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By Gilbert R. Byrne

[This essay was awarded first prize in the fiftieth anniversary contest for the best answer to the question which Mr. Byrne has chosen as his title.]

Modern professional practice of accounting covers a wide range of subjects, and its field, if the experience of the past decade can be taken as a guide, may be expected to widen still further in the future. For example, in 1931 a report of a committee of one of the professional bodies of accountants classified accounting services in six divisions; to this list would now have to be added those services performed by accountants in connection with registrations of securities and other matters for the Securities and Exchange Commission. To discuss the possibility of stating rules and standards relating to all of the matters coming within the practice of the present-day accountant would be quite impossible within the limits prescribed for this article, even if it were agreed that it is practicable to consider the formulation of rules and standards for, say, the installation of a cost system or the prosecution of a tax case.

It probably would be conceded that the major portion of the professional accountant's practice is concerned with the examination of financial statements and the accountant's report thereon; and the discussion which follows will be confined to a consideration of whether and to what extent this phase of the accountant's work can be reduced to rules and standards. As a preliminary to this discussion it will be helpful to recall that, broadly speaking, the accountant's purpose in making his examination is to determine that proper accounting principles have been consistently followed in keeping the accounts, and that clear and truthful financial statements have been prepared therefrom. To assure himself of these facts, he employs a technique of auditing procedures. There are, therefore, really three phases of the accountant's work in connection with the examination of and reporting on financial statements, each of which may be considered potentially subject to reduction to rules and standards:

(a) Accounting principles, and the rules derived from these principles,
(b) The practices and conventions relating to the presentation of accounts in financial statements,
(c) The technique of auditing.

The general question as to formulating and stating the principles, rules, conventions, or standards of the practice of accounting has engaged the attention of a number of writers and speakers on accounting subjects in recent months. There have been developed two quite divergent points of view; on the one hand, those who urge that a statement of accounting principles can and should be formulated, and on the other, those who envisage the impossibility, if not the undesirability, of the task. The following quotations, characteristic of the first school of thought, are interesting:

"After a quarter-century and more of active discussion and experimentation in this country, many of the simplest and most fundamental problems of accounting remain without an accepted solution. There is still no authoritative statement of essential principles available on which accounting records and statements may be based. Public accountants . . . have been asked to certify to the correctness and adequacy of accounting statements, when no satisfactory criteria of correctness and adequacy have been agreed to." [1]

And another commentator has expressed similar ideas in these words:

"Accountancy has . . . the tendency to rely on precedent and authority rather than on the scientific method. . . . It is as if engineers had no agreement on the required strength of foundations, structural steel requirements for skyscrapers, or efficient design for power plants." [2]

It is perhaps not unnatural that the authors of the above are men of academic or regulatory-body training; expressions of the opposite view given below are those of practising accountants:

[1] A Statement of Objectives of the American Accounting Association. *The Accounting Review*, March, 1936.

[2] George C. Mathews—Address before Milwaukee chapter of Wisconsin Society of Certified Public Accountants.

"The field of financial accounting is not one in which guidance is to be found wholly in fixed principles—it is a field of shadowy outlines in which the discovery of a correct course depends upon the possession also of an ability to recognize the essential facts and to appreciate their true significance (distinguishing where necessary between form and substance); upon informed and wise judgment; and upon objectiveness and honesty of purpose. It will be observed that these are not qualities which can be insured by regulation."[3]

Another practitioner comments on the published discussion as follows:

"First, what has frequently been spoken of as accounting principles includes a conglomeration of accounting practices, procedures, policies, methods and conventions relating both to the construction of accounts and their presentation; and second, there seems to be a general agreement among the commentators that the difficulty of any attempt to formulate so-called principles or prescribed rules and regulations on accounting matters is so large and the conditions encountered so diverse that few, if any, sweeping generalizations can safely be adopted."[4]

As indicated previously, there are three phases of the accountant's work in connection with the examinations of financial statements and his report thereon which may be considered potentially subject to reduction to rules and standards. First, the accounting principles which he must assure himself have been properly and consistently applied in preparing the accounts; second, the practices and conventions relating to the presentation of the accounts in financial statements; and third, the technique of auditing employed by the accountant in determining that the accounts and statements have been properly prepared. As indicated by the author of the last quotation above, recent discussions have used the term "accounting principles" to cover a conglomeration of accounting practices, procedures, conventions, etc.; many, if not most, so-called "principles" may merely have to do with methods of presenting items on financial statements or technique of auditing, rather than matters of fundamental accounting principle. It is not strange, perhaps,

