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The Development of Accounting Principles

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THE CONTROVERSY over comparability in corporate financial reporting continues to grow. We see evidence of this growth not only in professional accounting literature but also in newspapers and financial magazines. We hear this controversy discussed among our business associates, our educators, and our legislators.

All the reasons for this heightened interest in corporate financial reporting are not clear. I believe that it is the natural result of the high level of business activity, with the consequent increase in the number of users of financial statements. But, more specifically, this added interest may be attributable to the rise in merger activity, which has tended to focus attention on differences in reporting practices; and to publicity concerning methods of reporting used by companies that have found themselves in financial difficulties. Other contributing factors may be the continued emphasis on comparing companies and operating periods on the basis of earnings per share, return on investment, and other statistical measures of corporate earning power; and increased investor interest in corporate affairs, as evident in questions raised at meetings of shareholders of publicly owned companies.

Professional accountants have a particular interest in this controversy because, for the most part, the conflict arises out of the questions of what should constitute generally accepted accounting principles and what body or bodies should be responsible for their development.

UNIFORMITY VS. FLEXIBILITY

Much of the recent criticism of generally accepted accounting principles, in their present form, has been advanced by a few members of our profession through public expressions of dissatisfaction with the progress being made in developing accounting principles and in narrowing differences in practice. Not surprisingly, some segments of the public also are suggesting that accounting practices are inadequate or even misleading; after all, they are being told by some accountants that this is so.

Also, there is a tendency by some to stress rigidity or uniformity in accounting—to say that things should be done in only one way. These critics have labeled those who disagree with their line of thinking as advocates of flexibility. A consequent development has been the undue emphasis on comparability and uniformity in financial reporting.

I doubt that uniformity versus flexibility is a real issue, because these are extreme positions that I believe no responsible accountant espouses. At the present time, there are rightfully some "one-way" accounting principles. Situations that are really alike should of course be shown as comparable. Comparability, however, is relative, true parallels are not the common rule, and absolute comparability is unattainable.

LACK OF UNDERSTANDING

My view is that in many cases of differences in accounting practices cited by critics, the central problem has been not the lack of comparability or uniformity but the failure of users of the financial statements to assess properly the effect of accounting practices employed and the effect of other decisions by management. This failure suggests that accountants need to find ways of improving public understanding of the significance of financial statements. And I should hope that we might devote more of our efforts to this task.

ROLE OF AICPA

Because accounting principles rest only in part on demonstrable truths, they cannot be regimented. They must rely heavily on conventions—propositions that are acceptable but cannot be proved to the exclusion of all others. The process is to reach a consensus on conventions that cannot be proved categorically. The American Institute of Certified Public Accountants has attempted to follow this procedure in its approach to developing accounting principles. Leaders in our profession have consistently concluded that solutions to accounting problems cannot all be distilled into rigid answers, as some background information on the Institute's role in the development of accounting principles will demonstrate.

Correspondence between a committee of the Institute and the New York Stock Exchange in the early 1930s stated that "... [the arguments against] ... the selection by competent authority out of the body of acceptable methods in vogue today of detailed sets of rules which would become binding on all corporations of a given class" are "overwhelming."

Committee on Accounting Procedure

The Institute's Committee on Accounting Procedure, organized in 1938, announced in the beginning that its plan would be "to consider specific topics, first of all in relation to the existing state of practice and to recommend, wherever possible, one or more alternative procedures as being definitely superior in its opinion to other procedures which have received a certain measure of recognition and, at the same time, to express itself adversely in regard to procedures which should in its opinion be regarded as unacceptable." It also said that in dealing with each case, especially where alternative methods seemed to possess substantial merit, the aim would be to take into account the conflict of considerations that made alternative methods acceptable, and thus gradually prepare the way for a further narrowing of choices.

The accounting research bulletins issued by the Committee did not purport to constitute a rule book of answers to problems with which they dealt. Instead, the authority of the bulletins was stated to rest on the general acceptability of the opinions expressed in them. With minor exceptions, however, the bulletins have been recognized as authoritative on the subjects dealt with, and several of them have led to changes in practice. Altogether, they have had a significant effect on the development of accounting principles.

