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High Standards of Accounting

BY A. C. LITTLETON

As IMPLIED in the title above, I prefer to use the word "standards" rather than either "principles" or "rules."

Rules are authoritarian in nature; they seem to dictate conformity with indicated procedure. But business conditions are so varied and managerial judgment plays such an important rôle in business success that enough rules could not be constructed to anticipate all situations, and it is obviously impossible to reduce the accounting of an enterprise to a few rules.

The term "standards," however, carries a connotation different from that of "rules." While rules are made to afford a basis for conformity, standards are chosen as points of departure, when and if departure is necessary and clearly justifiable. "Standards," therefore, would not rigidly confine practices, but serve as guideposts to truth, honesty, and fair dealing in accounting reports. To serve their purpose most effectively, such standards would be expressive of the deliberately chosen policies of the highest types of businessmen; they, therefore, would be acceptable by business concerns generally as guides to good accounting practices and adequate financial statements.

The term "principles" does not carry the necessary connotation of adequate flexibility. I believe that is why some men say there are no real accounting principles, or so few of them that they constitute overgeneralizations which are unlikely to be helpful in practical affairs. The word "principle" will generally suggest a universality which obviously cannot exist in a service institution such as accounting. What accounting textbook writers are prone to call "principles" have nothing in common with the physical laws of nature; nor are they comparable to the accumulated precedents of the common law which rest upon evidence and testimony in court wherein the pros and cons have been fully argued and carefully weighed in arriving at a judgment; nor are they akin to the unwritten laws of social customs which derive their force merely from unthinking acquiescence.

On the whole, therefore, I am inclined to hold to the conception of a standard, for a standard directs a high, but attainable, level of action, without precluding justifiable variations.

I would not, however, want the phrase "justifiable variations" to be construed as merely another term for managerial decision to depart from a recognized accounting standard.

Since it is obvious that business management is not a science, it is to be expected that managerial decisions based on judgment will be frequently put to test; and, since accounting is not a science, it may be said that accounts and financial statements reflect many of the judgments made by management. Hence, if accounting standards are to be helpful to management, pronouncements regarding standards should give as many indications as possible of the basis for good managerial judgment. That is, where alternative treatments of a situation are available, the discussion accompanying a statement of accounting standards should indicate the considerations involved in making a choice; where law permits something less than wisdom would

NOTE.—This paper was presented as an address at a meeting of the Illinois Society of Certified Public Accountants, held March 29, 1938, at the Stevens hotel, Chicago, Ill.

dictate, accounting standards should propose that normal action should be above the minimum.

Flexibility

It will be understood that, once an accounting standard is properly stated, it becomes a guide, not a control. Departure from the standard will always be possible, but the burden of proof falls upon the one who advocates a variation. If management can convince a well informed, independent public accountant that a specific departure from a given standard is justifiable under known circumstances and for definite, acceptable reasons, we need not argue in favor of a rigid application of the standard. Acceptable reasons for departures must, of course, be something more than the desire of an individual or the convenience of the management; a sounder base would have to be found than timely expediency, vague conservatism, or persuasiveness to investors.

As an example of what is meant by using a statement of accounting standards as a guide to managerial good judgment, consider the following extract from page 42 of *A Statement of Accounting Principles:*

"Normal and expected losses incurred in developing a business to full capacity may reasonably be charged to asset accounts, though it would be more conservative to carry them as deficits until they may be charged off against ensuing earnings. This decision may be left to competent judgment, which will consider: (a) that whatever course is followed should be clearly shown; (b) that such deficits should not be converted into assets purporting to be tangible, but only into intangible assets; (c) that such procedure is justifiable only when the expectation of future earnings affords hope of earning a return on such assets, or of amortizing them; and (d) that the fact that the business may, upon reaching maturity, be transferred by reincorporation to new proprietors (while introducing the new element of the actual investment of these new proprietors) should not be permitted to conceal the true character of the predecessor company's investments and assets. At this stage the problem becomes one of asset determination rather than of income determination."

