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Accounting Theory: The Cornerstone of Our Profession

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All accounting activity is supported by a strong cornerstone of accounting theory. The purpose of this article is to review some current trends related to theory that may be helpful to all accountants.

Bulletins and Opinions

In October, 1964, the Council of the American Institute of Certified Public Accountants met to consider one of the most important matters ever brought before it. The Council heard the report of a special committee which recommended essentially that departures from Opinions of the Accounting Principles Board and from Accounting Research Bulletins issued by the former Committee on Accounting Procedure be disclosed either in footnotes to financial statements or in the accountants' report itself. Disclosure is effective for fiscal years beginning after December 31, 1965.

It may be well to interject here a comment on the composition of the Accounting Research Bulletins and Opinions mentioned in the Committee's report. There are 51 Accounting Research Bulletins, and they were issued from 1934 to 1959 by the AICPA's Committee on Accounting Procedure. The Accounting Principles Board has issued six Opinions since it succeeded the Committee on Accounting Procedure. Both the Accounting Research Bulletins and the Opinions discuss specific areas of accounting theory, give the pros and cons of alternative accounting techniques, and usually state a preference for one method over another.

Another pertinent comment would be that, up to this time, pronouncements on accounting principles issued by the Accounting Principles Board were not binding on AICPA members as long as the members had substantial authoritative support for other practices. Thus, the pronouncements had limited authority.

The recommendation of the Committee concerning departures was unanimously adopted and distributed to members of the Institute via a Special Bulletin. This action moved accounting theory and uniformity of accounting principles forward at least one decade.

Consider once again what this Special Bulletin says: Disclosure must be given, either in footnotes to financial statements or in the accountants' report, of departures from Opinions of the Accounting Principles Board and from Accounting Research Bulletins. It does not say that accounting *must* be done in the Institute's way, only that if there is a deviation, the public must be informed of it and its effect on income. Of course, if the deviation is too original and does not have substantial support in practice, the CPA's report will probably contain an exception. A discussion of that problem is beyond the subject at hand.

The action by Council in issuing this Special Bulletin has an effect on each one of us—whether we work in private industry or are in public practice. First to be determined is what the Opinions and Accounting Research Bulletins say; next, whether any of our accounting practices, or those of our clients, are in violation of the Opinions and Accounting Research Bulletins; and then, if they are, what we are going to do about them.

After the Opinions and Accounting Research Bulletins are read, one thought will surely come to mind. Many of them cite several acceptable methods for doing things. For instance, the Bulletin on inventories permits use of *lifo*, *fifo* or average cost. Pensions may follow the cash or accrual basis.

It is the thought of the APB, however, that as studies in depth are completed, opinions will be issued which favor only one acceptable accounting practice in any given fact situation. This then will tend to promote the comparability of financial statements. One can readily see that the effect of the Special Bulletin will have an even greater influence in the future.

The Accounting Principles Board or APB, as it is most generally called, was established in 1959 with the following objective:

> ". . . 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."[1]

The majority of the Board's 21 members are prominent accountants in public practice whose knowledge of the practical aspects of accounting and reporting are unquestioned, while the minority are equally qualified members from industry, government, and the universities.

Since the APB generally holds three or four two-day meetings each year, the research and preparation of background material must be done by the Accounting Research Division of the AICPA.

This Division is composed of a Director of Research and several Research Associates who work on various projects assigned by the APB. The Division has recently added an Administrative Director in order to speed up the production of "work in process." Also, the Division from time to time makes use of outside consultants.

The relationship between the APB and the Accounting Research Staff is well-described by Reed Storey, Director of Accounting Research, in his book, *The Search for Accounting Principles*.[2] The procedure would approximate the following:

1. A problem exists, and the Accounting Research Division is instructed to prepare a study.
2. The author of the study is counseled by a project advisory committee.
3. The Study is published, and comments are encouraged.
4. The APB considers the Study recommendations, and either adopts them through the issuance of an Opinion, or adopts its own Opinion contrary to the recommendations of the Study. In two instances, the APB Opinions adopted were contrary to the Study recommendations.

It might be well to point out that not all Opinions emanate from Studies. Opinions 1, 2, 4 and 6 are in this category. Opinion 6, *Status of Accounting Research Bulletins* (*Journal of Accountancy*, November 1965, p. 54) is the outgrowth of the Council's instructions last October to review prior to December 31, 1965, all Bulletins ". . . . and determine whether any of them should be revised or withdrawn."

Formulation of Theory

As must be apparent, the formulation of accounting theory, as contained in the Institute's Opinions, is rather well-structured. There is one way, however, in which we can have a part, and that is by reading the Studies, discussing them with others, and notifying the APB of our feelings. This awesome group cannot make decisions in a vacuum, and we can help to fill some of the "empty spaces."

