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SOME SOCIAL ASPECTS OF CONSERVATISM

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No book on accounting is published without mention of the word "conservative" either discussed as a concept by itself or used as an adjective to describe a choice of approach.

Why this reluctance to cast off a frame of reference that is, in its most positive aspect, obstinate, and, in its most negative, cowardly? I fear that it is because it is one of the bricks in Chambers' "wall."[1] To him, "The erection of any wall is, of course, the way to security, personal security. Wall-building is after the manner of fearful people, those who want to hold what they have."[2]

Definition

To judge properly, one must know as much as possible about the subject being judged. What then is "Conservatism"? If we are guided by lexicographers, it is:

> "*. . . the disposition or tendency to be conservative (adhering to the existing order of things; disinclined to novelty or alteration, as of institutions or methods; opposed to change; hence, often, opposed to progress.*"[3]

Others, social psychologists for example, offer alternative ways of defining the term:

> "*The first way is to regard it as an attitude of conformity with one's contemporaries . . . (It is the opinion of the present majority to which the individual adheres.) . . . The second conception of conservatism is that of adherence to the historically established view, or tradition, of the crowd.*"[4]

Conservatism to society is the steadfast maintenance of the status quo. How do members of the profession regard it?

Pros and Cons

Reading Sanders, Hatfield, and Moore today, one is astounded at some of their inconsistent statements on the subject of conservatism. In one breath, discoursing on overstatement and understatement, they assert with finality: ". . . deliberate misstatement in either direction is not to be condoned; . . . ".[5] In the very next breath, they propose just as positively:

> "*With many and substantial exceptions, the more common tendency is to err on the side of optimism in exercising the necessary judgments of accounting; to offset this requires an emphasis on the other side. This policy should be followed whenever it is likely that the tendency is towards overstatement. But when the tendency is in the opposite direction, the accountant should act accordingly and emphasize the more optimistic aspects.*"

This view of conservatism equates it with a subjective attitude that is indisputably biased. To the extent that it is not consistent with our professional concepts of ethics, independence and objectivity, it has no place in accounting.

Professor Robert L. Dixon of the University of Michigan suggests that "The proper role of conservatism in accounting is to insure that the uncertainties and risks inherent in any given business situation are given adequate consideration."[6] To my mind, this is being thorough, not conservative. The accountant or auditor who does not consider the effects of all available evidence in making his judgments is incompetent.

Story[7] found that Stephen Gilman, in writing the most ambitious book of his period (1939), considered conservatism to be one of

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the four doctrines or articles of faith of accounting, the other three being consistency, disclosure, and materiality. I would prefer to substitute objectivity for conservatism, and am inclined to agree with Paton[8] who considered conservatism to be "... The most objectionable and obstructive tradition of accounting . . . ."

Although Moonitz included a discussion of conservatism as an imperative in his Basic Postulates[9], he evidently thought better of it by the time Accounting Research Study No. 3[10] was published. He appears to have de-emphasized conservatism and relied more on analysis, reasoning, and logic. But has he? After a very convincing advocacy of current replacement costs for restating plant and equipment (pp. 32-34) and land (pp. 35-36) in external reports, he seeks to mitigate the probable outcry against doing this for each year, and adds "perhaps every five years". Logical? Consistent? More like conservative.

Conservatism vs. Objectivity

"Subjective" and "objective" are antonyms, as well as attitudes. Conservatism is subjective and involves the conscious striving to eliminate bias, although it does not equate with liberalism. Common sense will tell you that you cannot knowingly be both conservative *and* objective at the same time. John Wagner, Assistant Professor of Accounting at the University of California, Los Angeles, disagrees. In his article on objectivity,[11] he acquiesces that your point of view is determined by the structuring of your mind, and ". . . if the use of the mind connotes 'subjectivity', there can be no such thing as 'objectivity' for human beings." He then goes on to state, however, that "The accounting profession's prime asset is an attribute known as *professional judgment*," and that if we follow the previous reasoning we can't have both objectivity *and* a profession. He rejects the reasoning as being suitable only for commonplace situations—not up to our "sophisticated level".

