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Marquis G. Eaton

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Recommended Citation

Eaton, Marquis G., "Financial Reporting in a Changing Society" (1957). *Guides, Handbooks and Manuals*. 1337.

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FINANCIAL REPORTING IN A CHANGING SOCIETY

BY MARQUIS G. EATON

AN ADDRESS DELIVERED BEFORE THE ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

JUNE 7, 1957

Mr. Eaton is the forty-seventh president of the American Institute of Certified Public Accountants. A partner in the public accounting firm of Eaton and Huddle, of San Antonio, Texas, Mr. Eaton has long been prominent in professional accounting societies. He has served the Institute previously as a vice president and member of its governing Council, executive committee, trial board and other committees.

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BY MARQUIS G. EATON

AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
270 Madison Avenue, New York 16, N. Y.

Excerpts

Accounting is not a natural science, but a social science. It measures and communicates information about economic activities, which, because they involve human motivations and judgments, are in themselves dynamic and unstable.

The accounting profession, through the Institute, has accepted the responsibility of leadership in the incessant search for better methods of financial reporting. But it does not have, cannot assume, and in my opinion should not permit itself to be regarded as having the sole *responsibility for the results.*

Obviously corporate management does have and must have a part in determining the broad objectives and basic assumptions underlying corporate financial reporting.

It would be a great misfortune for American business, and the whole economy, if uniform accounting rules were to be prescribed by governmental fiat. It would probably mean the end of progress.

Other groups, such as bankers, financial analysts, economists, and financial editors, may have some responsibility to advise how financial statements may be made more useful for the purposes they are intended to serve.

The question is whether changes in accounting principles can compensate for the imperfection of money as a common denominator without sacrificing other vital purposes of financial reporting.

The income tax, for example, has spawned a whole new set of dilemmas. Its influence is powerful but not always healthy.

We are living in an economy which is quite different from anything the world has known before. It is doubtful whether anyone now alive thoroughly understands just what is happening to our economic system and what its future shape will be. Clearly an evolutionary process is going on — and at headlong speed. Pressures build up in various quarters and react upon each other, often in unpredictable ways.

One thing that holds the economy together under all these pressures, and in the midst of this swift evolutionary passage through time, is our system of financial reporting.

Financial reporting is simply the expression in terms of a common denominator of the whole complex network of elements which make up a business — land, buildings and machinery, raw materials, people at work, interrelated legal obligations — and, most important, the results which they produce. Without adequate information about the results of business operations no one could make intelligent decisions, and our economy would fall apart.

Of major concern in financial reporting is the determination of profits. It seems hardly necessary to remind this audience why the methods of determining business profits are important. But to set the stage for the questions I want to

discuss let me restate briefly some of the situations in which statements of the net income of business enterprises have significant influence on important decisions:

Public Interest in Profits

1. In decisions whether to buy or sell securities.
2. In corporate dividend policy.
3. In decisions to reinvest earnings in expansion of productive facilities.
4. In the levying of income taxes.
5. In fixing the rates (prices) of regulated industries.
6. In price determinations of unregulated business.
7. In granting long-term credit.
8. In collective bargaining.
9. In calculating national income and gross national product.
10. In fixing various kinds of property rights between parties.

This list could be extended, but these illustrations establish the premise that determination of business income is a matter of public concern.

Now, like all the other elements of our economy, the method of determining profits — which is one of the functions of accounting — is in the process of evolution, constantly adapting itself to change. But there appears to be a good deal of misunderstanding about what accounting is, and what it can and cannot do. Decisions based on erroneous conceptions of accounting can be extremely harmful to the economy.

Accordingly, it seems to me timely and useful to raise some questions about the determination of business profits which require more consideration than they have been getting.

These questions, I think, need the consideration not only

of the accounting profession but of business management, government agencies, investors, bankers, labor unions, economists, financial analysts, financial editors and everyone else concerned with the measurement and distribution of business profits.

Groups Concerned With Profits

The questions I have in mind are:

1. How are profits determined?
2. Whose responsibility is it to decide how profits shall be determined?
3. Are the present methods of determining profits satisfactory?
4. If not, what can be done to improve them?

Since I am speaking as president of the American Institute of Certified Public Accountants, I should say that my views, and the emphasis with which I state them, do not necessarily reflect the Institute's official policy. The vantage point which I occupy has widened my own vision of the problems to be discussed, and it seems no more than right to tell my fellow practitioners, and all the others concerned, what I think I see.

Now, how is business income determined?

For tax purposes, in accordance with the Internal Revenue Code, and related regulations and decisions.