Recent Studies

To give an idea of what some of the Accounting Research Studies (ARS) are like, the following is a brief review of numbers 6, 7, and 8, the most current ones published, none of which has resulted in opinions as yet by the APB.

ARS 6, *Reporting the Financial Effects of Price-Level Changes,* was written by the Staff of the Accounting Research Division, and published in October, 1963. In 1961, the APB had passed a resolution which said ". . . the assumption in accounting that fluctuations in the value of the dollar may be ignored is unrealistic, and that . . . the Director of Accounting Research . . . set up a research project to study the problem . . ."[3] This Study is the result of that direction. Considerable attention by accountants was focused on the price-level problem in the early fifties because of the very rapid inflation in our country following the Second World War. The American Accounting Association in 1951 recommended that price-level adjusted statements be used to supplement primary statements, and several such reports were prepared as an outgrowth of their study.

The only statement by the AICPA during this period which touched on the area of price-level adjustments was a reaffirmation of its position that depreciation be based solely on historic cost.

ARS 6 carefully defines what is meant by price-level changes and, just as importantly, what is excluded from the term. Price-level changes, as used in this study, do not include replacement costs or changes in the relative market position of the individual item. Price-level changes do mean, however, changes in the general purchasing power of the dollar that occur during a period of inflation or deflation.

The Study recommends that supplemental information recognizing price-level changes be included in reports to management, stockholders, etc. It does not recommend that price-level adjusted statements replace those based on historic costs.

Supplemental information may be given in several ways:

1. Parallel columns showing price-level adjusted information, along with the financial statements themselves.
2. A second set of financial statements using completely or partially adjusted data may be included, along with those based on historic costs.
3. Commentary, complete with charts and graphs, may give the impact of price-level changes without disturbing the conventional financials.

Needless to say, each of these presentations has advantages and disadvantages in any given set of circumstances.

There are several valuable appendices to the Study itself. The first, by Cecilia Tierney, deals with the Index Number problem, a problem that has stumped accountants in years past. The next is a demonstration of the adjustment technique which could be followed as

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a guide to developing price-level adjusted statements. Also included is a section containing examples of price-level adjustments appearing in published financial statements.

The Study will be a good starting point for anyone interested in understanding the price-level problem, but it is a subject which requires complete concentration on the reader's part.

The Accounting Principles Board is continuing its consideration of the Study, but acceptance of price-level adjustments will depend to a great extent on future changes in the value of the dollar.

ARS 7 is *Inventory of Generally Accepted Accounting Principles for Business Enterprises* by Paul Grady. This was published in March, 1965, and is just what the name implies—an inventory comprised of AICPA pronouncements and selected SEC Accounting Series Releases. Continuity is given to the many quotations by using frequent excerpts from *Montgomery's Auditing.*

The Study defines accounting in a manner that includes a broader range of activities than had previously been considered part of the accounting definition.

> "Accounting is the body of knowledge and functions concerned with systematic originating, authenticating, recording, classifying, processing, summarizing, analyzing, interpreting, and supplying of dependable and significant information covering transactions and events which are, in part at least, of a financial character, required for the management and operation of an entity and for the reports that have to be submitted thereof to meet fiduciary and other responsibilities." [4]

A word-by-word comparison would be impractical here, but there are significant ramifications to a definition this broad. We, as accountants, indirectly take on greater responsibility as the "accounting" definition itself is extended.

As you know, AICPA material and SEC Accounting Series Releases have always been catalogued in a sequential manner according to issue date. The material in ARS 7, however, is grouped by general topic. For instance, chapters are devoted to income and expense, equity, assets, liabilities, financial statements, etc. For this reason, the Study should be particularly helpful to the student of accounting, as well as to anyone in practice who is concerned with one particular aspect of accounting theory.

A committe of the APB is considering some of the chapters of the Study with a view to issuing brochures on the objectives of financial statements and the concepts underlying financial accounting. These brochures may help to create better understanding by nonaccountants of what financial statements are intended to be and do.

Accounting Research Study 8, *Accounting for the Cost of Pension Plans,* released in May, 1965, was written by Ernest L. Hicks, a partner of Arthur Young & Co. It is not only the most recent study published, but also that which has the most practical application for most accountants.

Before an analysis of the Study, consideration should be given to the two terms used whenever pensions are discussed. They are current or normal costs, and past service costs.

Normal costs are those costs which result from work this year, when the plan is in effect. There will be normal costs next year, based on next year's work, and so on, into the future.