Accounting Principles Board

The philosophy of the Committee on Accounting Procedure was carried over in the charter of the Accounting Principles Board when it was organized in 1959. The Board's charter provides that "the general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and of others." The charter goes on to state that "this means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. . . ." The same document says that the Institute should accomplish its purpose by persuasion rather than by compulsion, but that it should lead in the thinking on unsettled and controversial issues, and that it should enlist the closest cooperation of others concerned with the results of the work.

There has been a tendency by some to disregard the thinking of our predecessors, whose experiences taught them that accounting principles are developed more effectively by persuasion than by compulsion. This tendency became pronounced in 1964 when the Executive Committee of the Institute proposed to Council that opinions of the Accounting Principles Board be considered as the only generally accepted accounting principles in their subject areas for purposes of expressing opinions on financial statements. I was among the many accountants who opposed the Committee's recommendations, and after considerable debate, the proposal was modified to permit unqualified opinions on financial statements embodying accounting principles having substantial authoritative support, even though they might not conform with opinions of the Board. Again, an attempt to force accounting principles into a strait jacket was rejected.

Opinion No. 8

The best defense against attacks on our present method of developing generally accepted accounting principles is to be able to point to sound progress in narrowing differences in corporate financial reporting.

I believe such progress can be demonstrated, in part, by *Opinion No. 8 on Accounting for the Cost of Pension Plans,* which is now being printed and will be mailed within the next few days. In my view, this opinion will narrow differences in practice. Moreover, it was developed in a manner consistent with the Institute's intentions as expressed in the charter of the Accounting Principles Board, and in a manner that provides a sound framework for the development of future opinions of the Board. Therefore, I should like to review with you, in some detail, the procedures used in developing the Opinion on Accounting for the Cost of Pension Plans.

You may recall that the last pronouncement of the Committee on Accounting Procedure on pensions was *Accounting Research Bulletin No. 47,* issued in September 1956.

Wide Variations in Accounting

Despite the issuance of this bulletin, accounting for the cost of pension plans varied widely among companies and sometimes resulted in wide year-to-year fluctuations in the provisions for pension cost of a single company. A provision included in the bulletin giving recognition to the divergent views then existing contributed to the failure of the Committee's preferred method of accounting to achieve general acceptance. This provision stated that "as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased." In other words, it was acceptable practice to make no provision for pension costs so long as accruals and pension-plan assets were at least equal to the present value of vested rights. At first glance, this approach may not sound unreasonable to many of us; but the Committee did not explain what was meant by the term "vested" and did not make recommendations concerning appropriate actuarial cost methods, recognition of actuarial gains and losses, treatment of unrealized appreciation and depreciation of fund assets, and changes in assumed interest rates. As a result, varied practices of providing for pension costs arose.

Under present practice, many companies provide pension cost equivalent to the amount paid to a pension fund or used to purchase annuities. In many cases, such payments include amortization of past and prior service cost over periods ranging from about 10 to 40 years; in other cases, the payments include normal cost and only an amount equivalent to interest on unfunded prior service cost. Sometimes, payments from year to year vary with fluctuations in company earnings or with the availability of funds. The recognition of actuarial gains and losses in the year of their determination, or intermittently, has also caused year-to-year variations in such payments. Also, there is a significant number of companies using pay-as-you-go and terminal funding as a basis for cost recognition.

It is interesting to me that differences in the practice of providing pension costs have received comparatively little public attention recently, although the earnings of hundreds of companies are significantly affected.

Revision of ARB No. 47

During a meeting of the Committee held in June 1959, it was suggested that revision of ARB No. 47 might be needed and that suggested changes should be transmitted to the new Accounting Principles Board so as to be placed on its agenda. The consensus of the meeting was that the Board should be asked to give this subject high priority in view of the fact that the 1958 income statements of a number of companies had no provision for pension costs or had reflected substantial reductions in them as compared with previous annual charges. You may recall that

1958 was a recession year, and this, I am sure, had some bearing on the reduced charges for pension costs.