[3] George O. May—Improvement in Financial Accounts. JOURNAL OF ACCOUNTANCY, May, 1937.
[4] F. P. Byerly—Formulation of Accounting Principles or Conventions. JOURNAL OF ACCOUNTANCY, August, 1937.

that lacking completely satisfactory definition of terms, or clarification of the fields of discussion, there has been little or no agreement among accountants as to what extent, if at all, rules and standards of accountancy practice can be stated.

In fact, the confusion with respect to the matter of differentiating between accounting principles, rules, conventions, practices, etc., is so great that some have despaired of reaching a solution, and have raised the question as to whether, after all, there *are* such things as accounting principles. It is proposed, therefore, first to inquire as to the nature of accounting principles, the distinction, if any, between an accounting principle and an accounting rule, and then as to whether accounting principles and accounting rules can satisfactorily be formulated. Some consideration will then be given to the extent to which the accounting practices and conventions relating to the preparation of financial statements and the technique of auditing can be reduced to rules and standards.

The standard form of report used by most accountants in certifying financial statements of corporations whose securities are listed on the New York Stock Exchange is predicated upon the existence of known accounting principles, for it concludes, after an opening paragraph briefly describing the nature and scope of the examination made,

"In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, *in accordance with accepted principles of accounting consistently maintained by the company during the year under review*, its position at December 31, 19—, and the results of its operations for the year."

Such a statement presumably represents the informed and well-considered opinion of an expert in the field of accounting; it presupposes that there are principles of accounting, known to the accountant, which can be applied to business transactions so that the resulting books of account and the financial statements prepared therefrom may fairly reflect the financial position of the enterprise at a given date and the results of its operations for a specified period. There *must* be agreement among accountants that there are recognizable principles of accounting, for if there is not this agreement, accountants have indeed stultified themselves.

It is probably safe to say that all schools of accounting thought would agree that it is desirable to have formulated in an authoritative way the principles of accounting to which reference is made in the form of accountant's report quoted above. While there have been several attempts to enumerate them, to date there has been no statement upon which there has been general agreement. This lack of agreement, it is submitted, results in large part because there is no clear distinction, in the minds of many, between that body of fundamental truths underlying the philosophy of accounts which are properly thought of as *principles*, and the larger body of accounting rules, practices and conventions which derive from principles, but which of themselves are not principles. If accounting, as an organized body of knowledge, has validity, it must rest upon a body of principles, in the sense defined in Webster's New International Dictionary:

> "A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which others are founded; a general truth; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate."

President Coolidge said, "Laws, whether statutory or natural, are not invented—they are discovered, and discovered only after experience." In the development of any field, principles are discovered which represent the fundamental truths on which the field of knowledge rests. These principles are applied in the working out of problems that arise, and gradually, rules of practice evolve which, over a period of time, become accepted to a greater or less degree as reflecting the effect of the principle in oft-recurring cases. Such rules become the working tools of those engaged in the particular field of knowledge. While the principles upon which the body of knowledge rests cannot, from their nature, be subject to dispute, the rules derived therefrom have validity only to the extent that they properly reflect the principle. Pending complete demonstration of this fact, usually through experiment, there may be considerable disagreement as to whether a particular rule should be followed. Accounting, as well as law, engineering and many other fields, has followed, and is still following this pattern of development. It is probable that there are principles still to be discovered, and certainly accounting rules are still in process of crystallization.

