1964

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Recommended Citation
Haskins & Sells Selected Papers, 1964, p. 013-022

The Accounting Principles Board and Prospective Developments in Accounting Principles

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Presented before the University of Southern California College Accounting Educators Conference, Graduate School of Business Administration, Los Angeles—February 1964

IT IS a pleasure for me to participate in this discussion with Maurice Moonitz who has contributed so substantially to accounting thought. The fact that the Moonitz-Sprouse study of broad accounting principles was not accepted by the Accounting Principles Board does not reflect on the quality of his work, but rather results from a lack of reconcilement of presently accepted principles with those proposed by him. Nor should he be criticized for this, since he was not charged by the Board with the rsponsibility for such reconcilement. The Board now recognizes the need for reconcilement and is cataloging existing practices as a background for a comprehensive statement of principles to be followed in the future. Everyone here I am sure is interested in the further development of accounting principles. I think we all see the need for a comprehensive statement of principles. Several attempts to develop one have failed, but that is no reason why we should not succeed in the future. I, for one, think we will succeed.

There are many interesting and challenging approaches to the development of accounting principles. One concerns the role of the Institute and the philosophy of its leadership in advancing the written expression of generally accepted accounting principles. In this regard the profession faces a decision that is without question the most important decision in its history—whether to abandon persuasion in favor of compulsion as the basis of our leadership. The issue is clear: Is the profession to persuade or is it to force? Are we to guide or to dictate?

As all of you undoubtedly know, in September last year the Executive Committee of the Institute approved a resolution requesting the Council to declare that upon issuance, a pronouncement of the Accounting Principles Board is generally accepted, unless and until rescinded by Council.

The present Executive Committee recently made some changes in the details of the Resolution, but retained its compulsive effect. The Resolution now proposes that eighteen months after issuance a pronouncement of the Board becomes the only generally accepted accounting principle in the subject area for the purpose of expressing opinions on financial statements, unless Council changes the effective date, sends the pronouncement back to the Board for further consideration, or rescinds the pronouncement. During the eighteen months the pronouncement would have the same status as at present—that is, its authority would rest on its general acceptability in the true sense of the phrase. If Council were to take no action regarding a pronouncement, it automatically would become the only generally accepted practice in the area at the end of eighteen months.

Because the Resolution strikes at the root of how generally accepted accounting principles are to be formulated in the future, my comments will be confined to the Resolution. In my judgment, the arguments against it are overwhelming.

Before giving my objections to the Resolution, I would like to make it clear that I do not oppose enforced compliance from within the profession with pronouncements that receive general acceptance, but I am concerned with how general acceptance is to be obtained and officially recognized. Similarly, my opposition does not arise from any desire to perpetuate a wide range of alternative accounting practices, but rather relates to the means by which the undesirable ones are to be determined and eliminated.

Those favoring the Resolution as well as those opposing it have the same end in mind—the improvement of financial reporting. There is disagreement on the means to that end.

GENERAL ACCEPTANCE vs. COMPULSION

Instead of strengthening the concept of "generally accepted accounting principles," the proposal would undermine and nullify it by substituting an artificial interpretation for the ordinary meaning of the words.

The phrase "accepted accounting principles" evolved as a result of correspondence between an Institute Committee and the New York Stock Exchange during 1932 to 1934. It is clear that "accepted" was intended to mean exactly what the word itself implies in this context, namely, approval by those concerned with financial statements and use in a reasonably inclusive manner. In 1939, the Committee on Auditing Procedure recommended adding the word "generally" to the phrase thus making it clear that acceptance was required to be construed broadly rather than narrowly.

Blanket authority for all future Board pronouncements patently contradicts the meaning given to the phrase "generally accepted" by the profession for many years, as well as the ordinary meaning of the words. All of us involved in accounting have at one time or another been criticized because our terminology has not always been meaningful to the non-accountant. We are deserving of this criticism if we distort the ordinary meaning and common usage of the phrase "generally accepted." In my opinion, the use of a perverted meaning for the phrase raises a question of intellectual integrity.

The proposal is not forthright in requiring an opinion as to conformity with Board pronouncements. It attempts to do this indirectly by pre-empting the phrase "generally accepted" for Board pronouncements.

The authority of the Accounting Principles Board cannot extend beyond the Institute membership. An artificial interpretation of the words "generally accepted accounting principles" cannot apply to such words when used in statutes, regulations, indentures, or corporate contracts. This could mean a double standard for opinions in certain situations. The Resolution recognizes a double standard in permitting an opinion based on "generally accepted accounting principles" within the meaning of that term in applicable statutes, regulations or contracts, provided any departure from a Board opinion is disclosed and the two meanings of "generally accepted accounting principles" are explained. Is it possible for such an opinion to be meaningful to a non-accountant?