His conclusion is that the general meaning of objectivity in accounting is a relative absence of perceptual defects in the exercise of professional judgment.

There is no question in my mind that human beings cannot be objective, but the key word in all this rationalization is, of course, "relative". The smaller the degree of bias, the greater the degree of objectivity.

Based on a Report of the Committee on Concepts and Standards—General[12] appearing in The Accounting Review, it appears that the American Accounting Association is also of this view:

> "*Objectivity is social concensus—an event or datum is objective when there is no disagreement or variation in interpretation among all the persons who view it. This is, of course, an ideal: few phenomena are ever reported with complete objectivity, because the conditions, the environment, and the observer's own background will color the interpretations. However, objectivity is not disinterest, independence, or impersonality; some person must be interested and, to some extent, involved with an event or datum to observe it; the degree to which objectivity is achieved depends upon a number of factors.*"

A concomitant of objectivity is integrity— ". . . so much a part of the CPA's (and the accountant's) basic education and training that, to him, objectivity and integrity assume a tangible and dynamic nature."[13] It is difficult to visualize how an auditor (or accountant) to whom the concepts of independence and fairness are ingrained would knowingly select a course of action simply because of its safety. Each of us is subject to unconscious bias, but, bombarded as we are with advice on the subject, we cannot fail to be aware of the pitfalls of conservatism.

Conservatism vs. Consistency

In 1943 George O. May noted[14] that conservatism was once the "cardinal virtue of accounting; now, the virtue of conservatism is questioned, and the greater emphasis is on consistency." Later authors[15] warned that "As in the case of conservatism, however, consistency should not become a fetish, a blind, obstinate opposition to necessary alterations." They recognized that as conditions changed and better accounting methods and techniques became available, improvements were mandatory.

Chambers had this in mind when he quoted "To move forward clinging to the past is like dragging a ball and chain."[16] To select a "conservative" procedure as a matter of expediency (i.e., discount a risk) with the result that the effect in a later period is "non-conservative" is clearly inconsistent as well.

Moonitz also wondered "If experience indicates that profit is overstated in one case out of ten when 'conservative' procedures are omitted. Is this justification for understating it in the remaining nine?"[17] He concluded that it might be, if truly justified.

Again, charging off costs in the current period because of conservatism or doubt as to their recovery would probably result in not matching costs with revenues, thus violating one of the cardinals of accounting.

Objectives of Accounting

Carey's recent book[18] contains some provocative discussion on "What is the practice of accounting?" Citing wide differences of opinion within the profession on objectives and policies in every area, he defines the specific purpose of the profession as supplying needed and wanted economic services.

His three basic premises are that 1) the accounting function embraces the measurement and communication of all financial and economic data; 2) accounting is integrated—it must cover all of management's needs for external reporting and internal planning, control and decision-making; and 3) the attest function can be naturally and properly extended to other areas.

His major theme, echoed throughout today's literature is that the profession must adapt itself to expanding social needs in order to survive. Necessarily, his definition is broad. Although there can be little quarrel about the "need" for accounting services; not so the case with the "wanted". While the accounting function embraces *all* financial and economic data, it must be "dependable and significant"[19] to inspire the want.

Needs of Users

What do the users of accounting services want? Everything, naturally. But fundamentally they want data that is reliable, comprehensive, and meaningful. How can we provide users of financial statements with reliable data if we actively employ two of the criteria[20] of conservatism?: (a) avoid overstating assets even at the risk of understatement; and (b) avoid understating liabilities, even at the risk of overstatement. Moonitz and Staehling[21] offer an amusing, if antiquated, illustration of how deliberate conservatism boomeranged:

