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THE *Statement of Accounting Principles* by Professors Sanders, Hatfield, and Moore is a clear and straightforward exposition of principles underlying the best current accounting practice. The statement displays throughout a broadly tolerant point of view and a sympathetic appreciation of the problems of both business management and practising accountants. Its spirit of reasonableness will go far towards winning for it a general acceptance by the profession. Its influence should be an important factor in the standardization and improvement of accounting practices.

On many points, the statement recognizes the propriety of any one of various and sometimes divergent methods. However, this latitude of choice allowed to business management and accountants is always limited by an insistence upon clarity and consistency. We cannot commend too highly the repeated insistence that, wherever there is a choice of methods, accounting reports should in each case show what method has been used. And the same may be said for the further requirement that the selection of a method must not be a matter of capricious decision dictated in each case by the demands of an immediate situation, but shall be rather a matter of studied and consistent policy. These are underlying principles which are much more important than specific rules which deal with the treatment of specific accounting items.

COST ACCOUNTING

Notwithstanding its catholic and tolerant attitude towards general accounting practice, the statement makes no place for what is commonly known as cost accounting. Nowhere in it is there any inkling of such a sphere of accounting theory and practice. The threefold statement of accounting functions on page four includes the historical record of transactions, periodic calculations, and, based upon the other two, the preparation of summary statements. Later discussion of the income statement emphasizes the importance of a proper allocation of costs and incomes to the different fiscal periods, but here also no recognition is given to cost accounting. In fact, as will appear later, the discussion tends to run somewhat counter to the fundamental purposes of cost accounting.

The field of accounting which has been unfortunate in receiving the name, cost accounting, is concerned primarily with two fundamental purposes. One of these is the coördination of costs with the processes or operations through which business enterprise produces and sells goods and services. The second is the coördination of costs with the incomes which arise out of those sales of goods and services. The second purpose is realized by an allocation of costs to the goods and services which are produced and sold.

Cost accounting undertakes the development of rules and methods of procedure—including both principles and technique—which will assure the realization of its fundamental purposes. As cost accounting develops, it is becoming more and more apparent that the coördination of costs and incomes which has been afforded by general accounting practice in the allocation of those costs and incomes to fiscal periods does not agree with the results obtained through cost-accounting processes. One accountant whose experience has been in the field of cost accounting and another who has been in the field of general practice come to specific situations and specific problems with different conceptions of the term, "cost." If they become involved in an argument, much energy and, sometimes, even goodwill are likely to be wasted because neither of them realizes the nature of the difference in their thinking.

One problem which is raised by this difference of views is the determination of the place of cost accounting in the broader accounting field. Are the cost accountants to be limited by and subordinate to conceptions already developed by general accounting practice? Are they to have free rein in the development of their own concepts, but suffer the fate of having their principles excluded from accounting theory and their results excluded from the system of accounting records because their principles and results do not fit in with earlier established, traditional principles and methods? Or, finally, will the general body of accounting theory be flexible enough to absorb and adjust itself to developments in the field of cost accounting?

This divergence in the outlook of cost accounting and that of general practice will be clarified by the citing of specific illustrations. If there is a cost factor whose incidence is irregular, like the loss from industrial accidents suffered by manufacturing enterprises, cost accounting undertakes to spread it over all operations. The justification offered for this practice is that the cost chargeable to a given product is the risk of loss attaching to the operations which resulted in the product, rather than the loss suffered in accidents which chanced to occur in those operations. The operations of a given period may show no accidents, but it does not follow that those operations have carried no risk of accidents. If the cost accountant neglects this risk, he is not showing an accurate coördination of costs and incomes.

The traditional accounting view, of course, would be that of charging against each period the losses which happened to occur in that period. Some accountants would compromise the two views to the extent of using the calculated costs in monthly statements, while insisting upon the so-called actual costs in annual statements.

Another and somewhat similar example arises in the treatment of overhead costs. When the output of an enterprise is irregular, the idle capacity of the plant must be carried through slack periods. This extra capacity is provided for the production of peak periods. Hence, the cost of carrying it through slack periods is not a cost of operations or products of those periods. Cost accounting undertakes to meet this situation by charging overhead against operations and products at standard rates, thus affording standard costs for the products of both slack and peak periods.

