house in order, and that the function of determining accounting principles was taken over by some other group, perhaps by a legislative or regulatory agency of government. They may even single out this decade as the one in which the trend of the importance of the professional accountant in the economy reached its peak and began to decline. This is a critical period in the history of accounting.

Unquestionably, the Accounting Principles Board with its related research program entered the field at a critical moment. It represents, at present, the best hope for success in the formulation of a statement of accounting principles. But its ultimate success or failure rests on numerous factors, not the least of which is the extent to which the accounting profession chooses to take into account the lessons of the past.

The value of the study of history lies in man's ability to adapt its lessons to fit present and prospective conditions. This

brief excursion into the development of accounting principles was made with this thought in mind. Numerous conclusions might be drawn for the benefit of the present generation of accountants, and a number of such conclusions have been expressed throughout the study. No attempt is made to summarize them at this point. A few observations may, however, be pertinent in these final pages.

Progress

The first lesson that accountants should have learned from the experience of the last thirty years is that preparing statements of accounting principles and using such principles to narrow the areas of difference and inconsistency is neither simple nor easy. Past progress has been by inches rather than by miles and will probably continue to be so in the future. It is unrealistic to expect the Accounting Principles Board, the Accounting Research Division, the American Accounting Association, or any other individual or group to solve problems in the next few years which have defied solution for decades. Accountants who cry for action — any action, so long as it is action — are endangering future progress as much as those who cling tenaciously to the *status quo*. Extreme positions are as apt to be wrong in accounting as in any other field of endeavor, and precipitous action is often as inimical to progress as inaction. Calm, steady, and persistent progress based on good research and common sense is more likely to achieve the goal than either waiting for something fortuitous to happen or taking action which is erratic.

It is equally short-sighted to become impatient because the conclusions of research in accounting are not immediately and completely applicable to day-to-day problems. If research is to be of any real value in improving accounting practice, it must lead — not follow — practice. Accountants are now discovering something that is known in many other fields, i.e., that “principles” distilled from practice are capable of leading so far, and no further. A point is reached at which principles of this type become meaningless unless and until a conceptual framework is developed which gives meaning to

the procedures followed, or points out that the procedures followed do not make sense and should be replaced by others which do. Building a conceptual framework, which will be at once both the reasoning underlying procedures and a standard by which procedures are judged is a long-run process. It involves observing, reasoning, relating, comparing, analyzing, and testing, and only after the process has run through several cycles is the result likely to be ready to apply to practice. But a long-run process of this kind is basic to real progress once a discipline has outgrown its primitive state. The results of research must then be judged on the basis of the validity of the process used to develop conclusions and not on the basis of preconceived notions about what the results should be or on whether they are "practical."

Building Blocks

With the benefit of hindsight, it is now apparent that the inclusion of some of the buildings blocks which were rejected during the 1930's and 1940's would probably have hastened the development and strengthened the structure of accounting principles. Most important among these are: (1) the definition of "principles" to mean a higher order of things than procedures, (2) the formulation of a precise terminology, (3) the explicit use of logical methods, (4) the preparation and publication of lists of accounting methods used by individual listed companies, and (5) the more complete development of a concept of social responsibility on the part of independent accountants.

First, the term, accounting principles, has been defined so broadly that it includes a conglomeration of propositions, conventions, rules, and procedures of unequal quality which often conflict with each other. As a result, no one is quite sure what the term means, and confusion has resulted. Had the meaning of the term been restricted to the type of proposition implied in the report of the special committee on co-operation with stock exchanges in 1934 or to essentially the same idea espoused by the American Accounting Association—i.e., a broad standard against which a company's accounting can be

measured—much of the present confusion and imprecise usage could have been averted.

Second, the failure to define precisely a term as basic as “principles” is, of course, related to the larger problem of terminology. Accountants have been extremely careless in this matter, and the situation has degenerated to such a state that it is doubtful whether accountants really understand each other. The formulation of a set of precise terms is prerequisite to development in any field of endeavor. Until this is accomplished, accounting will be hamstrung.

Third, logical methods cannot solve all of the problems in the formulation of accounting principles. They can, however, make a positive contribution. The decision to rely on “distillation of practice” in the early days for the development of principles was probably a sound one. Accounting has now outgrown the stage in which a process of this type is sufficient. The work of the American Accounting Association, that of several individuals,¹⁰⁰ and the early Accounting Research Studies are ample evidence that logical studies of accounting are not only possible but can be important contributions. Accounting has developed about as far as it can without more reliance on the use of logic in the formulation of principles, and logical methods will become increasingly important in future developments.

Fourth, the 1934 report of the special committee on co-operation with stock exchanges contained a provision that, within the framework of the broad standard known as principles, each company should be able to choose the methods of accounting most appropriate to its own situation and that each company should prepare a detailed description of the methods it used for the benefit of stock exchanges and shareholders.