Here four specific considerations are given which should be weighed before a decision is reached to capitalize development deficits. Whether or not we are agreed that these are the only considerations that should receive attention, the point is still to be made that an indication is here given of the way to approach a decision on the issue in question. If these considerations were given careful attention, that fact should go a long way toward justifying a departure from the preferred or normal standard of carrying the deficit forward until earnings appeared. If they were inadequately considered, that would persuade us to hold to the standard. In this manner shortsighted management, or executives who desire to be less than frank, can be guided toward better practices.

It is to be regretted, however, that the monograph from which the quotation was taken does not give the same sort of guidance at numerous other points in the text where managerial judgment is accepted as the basis of the accounting treatment of certain situations. Sincere management deserves more constructive guidance to good judgment from the profession's statement of accounting principles than that contained in such phrases as ". . . the application of intelligent and impartial judgment to all the facts of the case" (page 3), and " . . . avoid arbitrary or fictitious values, and reflect real values as nearly as possible" (page 17). Can the profession, out of its accumulated experience, offer no suggestions of ways to attain the impartial judgment that management is expected to follow when it decides the rates at which the his-

torical cost of fixed assets shall be written off as charges against income? Would it not have been more helpful had the dictum of "reflect real values as nearly as possible" been accompanied by suggestions of ways and means of making good judgments regarding real values and fictitious values?

Would it not be constructive to give some indications of a basis for good business judgment in choosing between the alternatives of (a) writing off a so-called capital loss against current income, (b) carrying the amount as deferred, or (c) absorbing it into earned surplus (pp. 39, 57, 77)? Management may, upon occasion, be led more by wish than objective judgment to postpone recognition of needed adjustments to a more propitious moment; management may persuade itself, or be pressed from outside, to throw capital losses against paid-in surplus, while capital gains are consistently passed to current income; management for various reasons may be led to influence the calculation of net income, through depreciation, by writing fixed-asset values now up, now down. If a flat declaration is made in a given case that managerial discretion has been exercised, is that sufficient to satisfy the auditor that objective judgment and not wish is the real base of the action in question?

It is not necessary to suspect management's motives in order to raise questions about, let us say, the acceptability of a given treatment of losses. Management may have been innocently misled by a false theory that it has the power to stabilize earnings by accounting adjustments. But the fact is that figure-calculations do not make profit or avoid loss; accounting can only reveal profits and disclose loss. Reality lies behind the figures, not in them. It has come to be almost universally understood that ignoring depreciation in the accounts does not prevent plant wear and tear. Does writing up fixed assets actually increase the cost of using the assets, and does writing them down decrease the burden of owning assets that were bought at high price levels?

It is not generally acknowledged that a belated recognition of obsolescence expresses a diminution of assets even if the amount is charged against some kind of surplus. Is not the income statement the recognized means of conveying information to the reader about asset diminutions? Why should loss diminutions have a status different from that given to expense diminutions?

Management may also have been innocently misled by an outmoded tradition, inherited by our accounting literature from certain early British ideas and never thoroughly examined, to the effect that there was something in a business by the name of capital assets in which losses and gains could be recognized as quite distinct from other assets changes called expenses and revenues. Probably the tradition runs back to the double-account balance-sheet prescribed for British railroad companies in 1868 and to the theory of plant maintenance, in place of depreciation allowances, which was so solidly entrenched in railroad practice. Possibly both ideas derive from an interpretation of Adam Smith's discussion of fixed and circulating capital, which, no doubt, was based upon conceptions related more to landed estates than to business enterprises.*

Whatever the origin may have been, there is little ground in America today for trying to relate fixed assets, any more than current assets, to capital-stock investments after an enterprise has once been established. Since fixed

* The peculiar relationship established by trust estates between life-tenant and remainderman may justify considering a loss of corpus as a "capital loss" which the remainderman must bear. But in a corporation there are no comparable conflicting interests existing at the same time. During operations the holders of stock equities are in the position of life tenants; at liquidation the same persons are in the position

assets are not directly tied into ownership capital, it is difficult to see how one kind of fixed-asset diminution (loss) has more justification as a charge against capital or surplus than another kind of fixed-asset diminution (depreciation).