But when we come to the preparation of the income statement, we are outside the province of the cost accountant. For income-statement purposes, we insist upon adjusting standard costs to actual costs. The actual costs are those chargeable against the given fiscal period according to the cruder methods and technique of cost allocation developed by general accounting practice.

This illustration raises some significant questions. Are the so-called actual costs more accurate or significant than the standard costs? The two types of cost imply different coördinations of costs and incomes. The conflict between them calls for a decision as to which of the coördinations more nearly reflects underlying economic relations. It will be unfortunate if this issue is decided in favor of the views of general accounting practice on the bases of tradition, weight of authority, and priority of formulation.

All accountants should be able to agree that manipulation of accounts by management to make them show desired results is to be condemned, even if the management is honest and sincere. But it does not follow that an accounting procedure is bad because its use would afford results which are more acceptable to management. The use of standard costs in the income statement would tend to equalize profits, but it is not to be condemned either on that ground or upon the ground that it is contrary to traditional practice.

Conventional *v.* Statistical Approach

The cost accountant's approach to the problem of cost is essentially statistical in character. The conventional accounting approach is essentially that of the accounting record of transactions. Sooner or later there is bound to develop a clear-cut issue on the question of whether the conventional accounting coördination of costs and incomes in the income statement should not be replaced by a statistical coördination. The interests of management are such that, when this time comes, management will likely be found in the group favoring a statistical coördination.

We condemn the management which claims the privilege of an arbitrary allocation of depreciation in order to equalize profits, but in our condemnation we should give attention to the beam which may be in our own eyes. Is it possible that such a management may have been driven to take that extreme position by our insisting upon a traditional and inaccurate coördination of costs and incomes?

The notion of such a radical departure in accounting theory and practice as suggested in the above paragraphs is not merely idle speculation. Its possibility is foreshadowed by the tying-in of cost records with the general accounts and the coördination of all accounts with budgeting. It is suggested also by the increasing use of statistical methods, especially the use of operating and financial ratios, which sets up a constant pressure for a statistical determination of the terms of those ratios.

The substitution of a statistical control of costs for the conventional accounting control does not mean that costs would be out of control. The accountant who is accustomed to thinking in conventional terms is likely to feel that, with such a change, management would not need to manipulate the accounts—that the manipulation already would have been done by the accountant, if he could still be called an accountant. However, the situation would not be as bad as that. All that the change would require of the accountant would be that, to his skills in accounting theory, accounting practice, auditing, and business law, he should add two more skills, one in the theory and the other in the practical application of statistical methods.

It might well be added here that the familiar controversy over whether interest on capital used should be treated as an operating cost is another example of the conflict between the conventional accounting control and a statistical control of costs.

In pointing out the difficulties of a proper allocation of costs and incomes, Professors Sanders, Hatfield, and Moore write as follows: "The principles of accounting furnish a guide for the treatment of these areas of doubt, but there must always be a considerable exercise of judgment in arriving at the best procedure."

As a pronouncement upon the difficult question of income and expense accruals, this statement is somewhat disappointing. It is true that there are a great many specific principles and rules of thumb dealing with particular types of business and particular incomes and expenses. These specific principles and procedures have grown up out of accounting practice. They constantly are being applied to the infinitely complex and ever-changing mass of transactions and economic relations included in business activities. As new situations develop, old rules are applied to them, and frequently it is a difficult question to decide what rule is the best one to use. One of the chief purposes of a general statement of principles is to help standardize, clarify, and correct the applications of such detailed rules. In general, the work of Professors Sanders, Hatfield, and Moore does serve this purpose admirably. But on this point it does not help to say that a considerable exercise of judgment is required to select the best rule or procedure to follow.

If the general statement of principles is to be of help in the problem of income and expense accruals, it should present a principle which will organize the application of detailed rules of income and expense accrual and serve as a basis for discrimination when a choice must be made between them. Such a principle is to be drawn from the present statement of principles, even though it is not explicitly stated. Throughout the statement there is the spirit of an impartial and even-handed treatment of all the interests which are concerned with accounts, and that is the principle which underlies income and expense accruals.