As to the fundamental principles of accounting, there can be no more question of their "general acceptance" than of the moral rightness of the ethical principle that it is wrong to kill. But there are legal rules derived from the moral command, "Thou shalt not kill," which have differed at different times and in different countries. At one time no legal penalties attached to a noble who killed a serf, and even in our own colonial times no jail sentence awaited the Pilgrim Father who shot a stray Indian at sight. At present, legal rules derived from the moral principle are to the effect that an accidental killing is subject to less penalty than killing in the heat of passion without premeditation, and that the latter is considered legally less culpable than wilful, premeditated murder. Legal rules in different states classify differently legal culpability for killing. In short, while there is no difference of opinion as to the moral principle that killing is wrong, there have always been, and still are, differences of opinion as to how the principle shall be reflected in legal rules, and also differences of opinion as to whether the legal rules have been properly applied to the facts in a particular case. The latter is one reason for the popular interest in murder trials.

Another example of the differences between fundamental principles and the effects of their application may be drawn from the engineering profession. There are, of course, principles of engineering governing the size, weight and design of the steel members of a bridge structure. In designing the Manhattan and the Williamsburg bridges, which were built in 1909 and 1903, respectively, and were proposed to span the same stream, presumably sound engineering principles were applied to the problem in each case. In the application of those principles the results, so far as appearance of the two structures are concerned, are quite different, yet no one accuses the engineers of having applied different principles to their respective problems merely because the results of such application have not been identical bridges.

In much the same way, while there may be complete agreement as to the underlying principles of accounting, there may be legitimate and proper—one might say inevitable—differences of opinion as to the effect of the application of a particular principle of accounting to the facts in a particular case, or, in other words, as to the propriety of the accounting rules derived from the principle. Further, while the fundamental principles of accounting remain unchanged, the rules and practices derived therefrom will, and ought to, develop as required by changes in business practice. It should cause no surprise if financial statements a generation hence differ as much from those of the present day as these differ from those of a generation ago. The *principles* of accounting remain the same, and about them there should be no substantial disagreement; as to the body of accounting rules, practices and conventions derived from those principles, there may well be differences of opinion as to their validity in a particular case. As a result of such inevitable differences in opinion, therefore, it is not difficult, in reviewing the work of members of the accounting profession as exemplified by published reports of corporations accompanied by an accountant's certificate, to find instances where apparently similar transactions have been given what appears to be different treatment by different accountants. When analyzed, however, the differences in treatment most frequently reflect, not incorrect nor improper underlying accounting principles, but merely differences of opinion as to the best manner of presenting the accounting effect of the application of such principles.

From the above discussion there begins to emerge, it is hoped, an outline of accounting as an organized body of knowledge resting upon a body of fundamental principles admittedly known to and utilized by accountants in the course of their examinations of financial statements. Certainly, then, these principles can be stated. From these principles, however, have been derived certain accounting rules which have validity only as they correctly reflect the application of the principle on which they depend. Since there may be considerable difference of opinion as to the propriety of accounting rules, the task of stating those rules with respect to which there may be said to be general agreement, is a formidable one. It would seem, therefore, that a long step forward in the solution of the problem which is the subject of this paper would be to establish a basis for distinguishing between an accounting principle and an accounting rule.

Dr. Henry Carter Adams, in discussing the claims of accounting to classification as a science, has said, "The commonly accepted proof that a body of organized knowledge has attained the rank of an established science is the coercive or compelling character of the generalizations to which it gives rise and which come to be known as scientific laws (principles)."[5]

The compelling character of the scientific laws of health is evident, because to disregard them in the long run literally results in death. Engineering principles have a coercive character, because to ignore them in the building of a bridge would probably result in the collapse of the bridge. Such principles are compelling in the sense that they are in effect self-enforcing; they cannot be disregarded with impunity.

The principles of accounting are also characterized by their coercive or compelling quality because inherent in accounting principles are business laws which must be obeyed if in the long run the enterprise is to survive. This does not mean, of course, that adherence to correct accounting principles is, in itself, a guarantee of business success; accounting has to do largely with the financial policies of business, and policies of sales, production, labor, and other management problems are important elements in the success or failure of a business enterprise. It should be apparent, however, that the basing of financial policies upon accounting statements which in turn are not prepared in accordance with fundamentally right accounting *principles*, may lead to courses of action which, if too long pursued, will adversely affect the financial health of the business. It is in this sense that the fundamental principles of accounting may be said to be coercive and self-executory.