If disagreement upon the nature and treatment of losses still stands, it is probably due to differing views of the nature of surplus. Corporate surplus is not, I think, entirely analogous to the undivided-profits account of a single proprietorship.

The corporation is primarily a financial mechanism which draws capital from many different sources for a common productive purpose. The various capital interests are displayed on the right side of the balance-sheet. Every item on that side represents a capital interest; each one is a measure of an equitable claim against total assets. Under this conception, surplus, instead of being profits, represents a phase of capital. The "capital claim" of common stock is one total, common-stock equity; it consists of two elements; one is paid-in capital, the other is accumulated capital. One part, as a matter of law, can not be freely withdrawn; the other can. That is the only essential distinction between equity capital and surplus.

Since the financial likeness of the two parts is more fundamental than their legal distinction, it follows that surplus has more capital characteristics than it has profit characteristics. The situation is somewhat as if we were to say that earnings standing in the income account represent profit, but that the transfer from income account to surplus account marks a conversion of profit into (accumulated) capital. A loss charged directly to surplus, therefore, becomes a species of charge against one kind of capital and tends to obscure the distinction between capital and income, a distinction which the whole force of accounting theory is bent upon clarifying.

of remaindermen. The same person is life tenant and remainderman, but not at the same time. Hence the conditions under which the assets of a corporation are held, together with the identity of its "life tenant" and "remainderman," lead to the conclusion that there are insufficient grounds for carrying the conception of "loss of corpus" into the operations of a going concern under the designation of "capital loss."

The Balance-sheet

This may sound like strange accounting doctrine, but the conceptions of corporation finance will support the view expressed. The whole right side of the balance-sheet presents sources of financial capital; the whole left side presents forms of economic capital. Those forms are variously used in carrying on enterprise activities. Some of them may be exchanged at a gain, others may be lost outright. It takes the whole series of asset changes to tell the story of the administration of assets; a different treatment of certain asset changes destroys the completeness of the story.

What is meant by preserving the distinction between capital and income is not, as often thought, merely the separation of contributed capital and earned surplus. The basic thought behind the phrase is that transactions in capital equities and transactions in asset utilization are to be sufficiently separated by accounting processes to avoid mixing (a) financial activities concerned with funds and (b) operating activities concerned with assets.

It is this view which justifies the exclusion from the income statement of cash or stock dividends, as well as the results of transactions in the corporation's own shares. The same view of the distinction between earnings and surplus also directs the inclusion of all income and expense, and all losses and gains of whatever kind, in the income statement in some way. Transactions in equities are properly reflected if placed in the balance-sheet, but are improperly reflected if placed in the income statement. Transactions dealing with the administration of assets for

productive purposes properly affect the income statement, but would be improperly reported if only stated in the balance-sheet. Asset losses are transactions in asset utilization and not transactions in capital equities. Hence, such losses are more properly treated in the income statement than as surplus adjustments in the balance-sheet.

Mention was made of constructive guidance to good judgment in the use of accounting. In place of exhortations to avoid arbitrary values and to favor impartial judgment, would it not be more helpful, for example, to advocate, as a standard, passing all losses and gains to surplus only through the medium of the income report, and then support that standard with suggestions by which one could test his own inclination to vary from the standard?

If the conceptions of capital and income outlined above are sound, it would follow that the only diminutions of assets to be charged directly against any equity would be those coming from—

1. A withdrawal of assets to discharge a debt to a creditor, to pay a dividend declared, or to mark the withdrawal of an investor's interest, with an accompanying cancellation of his shares.
2. A net loss from the administration of the assets for the period, after including corrections due to losses just now recognized, losses from unpredictable destruction, confiscation, theft, and the like.
3. A reorganization of financial structure placing the company substantially in the position of a new corporation without a previously accumulated earned surplus.