Accounting Research Study

In October 1960, the Institute announced that the Accounting Research Division was about to begin a study of accounting for the cost of pension plans, under the direction of Maurice Moonitz, Director of Accounting Research at that time. Upon the resignation of Dr. Moonitz, the task of revising and completing the research study was assigned, in August 1963, to Ernest L. Hicks of Arthur Young & Company. Accounting Research Study No. 8, entitled *Accounting for the Cost of Pension Plans* was published in May 1965, and approximately 17,000 copies have been sold and distributed. Between June 1965 and January 1966, letters of comment on the research study received by the Director of Research included letters from the chief accountant of the SEC, the vice president of the New York Stock Exchange, professors of accounting, actuaries, the Financial Executives Institute, the American Petroleum Institute, and other industrial associations, state accounting societies, industrial and financial executives, and practicing accountants.

Although the Board formed the subcommittee to draft the opinion on pension costs in June 1964—before publication of the research study —actual work on the opinion did not begin until after publication and review of the research study. In the interim, deliberations of the subcommittee were, of course, going on. I was privileged to serve as chairman of the subcommittee, which included Marshall S. Armstrong, of Geo. S. Olive & Co., LeRoy Layton, of Main, Lafrentz & Co., and Oral L. Luper, of Humble Oil & Refining Company.

The research study and the letters of comment provided the subcommittee with excellent background material for preparation of the opinion. In addition, the subcommittee had the benefit of replies to a 1963 questionnaire prepared by the Accounting Research Division, soliciting comments on an earlier pension study from representatives of industrial, banking and finance, transportation, and public utility companies.

Point Outline

All this material was used by the subcommittee in preparing a point outline designed to bring before the full Board those points that had to be decided before an opinion could be written. The point outline included the subject matter, in point-by-point fashion, under each topic that the subcommittee considered appropriate for possible inclusion in the opinion.

The point outline was distributed to the entire Board in January 1966—seven months after the publication of the research study. The outline served as an extremely useful vehicle in conducting the discussion at the February 1966 Board meeting. It focused attention on the major problem areas by explicitly revealing those matters on which the subcommittee members had not reached a consensus. At the conclusion of that meeting, Board members were asked to complete the point outline by showing agreement or disagreement with each point listed and to return it to the subcommittee, together with any explanatory material or comments.

Meeting with Interested Groups

The subcommittee, in the meantime, met in early March with representatives of several industry groups—the Financial Executives Institute, American Bar Association, Society of Actuaries, American Gas Association and Edison Electric Institute—to discuss the tentative views of the subcommittee. Individual half-day meetings were scheduled with each group. A discussion outline presented the major points to be resolved before the Board could issue an opinion.

Thus, in preparing this opinion, the subcommittee sought the viewpoints of major interested groups before the first draft was ever written, and freely discussed the alternative positions that might be taken on the critical areas. This was the first time that the Board formally sought and received the views of industry representatives before issuing an exposure draft.

Armed with the research study, point outline, and comments, the subcommittee proceeded to prepare the first draft of the opinion, which was presented to the Board for study prior to its April 1966 meeting. As a result of the deliberations at that meeting and further written comments by Board members, it was necessary to prepare a second draft for presentation to the Board at its June 1966 meeting. After two full days' deliberation at the June meeting, an exposure draft was approved.

Distribution of Exposure Draft

Approximately 5500 copies of the exposure draft were distributed to a widespread, heterogeneous group, which included all presidents of companies listed on the New York Stock Exchange, a sampling of presidents of companies listed on other exchanges, co-operating industry associations, representatives of governmental regulatory agencies, deans of schools of business administration, state CPA society officers, selected AICPA committee members, and others. After allowing more than two months for comments, the subcommittee had several meetings to discuss the comments, determine the changes that should be made, and prepare a revised draft for study by the Board. The revised draft and a summary of the exposure comments were discussed by the Board at its October meeting, and additional changes were made to reflect the positions agreed upon. The opinion was unanimously approved by the Board earlier this month.

My purpose in offering this step-by-step description of the development of this opinion is to give you an idea of the effort that went into its development. I want you to be aware of the painstaking procedures that were designed to ensure the acceptance of the opinion—research, point outlines, industry meetings, drafts, exposures, and final opinion. This methodical, group-effort approach is essential to the development of accounting principles.