Professor Arthur S. Dewing, in describing the financial difficulties of the United States Realty and Construction Company in 1903 [6] said as to the causes therefor that "two of these causes were concerned with the methods of accounting tolerated by the company's management. . . ." Both of these methods clearly violated the accounting principle that unrealized and undeterminable profits should not be included in the income account. Professor Dewing [7] gives as one of the causes of the failure of the Consolidated Cotton Duck Company in 1909 the "inadequate allowance for depreciation." Any list of accounting principles would include a statement to the effect that the investment in an industrial plant should be charged to operations over the

[5] H. C. Adams—American Railway Accounting.
[6] Corporate Promotions and Reorganizations, p. 239.
[7] *Ibid.*, p. 374.

useful life of the plant. Most experienced accountants will recall other instances where failure to follow correct principles of accounting has led to financial embarrassment.

Accounting principles, then, are the fundamental concepts on which accounting, as an organized body of knowledge, rests. Like the axioms of geometry, they are few in number and general in terms; they possess the distinguishing characteristic of a compelling and coercive nature, and they are the foundation upon which the superstructure of accounting rules, practices and conventions is built. It is not the purpose of this article to attempt a formulation of the principles of accounting, but for illustration, it seems desirable to indicate roughly what, on the basis of the above description, such a statement would include:

(1) Accounting is essentially the allocation of historical costs and revenues to the current and succeeding fiscal periods.

(2) The investment in an industrial plant should be charged against the operations over the useful life of the plant.

(3) In computing the net income (available for dividends) for a period, all forms of expense incurred in the production of such net income must be provided for.

(4) The income shall include only realized profits in the period during which realized; profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sale price is not reasonably assured.

(5) Losses, if probable, even though not actually incurred, should be provided for in arriving at net income.

(6) Capital-stock and capital-surplus accounts, taken together, should represent the net contribution of the proprietors to the business enterprise.

(7) Earned surplus should represent the accumulated earnings of the business from transactions with the public, less distributions of such earnings to the stockholders.

(8) While it is not in many cases of great importance which of several alternative accounting rules is applied in a given situation, it is essential that, once having adopted a certain procedure, it be consistently adhered to in preparing the accounts over a period of time.

It is not suggested that the above list is complete, and certainly not that it is free from all possible criticism. It is urged, however, that it represents, however imperfectly, some of the underlying principles of accounting about which there can be no dispute as to their validity, which possess the characteristic of compulsion in the sense more fully referred to above.

From such principles are derived many of the rules, practices and conventions used in the practice of accounting. Some of these rules are really special cases under, or corollaries of, one of the fundamental principles, and as such have much of the compelling force of the parent principle. Such a rule is the familiar one that inventories should be priced at "cost or market, whichever is lower"; this rule is really an application of principle 5 above. On the other hand, many rules as to the pricing of inventories at "cost" have been developed, such as "first-in, first-out," "last-in, first-out," which cannot be considered as principles, because such rules obviously have no compelling character, of themselves. In the application of the principle that it is necessary to provide for probable losses, the accountant has full liberty to employ any one of these rules as to pricing, according to his judgment as to what is the most appropriate rule in view of all the circumstances, and, whichever one he selects, he should not be charged with violation of any accounting *principle*.

A familiar example is that of the numerous rules which have been proposed for charging to operations the cost of an industrial plant over its useful life. So long as this *principle* is applied, it can make little difference in the long run which of the *rules* for spreading the cost year by year is used. Such rules should not be confused with the principle, for they have not the coercive nature which characterizes a *principle*.

In the application of accounting principles relating to the allocation of revenues and expenses to periods and to the determination of the realization of profits in certain types of contracting business, there have been developed two accounting rules for use in appropriate cases. Where the contracts comprising the business on hand are few, large in amount, and require long periods for completion or fabrication, an accounting rule is invoked which permits the computation of periodical profits or losses based on the percentage of completion of the contracts in progress. On the other hand, if the contracts involved are numerous, moderate in size and the construction period is less than one year, it is considered that the accounting principles referred to have been correctly applied where profits (and losses) are determined when contracts are completed or deliveries made. It should be apparent that in borderline cases good accounting and business judgment based on long experience are essential for competent decision as to which of the above rules is properly selected. Such rules are not principles, for they are not of themselves compelling, and have validity only as they correctly reflect the principles on which they are based.