For rate-making purposes, in accordance with systems of accounts prescribed by the Interstate Commerce Commission, public-utility commissions and other regulatory bodies.

For purposes not subject to legal regulation, in accordance with "generally accepted accounting principles."

In our formal, conventionalized opinions on financial statements, we certified public accountants say that we have examined the accounts and believe that the financial statements fairly present the financial position of an enterprise and the results of its operations "in conformity with generally accepted accounting principles."

There is some reason to believe that this phrase – "generally accepted accounting principles" – suggests to the ordinary reader the existence of some authoritative code of accounting, which when applied consistently will produce precise and comparable results. The appearance of precision is strengthened by the reporting of net income in exact dollars and cents, instead of rounded approximations.

Accounting Principles are Broad Concepts

Now, we accountants all know that "generally accepted accounting principles" are far from being a clearly defined, comprehensive set of rules which will ensure the identical accounting treatment of the same kind of transaction in every case in which it occurs. We know that "generally accepted accounting principles" are broad concepts, evolving from the actual practices of business enterprises, and reflected in the literature of the accounting profession. To be sure, many of these principles have been formally defined or clarified in the accounting research bulletins of the American Institute. But we all know that in some areas there are equally acceptable alternative principles or procedures for the accounting treatment of identical items, one of which might result in an amount of net income reported in any one year widely different from the amount an alternative procedure might produce.

Alternative Methods Show Different Results

Two examples might be cited. A company which adopts the last-in-first-out method of inventory valuation will show, in a period of rising prices, less net annual income than an otherwise identical company which follows the first-in-first-out method. A company which adopts the diminishing-balance method of depreciation may show less income in the earlier years, and a greater net income in the later years of the life of a given asset, than an otherwise identical company which follows the straight-line method of depreciation.

There are perfectly sound arguments to support both inventory methods, and both depreciation methods. As yet no sound reasons have appeared to justify insistence that only one method is permissible. It would be unfortunate if any such decisions were imposed on the business community, arbitrarily and prematurely, because accounting procedure would be frozen, and future adaptation to changing conditions and improvement in theory and techniques would be stopped.

Yet, I suspect it would come as something of a shock to some people to realize that two otherwise identical corporations might report net income differing by millions of dollars simply because they followed different accounting methods — and that the financial statements of both companies might still carry a certified public accountant's opinion stating that the reports fairly presented the results in accordance with "generally accepted accounting principles."

The clause in our opinions that these principles have been "applied on a basis consistent with that of the preceding year" provides assurance that the statements of a single company

for a series of years may be compared without fear that the rules of the game have been changed from one year to the next.

It cannot be assumed, however, that all companies, even in the same industry, are following the same rules, and this makes it harder to compare results among companies or among industries.

Oswald W. Knauth, business executive, economist and author, put his finger on this problem in an article in *The Journal of Accountancy* for January 1957. He said:

Difficulty of Comparing Reports

> "The accountant can generally conform the reports of any one company to a single system, so that they are comparable from year to year unless conditions change radically. But he cannot make the reports of two or three companies comparable to each other. Nor can he add up a number of reports to find a general total. Yet that is just what is being done. We are told that the rate of profits in one industry is higher than in another; and that profits as a total are a decreasing percentage of the national income. Such statements are widely accepted, and they may be true. Nobody knows. Yet they are based on methods and postulates that are demonstrably questionable."

Mr. Knauth went on to say that comparisons between financial reports of two companies, and particularly between two companies in different industries, or between entire industries, are so arbitrary as to be not only worthless but dangerous.

He also suggested that accountants attempt to modify the

"reputation for infallibility" which is accorded them, lest some future financial crisis entailing serious losses should turn "the present overconfidence in accounting procedures" into undue skepticism.

Perhaps comparability among companies and industries is unattainable – perhaps it is not even desirable. There are wide differences in the nature of economic enterprises which naturally and properly lead to differences in accounting procedure. For example, a gold-mining company recognizes income as realized when its product is in the refining state, other companies recognize income when a sale is legally consummated, while some companies whose products are sold on long-term instalment bases recognize realized income only on the receipt of cash.

Much of the demand for uniformity in accounting is based on a wish for unattainable certainty in man's financial affairs, and on a desire that the extremely complicated elements reflected in financial reports be made simple of understanding, by even the uninformed.

Is Comparability Attainable?

In any event, the question whether comparability of financial reports among companies and industries is the ultimate objective – and whether it is attainable – is fundamental to our problem. It seems to me that the accounting profession should have the help of the business and financial community in answering it.