Concern Demonstrated by Business

In developing this opinion, a most encouraging feature was the substantial interest demonstrated by the business community. Almost 300 letters of comment on the exposure draft were received, the greater portion of which were from business corporations, industrial and trade organizations, consulting actuaries, and insurance companies.

Far more impressive than the number of letters received was the quality of the comments. From the content of the letters, many of which were from three to eight pages long, it was obvious that the exposure draft had been studied intensively. In most letters the comments not only set forth the writer's view on particular points but also gave constructive suggestions for improving those points and others in the opinion.

A copy of every comment letter was sent to each Board member and the Board itself was furnished with a summary of the comments on each major point. Primarily from the suggestions or comments in the letters arose the changes reflected in the final draft of the opinion over the exposure draft.

One other important point about the comment letters is that many came from corporate officials not directly concerned with accounting matters within their companies. This fact confirms my feeling that many executives have a substantial interest in the development of accounting principles. Their concern, it appears, is increasing. For this reason, I would urge each of you to discuss this opinion with your clients at an early date, because some important changes in their method of accounting for pension costs may be required.

Differences of Opinion

While Opinion No. 8 will serve to narrow differences in accounting for the cost of pension plans, it does not require all companies to account for these costs in precisely the same way. All members of the Board believed that the entire cost of benefit payments ultimately to be made should be charged against income. But honest differences of opinion existed among the members of the Board, as well as among other participants in the deliberations, concerning the best measure of cost. The different viewpoints deemed reasonable are set forth in paragraphs 12 through 14 of the Opinion. The Board concluded that "in the light of such differences in views . . . the range of practices would be significantly narrowed if pension costs were accounted for at the present time within limits based on Paragraphs 12, 13, and 14." In general, these limits require that the minimum annual provision for pension costs should be the total of normal cost and interest on any unfunded prior service cost, plus, if necessary, an additional amount so that all vested benefits will be covered within a reasonable period of time.

The maximum annual provision is the total of normal cost, 10% of any past service cost, and interest equivalents on the differences between provisions and amounts funded. The 10% limitation on past service cost is considered necessary to prevent unreasonably large pension provisions during a short period of years.

I should point out that the minimum accrual required by this opinion is significantly higher than the minimum accrual requirement set forth in ARB No. 47 because, regardless of other factors, normal cost and interest on past service cost must be provided each year. Also, in contrast to some of the Board's opinions, where but one rigid treatment was deemed acceptable despite significant differences of views, the opinion on pensions gives recognition to the existence of honest differences of opinion concerning the best measure of cost. The approach taken was designed to narrow the range of acceptable practice and at the same time to improve the level of practice.

SEC

There are those who suggest that if the Board does not move with greater speed in the development of generally accepted accounting principles, the Securities and Exchange Commission will exercise its authority to promulgate rules and regulations governing accounting practices for companies under its jurisdiction. Those who expound this suggestion point to two recent actions of the SEC. One was the issuance in December 1965 of *Accounting Series Release No. 102,* which specifies the balance-sheet classification of deferred income taxes arising from the use of the instalment method of reporting gross profit for income tax purposes. The other was Chairman Cohen's pronouncements concerning so-called conglomerate companies. He has suggested including in their financial statements information concerning the results of operations in each of their distinct lines of activity.

I do not view these recent happenings as indications that the SEC has decided to take a more forceful hand in the development of accounting principles. From its inception, the Commission has avoided setting requirements of strict uniformity in accounting, in matters either of classification or of principle. This policy was reaffirmed as recently as May 1966 by Chairman Cohen in an address before the Nineteenth Annual Conference of the Financial Analysts Federation.

ASR No. 102 was issued as a result of a petition filed by an accounting firm. Otherwise, the SEC might have waited for the Accounting Principles Board's recommendations concerning the classifications of deferred income taxes. This matter is rightfully a part of the broad subject of allocation of income taxes now under consideration by the Board.