A review of the published material relating to the matter of standardization of accounting practices indicates that it is largely the body of accounting rules derived from principles which the academically-minded critics wish to see definitely formulated. They become impatient at the fact that, pending crystallization of accounting practices based on fundamental principles into generally accepted rules, there are differences of opinion among accountants and among business men as to the proper application of a given principle of accounting, or as to which of two or more principles are applicable in a given case, or as to which of several methods of presentation of the effect of the application of a principle is the more logical or informative. They apparently feel that swifter progress would be made if accounting rules were presently established by an accounting authority, or possibly by dicta of government commission. Presumably our democratic political philosophy would then require some judicial body to which appeal could be made for decision between persons of opposite view, so that, following the example of the legal profession, official precedents would be established for future guidance. As to whether such procedure would in fact facilitate the formulation of generally accepted accounting rules, it should be recalled that whereas legal rules have been in process of formulation and definition for many centuries, some of them are still far from final settlement, and differences of opinion are so widespread that they are reflected in five-to-four decisions in our Supreme Court. We may be encouraged, then, in insisting on the present laissez-faire method of development of accounting rules when we consider by comparison the progress made by the accounting profession in its less than one hundred years of experience. As was said by Mr. Justice Holmes,

". . . When men have realized that time has upset many fighting faiths, they may come to believe that the ultimate good desired is better reached by free trade in ideas that the best test of truth is the power of thought to get itself accepted in the competition of the market; and that truth is the only ground on which their wishes can safely be carried out." [8]

And with specific reference to differences of opinion regarding reporting on accounting matters, Professor T. H. Sanders remarked:

"In the face of these difficulties the main reliance must be on accountants of sufficient experience, disinterestedness, and sound judgment to be able to make the best choices among alternatives. As experience accumulates, however, it becomes possible to embody it in general principles [rules] for the guidance of all concerned. Not that these principles [rules] can ever be a substitute for judgment and experience, but they may serve to supplement these in a helpful way and to reduce the area within which the application of judgment is desirable." [9]

There seems to be no good reason why the experience of the accounting profession to date should not be reflected in a statement of accounting rules, soundly based on fundamental accounting principles, provided it is recognized that such rules have validity in a particular case only if and to the extent that they correctly reflect the underlying principle. The choice between one or more rules, or between methods of applying the rule selected, must always rest upon the skill, experience, and informed judgment of the accountant. It has been well said that these are qualities which are not insured by rules and regulations.

THE FUNDAMENTAL principles of accounting followed in keeping the accounts are, of course, reflected in the financial statements periodically prepared therefrom. The manner of preparation of the statements, the classification of the data shown thereon, and the various methods of disclosure of pertinent information have, however, been the subject of many rules, regulations and dicta, which have frequently been dignified improperly with the title of "accounting principles." Such rules are properly designed to produce statements which are convenient and informative, but they are based almost solely on constructive and logical thought as to what presentation will most clearly inform the reader as to the facts desired to be set

[8] *Abrams* v. *United States*, 250 U. S. 616, 630.

[9] T. H. Sanders—Reports to Stockholders. *The Accounting Review*, September, 1934.

forth; they have not the quality of compulsion which it is urged is an essential attribute of a fundamental accounting principle.

Many of the rules and conventions relating to presentation of financial statements are so completely logical and have become so imbedded in practice that to disregard them would be to mark the practitioner as inept and unskilled in his art. Compliance with them is assumed by those accustomed to reading financial statements. It is customary, for example, to prepare balance-sheets in statement form, with assets on the left and liabilities and capital on the right; to separate and subtotal current assets and current liabilities, property accounts, long-term debt and the like. But suppose the items, correctly described, were simply listed in alphabetical order on a balance-sheet; the fact that conventional arrangement was not followed might mark an unskilled accountant and might cause annoyance to the reader of the statement, but the violation of the conventions relating to presentation would not cause financial embarrassment; they cannot be said to have compelling or coercive character.

Aside from the conventions as to form, the underlying principle relating to presentation and classification of items and accounts in financial statements is hardly an accounting principle at all but the moral principle that with respect to financial statements the accountant is bound to tell the whole truth. In other words, however an item is listed or classified, it should be correctly described. To include a note due five years from now in the usual balance-sheet under the caption "current notes receivable," to describe an investment "at cost" when it really had been written up 50 per cent., to include extraneous windfall profits in operating earnings, would violate this principle, and this principle is compelling in the sense that those who violate it are subject to moral and even legal penalties.