Such suggestions for the guidance of judgment in departing from the standard would also be significant in what they do not include. Accordingly, a wish to carry losses directly to surplus could not be justified as a considered judgment merely by a showing that the assets lost had been fixed assets, that the loss was extraordinary and nonrecurring, that the amount was large in proportion to current earnings, that the assets lost or devalued were related to capital stock.

Treatment of Losses

The accounting treatment of losses, therefore, would not be a matter of wish, or preference, or policy, but a question of fact. Was there a recognized diminution of assets? Was the diminution related to the administration of assets in carrying on the productive purposes of the enterprise? Or was the diminution related to the administration of equities in conducting the financial affairs of the corporation? When these questions of fact were answered, the proper treatment of the ascertained loss would be indicated. A diminution related to asset administration is properly reported in the statement designed to reveal asset changes, that is, the income statement, properly sectionalized, of course, in order to distinguish recurring and nonrecurring items. A diminution related to equity administration is properly reported in the statement designed to reveal the equities as they stand at a given date. that is, the balance-sheet.

We can easily realize the difficulties which the profession faces in making a pronouncement upon accounting principles. Between the public accountant and his client there is only a contractual relationship. The auditor, therefore, is in no position to demand corporate practices above a statutory minimum or, unaided, to change the direction of management's accounting decisions in particular situations. It is only natural that the profession's reaction should be against both a rigid codification of accounting rules and a statement of principles which would be no more than a rehearsal of minimum accounting practices now current.

While the reaction to the problem is understandable, some of it, I believe, rests upon erroneous premises. A pronouncement of accounting standards above the minimum would be no more embarrassing than a minimum statement, and no more enforceable by the accountant as an individual. But the backing which an authoritative statement of high accounting standards would give to individuals could be invaluable in helping them to secure a gradual advance in corporation accounting practices. It could give courage and strength, also, to those who hope to see state corporation laws further improved. The use of the conception of "standards" instead of "principles" would carry with it the thought of stating standards as points of departure, while making plain the necessity for clear justification for any variations from the standard. Obviously this would be quite the reverse of a rigid codification of accounting rules, and it would emphasize the quasi-judicial nature of the public accountant's consideration of the reasons given him in individual cases in support of departures from the standard.

Because the auditor must act as an independent critic of the maintenance of high standards of corporation accounting, it is entirely logical that the combined experience of the profession should be drawn upon in the framing of standards, especially in the direction of making clear in the context ways and means by which management may be assured that its accounting decisions will rest upon intelligent and impartial judgment.

A clear and concise statement of accounting standards emanating from the profession and supported by its organizations would undoubtedly be welcomed by corporation management as well as public accountants, just as the several statements on recognized audit procedure have been welcomed. The latter were accepted as explanation to the business public generally of the basis upon which would rest a certificate that was unqualified as to the scope of the examination. The former would undoubtedly be accepted as a message to the business public of the basis upon which a certificate would rest that was unqualified as to the auditor's opinion. Qualifications in the certificate then would become indications that the standard scope of investigation had been limited or that the company's accounting or reporting methods were not consistently in reasonable agreement with recognized standards.

The public looks to the profession for leadership and initiative in these matters. The day is past when public accountants were regarded merely as experts in unraveling tangled accounts, or as detectives burrowing in figures to put the finger on a dishonest clerk. A truly professional status is being achieved, and the public is coming to expect of the professional accountant not only technical skill, but high ideals, firm convictions, and a broad conception of public service. The profession could well afford to assume this high type of unselfish leadership. We need no longer fear that anything we say will be used against us; initiative will no longer bring the accusation that public accountants are but fostering a self-seeking monopoly. The public accountant owes a clear duty of professional skill and judgment to his client; but he also has an obligation to the public, to the legion of present and prospective absentee investors: an obligation of judicial disinterestedness, of independent views, of strong convictions on fair play.

The principal reason accountancy is rapidly gaining a real professional status is that the public is more than ever before convinced that public accountants stand for these ideals; their technical capabilities may even be considered somewhat secondary to a high sense of moral obligation.