Conglomerates

Concerning conglomerates, I understand that the SEC's consideration arose principally out of hearings conducted by Senator Philip A. Hart's Subcommittee on Antitrust and Monopoly. I might say also that the Commission, in line with its long history of close co-operation with our profession, referred to the Institute the question of the adequacy of disclosures made by conglomerate corporations. Although this matter is by no means settled, the Institute has made some preliminary studies and has formed certain summary conclusions. The Institute Committee on Relations with the SEC and the New York Stock Exchange held a series of meetings with representatives of the Exchange, the SEC, the Financial Executives Institute, and the Financial Analysts Federation to obtain the views of those interested groups. The Committee reported its findings and recommendations to the APB at its meeting in September of this year. The Board reasserted its responsibility for determining the need for disclosure in basic financial statements presenting the over-all results of business activities, but concluded that the disclosure of additional information breaking these results down by segments of a business is not necessary for fair presentation of financial position and results of its operations. The Board also concluded that it is not presently in a position to assess the extent to which such additional information is necessary, useful, or desirable for the purposes of financial analysts, governmental agencies, or others, and that intensive study will be necessary to determine these points. After this study has been made, the Board will express an opinion on the feasibility and methods of presentation of such information.

GOVERNMENT AGENCIES' LIMITED JURISDICTION

It is true that the SEC, as well as Internal Revenue Service and other governmental agencies, has played an important part in the development of generally accepted accounting principles, and I should expect these agencies to continue to make important contributions in this area. But I doubt that any single government agency would be in a position to assume total responsibility for the development of accounting principles, even if we were to accept the premise that accounting can be reduced to rigid rules. First, all such agencies have limited jurisdiction. Although the SEC has considerable influence over many of the larger companies in this country, there are countless other entities that do not report to the SEC. What body, then, would be responsible for guiding the accounting and reporting practices of this presently non-reporting group? Second, I doubt that an agency of the government could react any faster than the APB to changing business conditions that give rise to the need for new accounting rules. Rulings or opinions would have to be received on new accounting questions in sufficient time to allow financial information to be furnished to shareholders on a timely basis. Typical of the problems that could arise in this respect is the difficulty Comsat has experienced in getting approval, from the Federal Communications Commission, of the accounting methods the company is proposing to follow.

PROGRESS

Those who suggest that the Board is not moving fast enough in its effort to narrow differences in corporate reporting practices should consider the Board's activities in recent months and some of its plans for the immediate future.

The Board has held five meetings of two to three days each since January 1 of this year and has scheduled similar meetings at six-week intervals to the middle of 1967.

In May 1966, Opinion No. 7 on *Accounting for Leases in Financial Statements of Lessors* was published. In addition to developing the pension opinion that I discussed earlier, the Board has approved exposure of an omnibus opinion dealing with several matters not believed to be controversial and of an opinion on reporting results of operations, which should make a significant contribution toward narrowing differences in the reporting of extraordinary or special items in statements of income and retained earnings. Opinions on allocation of income taxes and price-level financial statements are nearing the exposure stage. An opinion on the nature and objectives of financial statements has been given considerable attention. Subcommittees are working on opinions on treasury stock and regulated industries.

Several research projects are currently in progress. Among them are foreign investments, intercorporate investments, goodwill and business combinations, research and development costs, materiality, and problems unique to extractive industries.

It seems to me that this level of activity is indicative of the Board's strong desire to narrow differences in corporate financial reporting as quickly as reasonably possible.

ACCOUNTING PRINCIPLES BOARD RESPONSIBILITY

I continue to regard the Institute, through the Accounting Principles Board, as the organization that should be responsible for leadership in the development of accounting principles. The Institute, through its staff and membership, has access to a vast store of knowledge and experience that can be directed toward finding acceptable solutions to accounting problems. My firm devotes, and will continue to devote, thousands of man-hours each year in furtherance of the work of the

Institute. I know that other firms and individuals make comparable contributions.

We must be aware that our rapidly changing world will continue to bring evolution of new business practices requiring new accounting treatment for us to develop. I have a source of pride in the considerable progress made by the Institute in the past 35 years. Although there will always be room for improvement, I believe financial reporting in the United States today is the best in the world.

In the APB we have a sound organization for the development of accounting principles. Its concepts and procedures will meet our changing needs. With the co-operation of business, educators, the SEC, and other interested groups, the Board can move quickly ahead to narrow still further the unjustified variations in corporate financial reporting.

The task will not be easy, but, given a fair trial, this plan will lead to orderly progress.