The Resolution would introduce further confusion into accountants' opinions by separating the fairness of presentation of financial statements from their conformity with generally accepted accounting principles. Without standards for fairness, there would be a downgrading of opinions.

Any attempt to define generally accepted accounting principles without recognizing acceptance by managements of business concerns is empty and meaningless. Management is primarily responsible for the preparation of financial statements. Management's acceptance of an accounting principle, therefore, is absolutely essential before anyone can even begin to label it as generally accepted.

We should also bear in mind the psychological reaction of management in this country to efforts to enforce "acceptance" of a principle. Acceptance strongly implies favorable reception and voluntary assent. Most businessmen today are extremely competent and intelligent and they are anxious that their financial statements fairly reflect the condition of their companies. Their acceptance of a principle can be obtained only by the reasonable exchange of ideas and through intelligent, well-thought-out persuasion, such as has established recognition and respect for pronouncements of the Committee on Accounting Procedure.

Sir Anthony Eden once said, "Nothing is more destructive of human dignity than a rule which imposes a mute and blind obedience." Similarly, I believe that nothing would be more destructive of our professional dignity than Board pronouncements that attempt to impose strict adherence by compulsion. Persuasion, evolution, and education have been the foundation of the profession's leadership in accounting matters. These cornerstones have been affirmed and reaffirmed by Institute groups on a number of occasions: by the former Committee on Accounting Procedure, by the Accounting Principles Board, and even by Council itself.

The Institute has obtained compliance with its views by persuasion, and four years ago restated its faith in that concept. Its influence and stature have been derived over the years from patient, reasoned, and dedicated thought. As I see it, a sound accounting practice does not need the force of rule to become accepted; and a bad practice cannot be made sound no matter how much compulsion is attached to it.

AUTHORITARIAN POSITION FOR THE BOARD

The Accounting Principles Board was not designed to accept compulsive authority. Its force was inherited from the dedication of its predecessor, the Committee on Accounting Procedure. The Special Research Committee, which recommended the founding of the Board, recognized that leadership was necessary to communicate effectively the facts about this complex and constantly changing economic system and that the best way to lead was through persuasion.

In commenting on Accounting Research Study No. 3, the Board stated: "Accounting principles and practices should be adapted to meet changing times and conditions, and, therefore, there should be experimentation with new principles and new forms of reporting to meet these conditions." The laboratory for such experimentation must be business itself. An important part of the Board's task is to evaluate the testing of accounting theory in actual business situations. This is a broad, forward-thinking and, to a certain extent, experimental type of program. Anything that smacks of compulsive authority is completely incompatible with both the purpose and the structure of the Board.

The weight of compulsive authority would deter the Board from issuing pronouncements when the business community and the profession need guidance. Compulsive authority often results in no leadership. Prudent men hesitate to exercise sweeping power. If the Board were to confine its pronouncements to principles that have gained general acceptability, it would certainly avoid difficulties, but would make little or no progress. If the Board, in a pronouncement, were to get ahead of current reporting practices in an attempt to lead the profession and the business community, it could stir up unnecessary conflict and discord within the Institute and between all other interested parties. Compliance could not be enforced on management, and there might be no change in reporting practice—the end sought by the Board. The pronouncement would simply result in a rash of qualified opinions, required by mandatory compliance, even after an eighteen month delay. Business concerns would be placed in an intolerable position. Users of financial statements would be thoroughly confused. Loss of stature for the Board and the profession would be inevitable.

DEVELOPMENTS LEADING TO THE RESOLUTION

The developments leading to the Resolution had their start only a few years ago with public expressions, mainly from within the profession, of dissatisfaction with the progress that was being made in developing accounting principles and in eliminating undesirable practices. Differences in accounting practices were being spotlighted as if all of them were unwarranted. Claims were being made that conditions were changing right out from under accountants and that accountants were laggard in not recognizing the effect of price-level changes, the substantive nature of certain long-term leases, the effect of differences between book income and tax income, and other similar matters. On occasion the criticism intemperately implied failure to accept responsibility and the condoning of unfair presentations of financial information.

The reaction by certain segments of the public was not surprising. Individuals generally uninformed as to the complexity and diversity of the circumstances of business began to say that accounting practices were inadequate and misleading, for after all they were being told by accountants themselves that this was so. As a result there developed some pressure, which was voiced in the press, to do things one way in accounting.