Perhaps it is also time for a reexamination of the "postulates," or general assumptions underlying financial accounting, which Mr. Knauth said "are demonstrably questionable."

Accounting is not a natural science, but a social science. It measures and communicates information about economic activities, which, because they involve human motivations and judgments, are in themselves dynamic and unstable.

But any technique of methodical measurement and communication must be based on certain assumptions, even if they are recognized as tentative.

The accounting assumptions, or postulates, to which Mr. Knauth refers are as follows:

Three Postulates of Accounting

1. The monetary unit is the best common denominator to use in measuring and reporting business activities. In other words, accounts are best stated in terms of dollars. Yet when the purchasing power of money fluctuates widely there is a distortion of "actual" economic results.

2. The corporation is a permanent institution. In other words the accounting is not based on the assumption that there will be a liquidation, but on the assumption that indefinite life will permit methodical charges of costs incurred to benefit future periods against the revenues of those periods. Obviously, not all corporations prove to be permanent, and when they fail, earlier financial statements will have proved to be misleading.

3. Profit or loss should be shown usually on the basis of a completed transaction. This is because of the assumption that until the transaction is completed the amount of profit or loss is indeterminate. But values often do increase or decrease prior to realization, generally without recognition in the accounts. Should approximate valuations be used to

show that the bulk of the gain or loss took place in a period other than that of realization?

There are other assumptions which might deserve formalization as "postulates."

The Need for Postulates

As Mr. Knauth says, these "postulates" or assumptions are used, not because they are true, but because they are necessary. George O. May, one of the deans of the accounting profession, has said that they would be "indefensible" if they were not "indispensable." They have been developed out of comparatively long experience, but they could be changed if more recent experience shows that other assumptions would be more useful.

However, these postulates cannot be changed by the ac counting profession alone. Unless such changes were accepted by the business and financial community, and by the government, they would only make confusion worse.

This does not mean that certified public accountants can escape responsibility for their own opinions as to whether financial statements are presented in accordance with generally accepted accounting principles. If these opinions are to have significance there must be objective criteria of what are generally accepted accounting principles. Therefore, I do not see how the American Institute of Certified Public Accountants can escape the responsibility for issuing bulletins or pronouncements on accepted principles for the guidance of its members.

Accounting Principles Evolve

No one can understand the significance of "generally accepted accounting principles" without realizing that, like the

common law, they develop by the evolutionary process — and their development will probably never be completed.

What is happening, in fact, is a never-ending search for better and more refined methods of reporting the truth about the financial affairs of corporations. But these affairs grow more and more complex, the truth is not clear and simple, and as a matter of fact there is no ultimate truth in the practical affairs of man. As George O. May once said, "Accounting can rise no higher in the scale of certainty than the events which it reflects."

In this search for improved methods there are bound to be differences of opinion, at any given moment of time, as to which method among two or more alternatives, all supportable in theory and in logic, would yield the result most useful to all concerned. Experience alone reveals which one is superior, and that method eventually becomes generally adopted. Meanwhile, however, there are variations in practice.

Progress in Accounting

It must be remembered that financial reporting as a discipline is relatively young. At the beginning of this century corporations reported whatever they pleased, if anything, and kept their accounts according to their own best notions. Independent audits were not required, and the accounting profession was a mere infant.

There has been impressive progress in the last forty years. As long ago as 1917, the American Institute of Accountants began the effort to narrow the areas of differences in accounting practices. It cooperated with the Federal Trade Com-

mission and the Federal Reserve Board in the development of a brochure recommending the type of information to be included in financial statements, which has subsequently gone through six or seven revisions. As long ago as 1926, certified public accountants were working with the New York Stock Exchange to improve financial reporting requirements and to eliminate accounting procedures which had been demonstrated by experience to be unsound. The profession has cooperated closely with the Securities and Exchange Commission, since its formation, in the gradual development of better accounting procedures, which are mandatory upon companies subject to the SEC's jurisdiction. Since 1939, the Institute's committee on accounting procedure has been publishing research bulletins indicating preferred methods of accounting. These publications have had a wide influence on financial reporting of corporations.

Trend Toward Uniformity

From 1939 to the present these bulletins have narrowed the areas of difference in accounting treatment of many items in financial statements in a wide variety of circumstances. They cover questions arising in quasi-reorganizations of corporations, in corporate mergers, in stock dividends and split-ups, in stock-option and stock-purchase plans. They set standards for inventory pricing, for dealing with differences between tax accounting and generally accepted accounting principles, for treatment of pension costs, current assets and liabilities, and goodwill and other intangible assets. They deal with special problems arising in long-term construction contracts, extraordinary gains or losses which might distort

income, accelerated depreciation for tax purposes, and various other matters.