¹⁰⁰ Specific mention should be made of the work of Ray J. Chambers and Richard Mattessich in this connection. Both have done preliminary analysis of great promise, and although a discussion of their conclusions is beyond the scope of this paper, every serious student of accounting should be familiar with them. It is worth noting that real breakthroughs in accounting theory are more likely to come from such sources—i.e., individuals working more or less alone on what are now considered the fringes of accounting and uninhibited by considerations of accounting practice—than from committees concerned with specific practical problems.

Companies have been free in the choice of methods but they have not prepared published lists of methods used. Because of this, it is difficult for even a sophisticated reader of financial statements to determine which accounting methods the company uses and their effect on the reported results. The suggestion was a good one, and since complete uniformity of accounting method among companies is neither achievable nor desirable, a detailed description of the methods followed by a company in preparing its financial statements would always be useful. This step should become a part of any program for improvement of financial accounting and reporting.

Finally, the profession has been highly successful in winning the confidence of management and of governmental agencies concerned with accountants' work. It has had markedly less success in inspiring similar confidence on the part of others who have a legitimate interest in the operating results and financial condition of business enterprises. The special committee on co-operation with stock exchanges proposed in 1932 that the profession undertake to educate the investing public regarding the potentialities and limitations of financial statements. Accountants have continually emphasized the historical nature of accounting and the fact that a balance sheet does not present the current values of all assets. In spite of what accountants did in this direction, fifteen years later conditions were not substantially different. The public at large, including both shareholders and employees of the companies whose annual reports were widely distributed, were still substantially ignorant regarding the information presented in financial statements.

There is little reason to believe that the public is significantly more sophisticated today. A lesson to be learned from the experience of the past three decades is that there are definite limitations on the profession's ability to educate the public about accounting. While the two-pronged program involving both improvement of financial reporting and education of the investing public is conceptually sound, in practice the profession's attempts to improve financial accounting and reporting will have to go considerably more than half way if the two prongs are to meet at the objective.

Approach

The practical approach to the formulation of accounting principles, as exemplified by the Accounting Research Bulletins of the Institute, has created almost as many problems as it has helped to solve. The exclusive use of this piecemeal method by the Institute is undoubtedly responsible for much of that which is unsatisfactory in current practice. The exclusive use of the conceptual approach by the American Accounting Association has been equally ineffective. Although this method has fared better than the practical approach from the standpoint of internal consistency, it has had almost no influence, good or bad, on accounting practice. In other words, the profession must find a way to combine the best aspects of the conceptual, logical, and practical approaches to the formulation of accounting principles.

When the conceptual and practical approaches are integrated, it should be possible to discard two propositions which are unfortunate variations of the practical and conceptual approaches respectively. The first of these is that accounting principles must be developed on a case-by-case basis, as are the principles of common law. The analogy is a poor one. Machinery does not exist for deriving accounting principles in that way, and most accountants would probably oppose its establishment should such an undertaking be considered. The common law is formulated by judges who have ceased to be members of the legal profession. When a lawyer is appointed to be a judge, he severs all connections with associates and clients and he disqualifies himself from hearing cases involving his former associates and clients. Unless accountants are willing to set up similar machinery—an accounting court composed of judges who have severed all relationships with clients and firms or something comparable—they should stop using the analogy. Under present circumstances, analogies to the principles of economics or of statistics are more nearly accurate.

A second proposition that should be laid to rest is that the purpose of accounting principles is to justify accounting practice. The literature of accounting is replete with so-called accounting theory which is nothing more than an attempt to

rationalize the *status quo*. Although much of this is perhaps unintentional, it is unworthy of the profession. A rationalizing effort is not properly termed "research" for its intent is to defend existing conditions, whether good or bad, and is the antithesis of a search for the truth. If the profession is truly working toward improvement in financial accounting and reporting, rationalization of this type is unnecessary.

The question of how best to integrate the practical, logical, and conceptual approaches to accounting principles does not, of course, lend itself to easy solution. This process will undoubtedly take time. Some beginning steps should, however, be taken now. First, the Institute's present effort (which is so far the only attempt to combine the various approaches that is even partially successful) has had inadequate time to prove itself. Fundamental changes in the program would be premature. Second, the practicing accountants and the professors must find ways to work more closely together in various ways, each contributing his own particular talents, to develop sound accounting principles. Co-operation rather than uncoordinated activity, is the key to success.

Co-operation will require some changes in the attitudes of both groups. Present relationships, in spite of the fact that the two groups are generally friendly and have worked together to some extent, are characterized at best by mutual misunderstanding and at worst by mutual disrespect. The professor too often suspects that practitioners do not really care about improving practice but are concerned primarily with clients and fees. The practicing accountant, on the other hand, often regards the professor as living so high in the ivory tower that he just does not understand the problem. As a result, each group has tended to go its own way without the benefit of the help which the other could give. The professors will, in effect, have to descend from the ivory tower and find ways to make their influence felt in current practice as well as in long-range trends. The practicing accountants will have to develop a "feeling for research" and be more tolerant of "impractical" ideas. In short, integration of approaches should prove exhilarating, if sometimes frustrating, for both groups.