During this same period the Institute was reorganizing itself to advance the written expression of generally accepted accounting principles. The Accounting Principles Board was formed to strengthen the persuasive influence of the profession in eliminating undesirable practices, and the research arm was created.

It was recognized, too, that the order of attention to these matters was important. Postulates were to come first; the principles next, building on the postulates; and the rules last, building on both the postulates and principles.

This order soon became somewhat disarrayed. The postulates study was issued fairly soon (in 1961) after the program got under way. About seven months later the principles study was issued. The profession responded somewhat passively to the postulates study, but strong criticism was generated by the principles study. The Board commented on these two studies to the effect that, although they are valuable contributions to accounting thought, they are too radically different from existing generally accepted accounting principles for acceptance at this time.

THE TAX INVESTMENT CREDIT

It was in this setting that the Board took up its consideration of the investment credit. The Board was considering a new situation and was attempting to devise an accounting rule without a consensus as to co-ordinated basic accounting principles, and was doing so when there was some restiveness to do things one way in accounting.

Strong, opposing views soon developed in the Board. Basic concepts of cost determination and expense recognition were not sharply enough defined to provide only one answer as to the nature of the investment credit.

So an additional issue arose. Should there be only one way to account for a matter when the basic concepts seem to support each of two ways, or should there be equally acceptable ways, with adequate disclosure, until the basic concepts have been resolved?

As is well known, the majority of the Board, a bare majority, decided that there should be only one way, and accordingly the Board issued an opinion that rejected the so-called 48-52 method in favor of the full-deferral method. The Board issued Opinion No. 2, therefore, when it was well known that its recommendation did not have exclusive acceptability. It did so in the face of a study by the Director of Research supporting the 48-52 method, strong support for the 48-52 method by numerous practitioners, business concerns, and teachers, as well as by the Securities and Exchange Commission.

Issuance of Opinion No. 2 did not bring about exclusive acceptability of the full-deferral method. Soon after issuance the Securities and Exchange Commission stated that it would accept either the full-deferral method or the 48-52 method. In addition, many business concerns adopted the 48-52 method, and only two qualified opinions in this regard have come to my attention.

Many accounting firms passively withheld their support of the Opinion by accepting the 48-52 method on the ground of immateriality, and accordingly gave unqualified opinions.

My firm opposed in principle the Board's position on the investment credit; nevertheless our position with respect to the pronouncement was and is the same as that taken with respect to all predecessor pronouncements, including the accounting research bulletins. This position is that we support them unless it becomes clear that a pronouncement lacks general acceptance. The full-deferral method of accounting for the investment credit did not win exclusive acceptability. My firm, accordingly, took the position called for in the stated basis of the issuance of all Board opinions, namely that both the full-deferral method and the 48-52 method were generally accepted.

Those who favor the Resolution contend that the experience with the investment credit demonstrates the need for the adoption of the Resolution. This is nonsense.

If there is a feeling that the full-deferral method should be made mandatory, this can be done by obtaining Institute membership approval of the Opinion—the present rules are adequate to do this.

If the concern is that some accountants withheld support of the pronouncement by asserting their conviction that it had not won exclusive acceptability, it should be borne in mind that almost all practicing accountants withheld support of Opinion No. 2 in one way or another.

The fact of the matter is that Opinion No. 2 was a bad pronouncement. Through it the Board attempted to force one-way accounting. The Board simply did not act with prudence in this matter.

STATUS OF EXISTING PRONOUNCEMENTS

Those who favor the Resolution argue that at present it is impossible to discover what principles are generally accepted and that the adoption of the Resolution will solve that problem. This argument is naïve. It certainly will not lead to the development of a written statement of basic accounting principles any more rapidly than under the present authority. Practically all of the Accounting Research Bulletins Nos. 43 to 51 would now be conceded by most CPAs to be generally accepted so that nothing would be added to their effectiveness.

These circumstances clearly demonstrate that the profession is capable of distinguishing unsound pronouncements from sound ones, and that there is no urgent need to buttress the latter with compulsive authority. Consequently, I believe the profession's urgent need is for the Board to concentrate its efforts on the further development of sound pronouncements as a means of continuing the improvement in financial reporting.

If there is a need to label accounting principles that are "accepted" it should not be done by the small group that created the principle, but rather a body such as the Institute Council should examine the evidence of practice and, if satisfied, pronounce a principle accepted, not just sit back and passively allow it to achieve that status automatically as called for by the Resolution.

CONTINUING IMPROVEMENT IN FINANCIAL REPORTING

Some claim that progress in improving financial reporting has been too slow; that leadership through persuasion has not worked; and that something new must be tried.