Taken as a whole this represents a considerable achievement.

Compared with some foreign practices, financial reporting in the United States has attracted praise. *Fortune* magazine in March, 1956, in discussing the accounting standards of some European countries, said: "U. S. accountancy is certainly not perfect, and even if it were it would be no substitute for traditional business integrity. On the evidence, however, U. S. business has something more to give the world than dollars and lessons in American salesmanship and mass production. That something is truthful reporting of what goes on. The certified public accountant is now as much a part of the U. S. scene as the corporation lawyer. Abroad, he still has an unlimited world to conquer."

But the fact that much progress has been made does not mean that all of the problems of accounting are being rapidly solved. We must squarely face the possibility that economic and social changes may be creating new problems at least as rapidly as older ones are being liquidated.

Taxation and Accounting Methods

The income tax, for example, has spawned a whole new set of dilemmas. Its influence is powerful but not always healthy. Where permissible alternatives exist business management is naturally inclined to adopt whichever accounting methods will result in the least tax. These may not always seem the best methods for purposes of reporting results to shareholders and the public – even though acceptable to the

Internal Revenue Service. Accountants can hardly insist that stockholders ought to pay millions of dollars in additional taxes as the price of abandoning a lawful and acceptable method of determining net income in favor of one which the accountants may believe to be preferable.

Regulatory bodies, too, have a profound influence upon present-day accounting. They may impose rules upon some segments of business that are designed to enable the agency to perform its supervisory functions, but may be less desirable in terms of fair financial presentation. Yet these rules may become precedents of "accepted accounting."

Accounting Responds to Change

And there is a third force that shapes accounting: the impact of fast-changing business practices.

The widespread adoption of pension plans differing in nature, legal structure and procedure; the diversification of products within corporate entities; the swift-running tide of mergers and consolidations; the increasing amounts devoted to research, advertising and other activities which tend to benefit future periods; the huge investments in new plant, equipment, or exploration whose profitability can be determined only by future events; the sale and leaseback of plants and machinery – all of these developments have created a host of new and complex accounting problems.

Perhaps the most significant of these recent developments has been the steady decline in the purchasing power of the currency. This has touched off a debate, which has now been raging for ten years, around the question whether fixed assets should continue to be depreciated on the basis of historical

costs, or whether depreciation should be adjusted to reflect changing price levels.

Some distinguished certified public accountants and many business leaders argue persuasively that reported profits are grossly overstated, and capital is being taxed instead of income, when the difference between depreciation charges and the cost of replacing worn-out facilities is not given recognition as an expense.

On the other hand many thoughtful certified public accountants and business executives do not believe that it would be desirable to determine profits on a basis which, in effect, substituted replacement cost for actual cost of fixed assets. They recognize that inflation confiscates capital, but contend that this cannot be cured by accounting. Rather, they hold, amounts should be retained from profits to replace assets at current costs when they are greatly in excess of the historical costs.

The Profession Examines Inflation

The Institute has given this admittedly complex problem extensive and intensive consideration. Ten years ago it sought the opinions of hundreds of corporate executives and found opinion widely divided. Another similar survey will be conducted in the near future.

In 1947, the Institute sponsored a "Business Income Study Group," composed of accountants, lawyers, corporate executives, labor leaders, economists and government officials. For some four years, with Rockefeller Foundation support, this Group studied the problem of determining business income in a period of inflation. The conclusions, which

might be interpreted as recommending as a long-range objective the determination of income measured in units of approximately equal purchasing power, was subject to 32 pages of comment and dissent by 15 of the 44 members of the Group.

The Institute's committee on accounting procedure has issued two releases on the subject, suggesting supplemental statements showing amounts of profit which must be retained to make up the difference between depreciation allowances and replacement costs. Few companies have followed this suggestion.

Study of the problem nevertheless continues. The Institute committee has periodically reviewed its earlier conclusions. Up to now it has not felt that it would be in the best interests of all concerned to recognize as in conformity with generally accepted accounting principles the adjustment of depreciation so as to reflect the current value of the dollars actually invested in the depreciating assets.

Actually, this problem arises from a weakness in money as a medium of exchange and a measure of values. The question is whether changes in accounting principles can compensate for the imperfection of money as a common denominator without sacrificing other vital purposes of financial reporting.

Responsibility for Accounting Principles

This brings us to the question of just who is responsible for the development and enunciation of accounting principles which may be regarded as "generally accepted."