> *"The case of one clever businessman is appropos. For years he had been progressively and deliberately understating his inventory valuations in order to reduce his recorded profits and hence his income taxes. At the outbreak of the war, he had a warehouse full of valuable materials carried on his books at a ridiculously low figure. Some Naval procurement officers walked into his warehouse one day and requisitioned the entire supply. The government paid a fair price for the materials taken. This man's recorded profits that year were phenomenal because he had no inventory per books to speak of to charge off as cost of goods sold to Uncle Sam. Income tax rates in his year of reckoning were the highest on record up to that time; the size of his tax bill made him gasp. He had sense enough not to file amended returns for prior years, thereby laying himself open to possible fraud charges. The workings of retributive justice, in cases of this type are gratifying to watch; they were not so gratifying to the ones who 'paid through the nose', as it were."*

This is not a representative example by any means, but had the business man submitted financial statements, and third parties relied on them, there would have been cause for much concern. Misleading statements can also result when failure to recognize appreciation has the effect of valuing assets at a nominal sum although they may actually have a worth of many thousands of dollars[22] and recognition of "unrealized losses" accompanied by non-recognition of "unrealized gains" is a form of discrimination in favor of those acquiring, as opposed to those disposing of, equities.[23] Catlett[24] cites conservatism as one of the reasons for the wide variety of alternative accounting practices considered to be "generally accepted". His list, reflecting varying degrees, is composed of:

> *"1. The LIFO method of inventory costing as compared with the FIFO method.*
> *2. The charging of research and development costs to expense, by industrial and natural resource companies, as compared with capitalizing such costs.*
> *3. A full accrual of pension plan costs as compared with a partial or minimum accrual.*
> *4. The completed-contract method for construction companies as compared with the percentage-of-completion method.*
> *5. Recording the accelerated depreciation allowed for Federal income tax purposes as compared with straight-line depreciation."*

Mahon,[25] on the other hand, lists eight major areas where selection of alternate methods can produce substantially different results: investment credit, business combinations, consolidated and unconsolidated subsidiaries and affiliated companies, pension costs, research and development costs, income tax allocations, long-term leases, and special items (inclusion or exclusion of significant nonoperating and nonrecurring gains and losses in net income). Management has many reasons for selecting a particular alternative, of course, but the introduction of conservatism to the decision process only serves to widen the comparability gap.

Legal Implications

Aside from the controversy within the profession concerning which of these alternative methods to select, the accountant/auditor of today is faced with the ever-increasing possibility that he may be involved in a lawsuit because he sanctioned "too liberal" accounting methods. He cannot protect himself by citing generally accepted accounting principles as a defense; he must stand the notoriety and legal expense until a court resolves the matter.

Cases of this nature have not yet been given a great deal of publicity. It may be that pressures have been brought to bear to underplay the accountant's role until an actual trial takes place. Whatever the cause, magazines are virtually silent and newspapers disturbingly brief on some of the cases. Two such suits with interesting aspects that bear watching for developments are Westec Corp. and Continental Vending.

Downfall of the Westec Corp., a maker of geophysical instruments whose stock rose from $2 in 1964 to $67 in 1966 before it sought protection under the Federal Bankruptcy Act, is attributed in part to a lack of conservatism. According to Dun's Review,[26] "the company aided its market progress by opting for liberal accounting methods whenever it had a choice". The Economist[27] termed these methods "unorthodox", and The New York Times[28] commented that "The suggestion was that they were rather liberal and tended to overstate the Company's earning power." The Times also noted that the split "between the 'conservatives' and the 'liberals' " had now been taken out of the profession and placed in the courts.

The prime cause of the debacle was the manipulation of the company's stock by some of its executives, with the SEC contending[29] that its six months earnings statements were "inaccurate and improperly audited". Focal point of the dispute are earnings for 1965 which pooled results of companies acquired early in 1966. Ernst & Ernst certified the report, and Richard T. Baker, a managing partner, defended their position by saying: "The SEC gave the company no choice. If an acquisition is deemed to be a pooling of interests, and if it is completed before your annual report is out, the SEC says you have to show the earnings even though the transaction took place after the books were actually closed. Westec had no alternative but to do what it did, and we had no alternative but to go along with it."[30] There is unquestionably more to the story than that, (disclosure for one thing) but we can only wait. At last reports,[31] Lester L. Lilley, a CPA and brother-in-law of the firm's indicted president, had pleaded guilty to complicity in the stock manipulation, been released on bond, and was under investigation by the AICPA's committee on professional ethics. Herbert R. Belcher, another CPA and the firm's former controller, had also been indicted and his case, too, was under review by the AICPA.