I cannot agree with these contentions. They play down the significant improvement that has been made in financial reporting over the past thirty years. The fifty-one pronouncements of the Committee on Accounting Procedure have importantly affected accounting theory and practice. Many important broad principles have become recognized as universal as a direct result of those pronouncements. Financial reports in the United States are the best in the world. Of course, there is still room for improvement. I suggest that we retain the philosophy of general acceptability which has contributed to this superiority and move forward toward additional improvement.

Early in its career, the Committee on Accounting Procedure, formed in 1938, discussed the desirability of preparing a comprehensive statement of accounting principles. The committee rejected the idea because it would have taken a very long time before any such statement could be agreed upon. Furthermore, at that stage of accounting development it was felt that it was not feasible to construct a body of principles sufficiently comprehensive to solve very many accounting problems. The committee decided, therefore, to deal with specific areas.

Again, in 1949 and 1950, the feasibility of preparing a comprehensive statement of principles was considered by the committee. But it was abandoned in favor of a restatement of previous bulletins.

The Accounting Principles Board has taken on an assignment that has been attempted twice before but never accomplished. It is a big job and it is not easy. Anything as comprehensive and worth while as a statement of the basic postulates and broad principles of accounting will require deep deliberation and extensive discussion in order to create a useful constitution for accounting. We cannot expect overnight results. At the same time, we should not become discouraged because the road to accomplishment is winding, hilly, and difficult to travel. We should accelerate our efforts to eliminate undesirable accounting practices and to narrow areas of unwarranted differences in financial statements. If we attempt to speed up the process unduly by force, our effectiveness soon would become lost in discord, controversy, and the mistakes of hasty action.

All of us hope to achieve maximum comparability. It is achieved with uniformity of basic principles, and with variability of their application only to the extent necessary to fit the conditions. An accounting practice that does not fit the conditions and that obscures differences surely will mislead. This is the real danger in the one-way, right-or-wrong, approach to accounting. The condoning of a one-way, cook-book approach to accounting, while being fully cognizant of its misleading implications, is incompatible with the intellectual integrity inherent in professional thinking.

There will be occasions when it will not be clear as to the application that fits a set of conditions, such as was true in connection with the accounting for the investment credit. For a time, therefore, equally acceptable alternatives may exist. Then disclosure becomes a powerful tool for comparability. During the interim the basic principles should be reexamined to determine whether they should be sharpened so as to eliminate one of the alternatives. This is the orderly way.

The accounting profession must simultaneously advance on several fronts in order to accomplish its purposes:

1. We must renew our efforts to formulate a statement of the basic postulates and broad principles of accounting. This is the constitution that the Board needs to avoid the issuance of arbitrary pronouncements on isolated matters. Like the statement of generally accepted auditing standards, the statement of accounting postulates and principles should be approved by the membership of the Institute. Then Board pronouncements would be interpretations of the constitution and general acceptance should follow almost as a matter of course.

2. We should strive for an early completion of the inventory of current practices and identification of the areas of evident differences in practice. This will lead to an examination of alternative accounting practices and the circumstances surrounding them. If differences in practices seem not to be supported by differences in circumstances, the profession should move with dispatch to narrow the differences. This inventory should prove helpful in evaluating the statement of postulates and principles. It is always useful to test the experimental and untried against that which has been in use for a period of time. This process of comparison highlights the practical strengths and weaknesses of both the new and the old. On balance, it should bring about the formulation of a useful workable set of basic postulates and co-ordinated broad principles of accounting.

3. All members of the profession should work toward the education of the public on the significance and limitations of financial statements. We should point out the usefulness of disclosure as a means of improving the comparability of financial statements of business concerns that operate in dissimilar circumstances. This should help to eliminate any public confusion concerning the inherent complexities of accounting information.

It will also overcome any belief that financial statements and the understanding of them can be made simple by a set of rules that would be binding on all businesses. The concept that all knowledge about a company can be derived from one figure, earnings per share, is dangerous. We have not done enough to combat this illusion.

CONCLUSION

Everyone in the accounting profession believes that our goal should be to advance the written expression of generally accepted accounting principles. We must continually attempt to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. Our disagreement hinges on the means to that end, not the end itself. I believe that the original charge to the Accounting Principles Board can and will take us to our goal. I believe that persuasion will get us there and that compulsion will not. Patience and reasoned thought are effective in gaining acceptance of meaningful presentations of financial information; decree and arbitrary action soon lose their effectiveness in discord.

Robert Browning wrote,

> "The great mind knows the power of gentleness,
> Only tries force, because persuasion fails."

Persuasion has not failed, but has served us well. Let us not discard it but rather let us try to be great minds influencing accounting evolution through education and persuasion.