A number of rules which are really based on this principle are given in the text of section 2 of the bulletin, *Examination of Financial Statements*, issued by the American Institute of Accountants in January, 1936. For example:

Funds subject to withdrawal restrictions should be so described on the balance-sheet.

The reserve for bad and doubtful accounts should be shown as a deduction from the corresponding assets.

The amount of any accounts receivable that have been hypothecated or assigned should be so shown on the balance-sheet.

Notes payable to affiliated companies and to stockholders, directors, officers and employees should be shown separately on the balance-sheet.

Any default in the interest or sinking-fund requirements that may exist (as to funded debt) should be mentioned on the balance-sheet.

Serial bonds, notes and mortgage instalments due within one year should be separately disclosed and, if material, should be included with the current liabilities.

Such rules as the above are essentially suggestions which, if followed, will tend to insure that no material fact is overlooked in the preparation of financial statements. A considerable body of this type of rule has been stated in the bulletin referred to; while others could no doubt be added, it is obviously impossible to foresee and provide rules to cover all possible situations. The busy practitioner knows how very frequently problems of presentation arise which are not covered by any stated rule; his recourse is to apply the moral principle that it is his duty to give the reader all pertinent information in a logical and understandable manner. The result must rest primarily on the integrity and skilled, informed judgment of the accountant. If, in similar situations, equally capable practitioners arrive at different solutions, it may well call for what Dr. Lin Yutang calls a typically Chinese point of view, that "A is right, but B is not wrong either."

There is a large volume of accounting literature dealing with the technique of auditing procedure employed by the accountant to assure himself that correct accounting principles have been employed in arriving at the balances in the accounts, and to afford him the necessary information for judging whether the pertinent facts are fully and truthfully displayed in the financial statements prepared from the accounts. Most of this literature represents an attempt to reduce auditing technique to rules and standards. Probably the most successful general statement of the rules of auditing technique is contained in the second section of the bulletin *Examination of Financial Statements* issued by the American Institute of Accountants in January, 1936. The text of the bulletin emphasizes that in determining the nature and extent of the examination, the accountant will necessarily take into consideration, among other things, (a) the purpose of the examination, (b) the amount of detail included in the statements to be covered by his report, (c) the type of business the accounts of which are to be examined, and (d) the system of internal check and control.

It seems apparent that the rules of auditing technique must be limited to rather general statement, such as that contained in the bulletin referred to above, and that the element of personal judgment, competence and integrity of the auditor is far more important than detailed specifications for making audits. With respect to auditing procedures to be undertaken in a specific engagement, however, an audit program written for that particular engagement is a desirable aid to a well-conducted examination, and is a valuable record of just what was done.

TO WHAT EXTENT can the practice of accounting, as it relates to the examination of and reporting on financial statements, be reduced to rules and standards? Accountants of the highest abilities and reputation are willing to give their considered opinion, after due examination, that the financial statements under review fairly present the position of a company based upon accounts determined in accordance with accepted principles of accounting. It follows that these fundamental truths upon which such opinion is based, and which may be properly dignified with the term principles, are known to the accountant and are matters with respect to which, by their very nature, there can be no general disagreement. These principles are characterized by their compelling or coercive nature, and this attribute distinguishes them from those rules of accounting which have been derived from principles but, of themselves, have no validity except as they logically depend upon principles. The principles of accounting, as herein defined, are capable of being stated and agreed to; the rules of accounting derived therefrom are subject to gradual crystallization as experience winnows those which are valid from those which are doubtful. The conventions and rules with respect to the presentation of data in financial statements depend on the moral principle that all material facts necessary to the proper and complete understanding of the statements must be given; many of these conventions are so firmly imbedded in practice that there should be no difficulty in enumerating them. As to the rules of auditing procedure, a general course may be charted, as in the American Institute bulletin, and certainly programs of audit for specific engagements are useful tools, but in preparing such a program the first essential is a high type of professional and moral equipment on the part of the practitioner.