Those rules of thumb and practical procedures which most effectively promote an equitable adjustment of all the interests involved in business enterprise are best, and those which fail to contribute to that end are to be corrected or abandoned. Such is the essential significance of the general rule that accounts shall be kept in accordance with generally accepted accounting principles. The practising accountant is no mere hired representative of business management. He carries the responsibility of protecting all of the different interests involved in business enterprise. It is the assumption of this responsibility that makes accounting a profession. The statement of accounting functions presented by Professor Sanders and his associates would have been better if it had included a specific expression of this protection of equities or social control function.

In a competitive system, the market adjusts the conflicting economic interests of all those who are competitors in the market. But when the typical unit of competitive enterprise became a complex group of varied interests, the market could not provide effective adjustments between them. Some indirect adjustment of internal interests is worked out in the market, as in the terms of sale of bonds. Enforcement of the terms of the bond contract, however, may depend upon the accounts. When it comes to other conflicts of interests, such as those between present and future stockholders, the dependence upon accounts is much more direct and complete.

On page 46 of the statement there is this significant sentence: "The statutes and judicial decisions have, in general, left to accounting principles and sound business judgment the determination of income available for dividends."

Accounting is responsible for showing what income has been earned, but management must assume responsibility to decide whether, in the light of all attendant circumstances, it would be wise to pay out those profits in dividends. In determining the amount of income earned, accounting works out the adjustment of various interests which are actually or potentially internal to the business enterprise.

Accounting and the Law

There are many illuminating analogies between accounting and the law, and this discussion of accounting responsibility suggests one of them. For a very long period in Anglo-Saxon legal history, the dictum that judges never make law but only find it was accorded a high place among legal principles. It had the support of the most unimpeachable authority. But now, with a more realistic approach to law, we recognize that, in his interpretation of statutory enactments as well as in his development of common-law principles, the judge plays a very important part in the making of law. In the same sense that we could properly say that the judge does not make law, we could say also that the legislature does not make law, but only finds it—and on occasion fails to find it, as in the passing of enactments which are contrary to fundamental law.

A Dictum Questioned

In accounting we now have a dictum which has received the support of the most unimpeachable authority. This dictum runs to the effect that accounting is not essentially a process of valuation, but is rather a record of historical costs.

To appraise this dictum we need only to review what has already been said in this paper. The valuations which are made by the market are not ends in themselves. They are but the means of adjusting conflicting economic interests. Such adjustment of interests is the essence of the process of valuation, and whether accountants recognize it or not, the net effect of their efforts is an adjustment of conflicting economic interests. Indeed, the effective adjustment of such interests is the controlling purpose behind the keeping of the record of costs. Hence, regardless of the character of the authority supporting it, we are compelled to conclude that the accounting dictum, like its earlier counterpart in the law, does not correctly express the accounting functions to which it is supposed to apply.

Not many detailed criticisms are to be made of the statement by Professor Sanders and his associates. Their discussion of conservatism is an apologetical masterpiece. Almost it persuades even a confirmed heretic that, in accounting, conservatism is more accurate than accuracy itself. The tenacity with which the accounting profession clings to the dogma of conservatism reminds the writer of the time when he was a small boy on the farm and had an uncle whose family always kept their clock fifteen or twenty minutes too fast. Their justification of this practice was that it would help them to be on time. They were in fact notorious for always being late. Their keeping the clock too fast was, I am sure, one of the factors contributing to their habitual tardiness.

Conservatism muddies up the accounting waters. It dulls the accountant's sense of accuracy and gives him a false sense of security and righteousness. It impairs the usefulness of his results for purposes of analysis, comparison, and prediction.

One other detail upon which some comment is in order is the reference to the use of a retirement reserve as a substitute for depreciation. The discussion on this point appears to justify or at least condone the use of a retirement reserve if a large enough charge is made to maintenance to make up for the inaccuracy which is implicit in the retirement method. On the same grounds we would be justified in ignoring depreciation altogether if enough additions to keep up the value of the property were charged to maintenance.