The Continental Vending Machine Company situation is the more intriguing because of its greater mystery. Diligent research has failed to uncover a magazine reference to the subject, and there is a paucity of articles in The Wall Street Journal and The New York Times. In November 1967 The Journal of Accountancy[32] whetted our appetites with a flash that Lybrand, Ross Bros. & Montgomery had offered to settle out of court for $1.96 million "to avoid further protracted and expensive legal proceedings." Details were to be supplied by Mr. Walter R. Staub, the firm's managing partner, in a later issue. The proposed settlement grew out of a $41 million suit filed in 1965.[33] Charges against Lybrand[34] were that they had prepared false financial reports for 1958 through 1963, grossly overstating Continental's financial position. In 1965 when Lybrand was first charged, spokesmen for the accounting firm disclosed that the plaintiffs' lawyers had agreed to omit Lybrand's name

FOOTNOTES

[1] R. J. Chambers, "Prospective Adventures in Accounting Ideas," The Accounting Review, April 1967, p. 243-"In effect we have built a wall around ourselves. Inside the wall we do what is proper in accounting."

[2] Ibid.

[3] Funk & Wagnall's New "Standard" Dictionary of the English Language, Funk & Wagnalls Company, New York, 1957, p. 561.

[4] W. Edgar Vinacke, Warner R. Wilson, and Gerald M. Meredith, "Dimensions of Social Psychology", Scott, Foresman and Company, Chicago, 1964, p. 20.

[5] Thomas Henry Sanders, Henry Rand Hatfield, and Underhill Moore, "A Statement of Accounting Principles", American Institute of Accountants, New York, 1938, pp. 12-13.

[6] Ascribed to him by Maurice Moonitz in "The Basic Postulates of Accounting", Accounting Research Study No. 1, American Institute of Certified Public Accountants, New York, 1961, p. 47.

[7] Reed K. Storey, "The Search for Accounting Principles", American Institute of Certified Public Accountants, Inc., 1964, pp. 22-23.

[8] W. A. Paton, "Accounting Procedures and Private Enterprise", The Journal of Accountancy, April 1948, p. 279.

[9] ARS No. 1, op. cit., pp. 46-48.

[10] Robert T. Sprouse and Maurice Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises", American Institute of Certified Public Accountants, New York, 1962.

[11] John W. Wagner, "Defining Objectivity in Accounting", The Accounting Review, July 1965, pp. 599-605.

[12] April 1964, p. 430.

[13] John L. Carey, "CPA's Under Fire?", Financial Analysts Journal, January-February 1967, p. 36.

[14] "The Nature of the Financial Accounting Process", The Accounting Review, July 1943, pp. 189-93.

[15] Maurice Moonitz and Charles C. Staehling, "Accounting, An Analysis of Its Problems," The Foundation Press, Inc., 1952, p. 211.

[16] Op. cit., p. 250.

from the proceedings if they would pay $600, 000. Lybrand refused, and two years later agreed to settle a civil suit for more than three times that amount. (Here would have been an instance to apply some of their vaunted conservatism.) Three members of the firm were later brought to trial in a criminal suit commencing on December 5, 1967[35] and ending in a hung jury in February, 1968. Although it now appears that there is a good deal of support for the criminal action, there was some early indication that a lack of conservatism in accounting procedures was the point at issue. Reference to some of the "special items" written off by the company after a court-ordered review gave an inkling:[36]

$ 4,137,675	*worthless loans*
3,149,054	*reduction in asset value-vend machine concerns*
1,550,000	*allowance for bad accounts receivable*
983,124	*loss on closing Florida mfg. plant and other operations*
1,537,618	*previously deferred research and development*
439,786	*related to development of in-plant feeding programs*
11,797,257	
477,180	*not explained in article*
12,274,437	*total "special items" charged off*
1,150,634	*additional operating losses*
$13,425,071	*Total fiscal year 1962 loss*

The whole story, if and when published, should contain much to excite reader interest.