The accounting profession, through the Institute, has accepted the responsibility of leadership in the incessant search

for better methods of financial reporting. But it does not have, cannot assume, and in my opinion should not permit itself to be regarded as having the *sole* responsibility for the results.

Corporation managements have the primary responsibility for their own financial statements. The statements are representations by the companies themselves. Obviously corporate management does have and must have a part in determining the broad objectives and basic assumptions underlying corporate financial reporting.

Government, too, has a responsibility to exercise its taxing powers and its regulatory powers in a way that will facilitate, rather than impede, sound financial reporting.

Government Responsibility

As a matter of fact, the Securities and Exchange Commission already has authority to control the financial reporting of a major segment of business society. Fortunately, the Commission has wisely chosen not to exercise it, preferring to enforce the principles developed in the evolutionary process by the accounting profession and by business. But the words of an early chairman of the Commission, the late Jerome Frank, are worth remembering: "Accounting is the language in which the corporation talks to existing stockholders and to prospective investors. We want to be sure that the public never has reason to lose faith in the reports of public accountants. To this end, standards of thoroughness and accuracy [must be] protected. I understand that certain groups in the profession are moving ahead in good stride . . . but if they are unable . . . to do the job thoroughly we won't hesitate to step in to the full extent of our statutory powers."

It would be a great misfortune for American business, and the whole economy, if uniform accounting rules were to be prescribed by governmental fiat. It would probably mean the end of progress. The Interstate Commerce Commission did exactly this in 1914 for the regulated railroads. At the time, the ICC accounting classification was hailed as reflecting the best accounting thought of the day. It was cited as a model in accounting textbooks. By 1957 it was completely out of date – far behind the financial reporting standards of industrial corporations. Just a few months ago, a committee of the American Institute pointed out six major changes that would have to be made in ICC rules in order to bring them into harmony with generally accepted accounting principles. Until such changes are made, certified public accountants cannot certify financial statements of railroads as being in accordance with generally accepted accounting principles.

Responsibility of Other Groups

The New York Stock Exchange has a responsibility for the financial reporting practices of listed companies, and has actively encouraged improvement of accounting methods in cooperation with the Institute.

The accounting teachers, through the American Accounting Association, have assumed a share of responsibility for the development of accounting theory, and have issued a number of useful statements on the subject.

Other groups, such as bankers, financial analysts, economists, and financial editors, may have some responsibility to advise how financial statements may be made more useful for the purposes they are intended to serve.

In an informal, voluntary way, and in varying degrees, all these elements of our society have had a part in bringing the methods of determining and reporting business profits to a point far in advance of where they were forty years ago — even twenty-five years ago.

Throughout this process the practicing profession of certified public accountants has had the responsibility for weighing the question whether new practices or proposed changes in accounting principles met the test of fairly presenting financial position and results of operations to an extent warranting the conscientious expression of a professional opinion.

Is Progress Fast Enough?

We must now face my final question — whether progress has been fast enough to meet the needs of our fast-changing society.

Perhaps the present process is satisfactory. The following statement by Justice Holmes in *The Common Law,* seems to be applicable to the development of accounting principles:

> "The law is always approaching, and never reaching consistency. It is forever adopting new principles from life at one end, and it always retains old ones from history at the other, which have not yet been absorbed or sloughed off. It will become entirely consistent only when it ceases to grow."

But to say that accounting must develop, like common law, by the evolutionary process, is not to say that there is no urgency in the need for solutions to problems which confront us right now.

Here is a partial list of problems not yet solved:

We have made some progress, but have some way to go in establishing the most useful and acceptable practices in connection with income tax allocation, where the amounts shown on the tax return do not correspond in important respects to the figures on the income statement or to the organization of the financial statements.

We recently made a survey of consolidated statement practices which disclosed a good many points of variation in practice which are being explored in an attempt to reduce the number of differences to a minimum.

There is a large group of problems in the intangible asset category, many of which are old matters which have plagued us for years. I am thinking of such things as the write-off of goodwill, the treatment of organization and promotion costs, the accounting for research and development costs, the handling of exploration costs of timber and mineral tracts and of intangible drilling costs in the oil industry, and others of this type which present baffling problems in accounting.

We have achieved much improvement in the form of the financial statements, but there is still much that could be done to make them more effective and readable.

Accounting Profession Welcomes Assistance

The Institute intends to continue its attack on all these problems. We would welcome the advice and assistance of those who share the responsibility with us. Meanwhile we ask the understanding of all concerned that these problems are not simple; that in a dynamic society they are never-ending; and that there may be no substitute for time and experience in finding solutions.