Retirement Reserve or Depreciation?

The conclusion of the authors evidently was that the use of the retirement method comes within the limits of tolerance which they would set. This conclusion would be better defended upon other grounds. Assuming otherwise correct accounting, the retirement method results in overvaluation of the assets to which it is applied. Its use was hit upon as a reaction against the undervaluation which is inherent in the straight-line method. In particular cases the error involved in the use of the retirement method may be the smaller of the two. Whether it is larger or smaller will depend upon the amplitude of the working margin allowed in the operation of the retirement reserve and the rate of discount applicable to the case.

It may well be pointed out that the inaccuracy of the straight-line method is most serious in enterprises using a large amount of invested capital, in which the cost of maintaining that capital investment makes up a relatively large fraction of the total production cost. Public-utility enterprises are typically of this character. It would be an entirely reasonable position to hold that the retirement method is acceptable practice in public-utility accounting as long as the straight-line method of depreciation is deemed to be acceptable in the same field. If this position is accepted, the first step in any attack upon retirement accounting should be an advocacy of more accurate depreciation methods for the public-utility field.

An attempt at the formulation of a statement of principles for any profession should have two essential purposes in mind. The first of these already has been discussed. It is to present a basis for the coördination, standardization, and correction of detailed rules which have developed out of the practice of the profession. With a general statement of principles, practice is integrated and improved.

Social Orientation

The second major purpose is closely related to the first; the difference is that, while the first is concerned with the internal improvement of the profession, the second is concerned with its external relations. A general statement of principles should give the profession a social orientation which will enable it to play a more effective rôle in society.

The whole problem of professional guidance is beset with special difficulties at this time because so many traditional principles of social organization have been abandoned or are being abandoned. Western civilization is in the throes of a critical self-analysis. The different peoples of Western culture are trying to find out what are the basic principles of social organization to which they now subscribe. While professional guidance is more difficult in such a situation, it is also more important. Clear-cut statements of governing principles in the different professions cannot fail to contribute to the broader problem of a reclarification of basic principles of social organization.

There is no intention on the part of the writer to criticize Professors Sanders, Hatfield, and Moore because they did not discuss the social-control aspect of accounts or the social responsibilities of accountants. It may be assumed that they took such matters for granted as the by-products of humbler tasks well done. The question is brought up here only because of the wide divergence of present opinions as to relations between the theory and the practice of accounting. Some hold that practice of the profession cannot be controlled by any formulation or general acceptance of principles. Others hold that accounting practice may be standardized and controlled by generalized rules based upon such practice. The first view in effect denies the existence of accounting theory, leaving only practical rules of thumb and personal judgment to guide the practising accountant. The second view looks upon accounting theory as a body of rules or generalizations which summarizes the experience of the profession. It tends to subordinate theory to the practice from which it is assumed to be drawn.

Neither of the foregoing views is the one adopted in this discussion. Principles cannot be subordinated to their application.

Practical rules which apply to specific situations are all the while developing out of the concrete process of living. Whether these rules are in accounting or law or any other field of social activity, they are subject to appraisal and approval, revision, or rejection in the light of more general rules applying to a wider range of experience or a greater variety of situations. The appeal is always from the specific to the general and from the less general to the more general. When we come to the most general rules which are peculiar to any given profession, the appeal lies to still more general principles which underlie broader aspects of social organization. Thus accounting theory must tie in with more general principles of social theory. It is theory, in this broad sense which should dominate and control the practice of all professions.

For present purposes the essential point is that leadership in the accounting field must look beyond the technical practice of the profession to a sound social theory. In this connection a distinction should be made between practice and practitioners. The fact that a man is engaged in practice does not excuse him from taking an active interest in the abstract theory underlying his profession. When we say that theory must control practice, the statement has no personal significance. It would be extremely unfortunate if public practitioners, corporation accountants, teachers of accounting, or any other one group should undertake to dominate the field. What is called for is leadership in all such groups, with vision broad enough to give the profession effective social guidance. Such leadership can be effective only through the development of sound and illuminating principles.

The next formulation of accounting principles should undertake a discussion of the relations between accounting theory and accounting practice.