Past service costs are those costs based on work done by employees in years prior to the adoption of the plan. Both normal and past service costs are usually determined by actuaries.

Mr. Hicks began ARS 8 by reviewing current accounting practices for pension costs; he found they took several forms:

1. The recognition as expense of only the current service costs, and ignoring past service costs.
2. The recognition as expense of the current service costs and interest on the unfunded past service costs.
3. The recognition as expense of the current service costs, and a portion of the past service costs.

With all of these practices considered to be "generally accepted," is it no wonder that a Study was needed?

The Study states that proper accounting for pension cost hinges on the timing of charges to expense. What the proper timing is, of course, depends upon the type of pension plan under consideration.

According to the Study, pay-as-you-go plans, with the expense recorded only when the payment is made to the pensioner, approximate the cash basis of accounting and are unacceptable for accrual systems.

The terminal funding method, with the expense recorded only when a lump-sum annuity is purchased, also approximates the cash basis, and therefore, according to Mr. Hicks, is also unacceptable for accrual systems.

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The last type of plan, the defined benefit plan, is one which is usually funded through periodic payments to a trustee, and the company's expense is recorded annually, based on an actuarial cost method. There are several actuarial cost methods which may be used that properly reflect the expense on an accrual basis.

The problems connected with defined benefit plans are usually centered on the amount of past service costs that exist when a plan is adopted. Depending on the ages of the employees and their lengths of service with the company, the amount of past service costs for a relatively small company can easily exceed a million dollars.

Current reporting practice of pension matters is to incorporate in the financial statements or their notes, the amount of pension costs in expense, the amount of unfunded prior service cost, the basis for funding such cost, and a brief explanation of any changes to the plan.

Mr. Hicks suggests that if the recommendations of the Study are adopted, the range of accounting practices will be limited, and therefore disclosure may be diminished. Significant changes to plan, however, which have an affect on pension expense, will continue to be disclosed.

Adoption of the Study's recommendations will create problems of implementation in the year of transition. It is suggested by the Study that a determination be made of the cumulative differences between previous accounting methods and the recommended ones and that the cumulative effect between methods, net of tax, be charged preferably to prior periods or to future ones.

ARS 8 also contains helpful information in the Appendices. One deals with the socioeconomic aspects of pensions, while another deals with actuarial techniques. The actuarial material serves as a sound introduction for an accountant who is uninformed in this area. Pensions are an important part of our business economy today, and it is imperative that each of us be aware of the information in this Study. Incidentally, it is written in quite a readable manner.

Studies in Preparation

Presently in preparation are studies dealing with the following topics: Income Taxes in Corporate Financial Statements, Foreign Operations, Intercorporate Investments, Goodwill and Business Combinations, Product Research and Development Expenditures, Extractive Industries, Materiality, and Income and Retained Earnings. The Accounting Research Division obviously has a rather ambitious program under way.

It is important to emphasize that Accounting Research Studies 6, 7, and 8 have not been approved, disapproved, or otherwise acted on by the Board, the membership, or the governing body of the Institute. They are published to stimulate thought and discussion on important areas of accounting.

Conclusion

To this point the center of discussion here has been the Institute's Special Bulletin requiring disclosure of departures from APB Opinions, the organization and structure of the APB and the Accounting Research Division, and three of its latest studies. The reader may ask why we should be concerned about these activities, but it isn't necessary to say that it has been rather fashionable in the past few years or so, to take pot-shots at accounting, accounting theory, and accounting principles. Some of the criticism has been justified, and some has not. At any rate, the AICPA through its APB and its Research Division has worked diligently to clear up the faults it found.

The efforts just described here are only a small part of the effort that has been expended. But the responsibility is not theirs alone. We, individually and as an organization, can no longer stand back and be observers. The written expression of accounting principles which is being developed affects us, no matter what our area of responsibility. Accounting theory serves as a cornerstone on which our profession is based. We must take an interest in its development, have knowledge of its perimeters, and most certainly contribute to its development.

References:

[1]Reed K. Storey, *The Search for Accounting Principles* (New York: American Institute of Certified Public Accountants, 1964), p. 55, citing *Organization and Operation of the Accounting Research Program and Related Activities* (New York: American Institute of Certified Public Accountants, 1959), p. 9.

[2]Storey, p. 65.

[3]AICPA, *Reporting the Effects of Price-Level Changes* (New York: American Institute of Certified Public Accountants, Accounting Research Division, 1963), p. 1.

[4]Paul Grady, *Inventory of Generally Accepted Accounting Principles for Business Enterprises* (New York: American Institute of Certified Public Accountants, 1965), p. 4.