(On May 20, 1968, page 6 of The Wall Street Journal carried the following headline: "Second Trial Involving Three Lybrand Officers to Begin Today."—Editor's Note.)

The probable ramifications of these and other suits are of immense importance to the profession. With the general public nowadays conditioned to suing everyone in sight on the off-chance of success, the accountant may well become the cynosure. A plaintiff is not concerned with the defendant's motives in settling, only that he settles. And if it is cheaper to settle than to fight through the courts, how many will choose to defend their integrity in a circumstance that can only prove harmful, no matter what the outcome?

Granted that these are Moonitz' "one out of ten" or Carey's[37] "infinitesimal few out of thousands upon thousands of audits performed annually", ours is not a gambling profession. Over the years the pendulum has swung away from conservatism toward liberalism. It now seems likely to swing back again. Caught in its path is the accountant/auditor who is pressured from one side by management's commands for a more favorable earnings picture and from the other side by government demands for higher taxes on those earnings and by investor lawsuits. Isn't it likely that he will opt for the safest position?

Conclusion

All of us are affected in some way by the accounting process. There may be more direct and immediate users of the accounting product, but the ultimate responsibility is overwhelmingly social. Accountants, therefore, should not use conservatism as a crutch to justify compromise or inertia. They must exclude the conscious bias that governs the selection of the lowest value simply to be safe.

Conservatism will never be completely eliminated so long as we have a choice of alternatives and "substantial authoritative support". The goal is to exercise our choice in favor of the method "best suited", all factors taken into consideration.

[17] "The Basic Postulates", op. cit., p. 48.
[18] John L. Carey, "The CPA Plans For The Future", American Institute of Certified Public Accountants, Inc., New York, 1965, Chapter 6, pp. 114-127.
[19] Paul Grady, "Inventory of Generally Accepted Accounting Principles For Business Enterprises", American Institute of Certified Public Accountants, Inc., New York, 1965, p. 4.
[20] Moonitz and Staehling, op. cit., p. 209.
[21] Ibid., p. 210.
[22] William A. Paton, "The Significance and Treatment of Appreciation in the Accounts", Twentieth Annual Report of the Michigan Academy of Science, 1918, pp. 35-49.
[23] Sprouse and Moonitz, op. cit., pp. 31-32.
[24] George R. Catlett, "Factors That Influence Accounting Principles", The Journal of Accountancy, October 1960.
[25] James J. Mahon, "Accounting Principles Debate and Investor Confidence", Financial Executive, December 1966, p. 34.
[26] "Accounting—The Other Side of the Ledger", March 1967, pp. 36-37, 89-92.
[27] "Westec—Same Old Story," The Economist, October 8, 1966, p. 195.
[28] "The Westec Flurry: New Insulation for a Partnership," The New York Times, October 17, 1966, p. 57, col. 2.
[29] "Why Westec Turned to Chapter X", Business Week, October 1, 1966, p. 44.
[30] Dun's Review, op. cit., p. 92.
[31] "CPA Pleads Guilty in Westec Case", The Journal of Accountancy, January 1968, p. 12 and "Second Accountant Charged in Westec Stock Probe", The Journal of Accountancy, February 1968, p. 12.
[32] "Late Developments", p. 3.
[33] "Accounting Firm Offers $2.1-Million to Settle Lawsuit", The New York Times, October 17, 1967, p. 61, col. 7.
[34] The Wall Street Journal, July 6, 1965, p. 7, col. 2.
[35] The Wall Street Journal, February 1, 1968, p. 6, cols. 3-4.
[36] The Wall Street Journal, May 24, 1963, p. 10, col. 3.
[37] John L. Carey, "Where Were The Auditors?", Banking, June 1966, p. 41.