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John W. Queenan

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The Development of Accounting Principles

by John W. Queenan
Partner, Executive Office

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The Accounting Principles Board presently finds itself in a position colloquially described as "damned if you do and damned if you don't." I don't know how closely you've been following newspaper and magazine articles dealing with the Board's activities, but it's been interesting to me to see how many times the Board has been put in a "can't win" kind of situation. For example, in a recent article, one critic accused the Board of being biased in favor of the "public accounting" approach to accounting principles, and not enough directed, or oriented, to the practical, businessman's side of accounting principles. In support of his contention he contrasted the large number of practicing public accountants on the Board, including the more or less automatic representation of the so-called "Big Eight" accounting firms, with the minimal representation given to business. (The Board, by the way, presently has 19 members, of whom 15 are practicing CPAs, including representatives from the Big Eight firms; two are from the accounting departments of large universities; and two are from industry.)

Meanwhile, other critics look at the representation of the large firms on the Board in quite a different light. These critics note that the Big Eight accounting firms are the auditors for all but four of the 100 largest industrial corporations in the United States and for all but about three dozen of the 500 largest industrial corporations. Then, giving us little credit for our reputation for independence and ethical behavior, these critics point out what they consider to be the inevitability of the collective influence of all these large corporate clients on the direction that proposed Opinions of the Board will take.

So, according to some, the Board has too little industry representation, while, according to others, industry has an indirect but pervasive influence on Board decisions.

Uniformity—Too Much or Too Little?

Another of these "can't win" situations relates to the matter of uniformity of accounting principles. On the one hand, some critics assail
the Board for tolerating the continuance of several alternatives in accounting for a single economic fact; while on the other hand, other critics, primarily from industry, accuse the Board of trying to impose a strait jacket on management's right to select the accounting methods most appropriate to its goals.

OTHER CRITICISM—GOVERNMENT REGULATION

One surprising illustration of the diverse range of criticism that has been leveled at the Board relates to the matter of government regulation. I believe that even those who are the Board's most vocal critics recognize that some form of self-regulation—such as by the Accounting Principles Board—is highly preferable to almost any form of government regulation. On this point, the Board can usually expect the support of almost all its critics. Apparently, that is, except for those whose accounting practices are already under some form of government regulation. These people, it seems, would rather see the Board yield to regulatory authority in the development of accounting principles than attempt somehow to influence regulatory authorities to conform their accounting and reporting requirements to what the Board considers to be more appropriate accounting principles. As a result, perhaps for reasons of practicality in statement preparation, perhaps because they are reconciled to the enduring need for government regulation, these critics attack the Board for the very things for which other industry members defend it. For example, certain bankers who have urged consistent accounting procedures within and among companies have not felt the same about application of those consistent principles to banks.

I present these illustrations of two-sided criticism to you not to debunk the Board's critics, or to say that they are not fair. To the contrary, the personal reputations of the critics and of their companies and organizations themselves speak of their honest and constructive intentions. My purpose is simply to point out that the Board will have criticism leveled at it no matter what it does. If the Board is to deal with controversial accounting matters, we must expect to see it involved in controversy.
HOW THE BOARD OPERATES

Let me now go on to tell you something about the Board’s operations, which, if truly understood, are more likely to elicit respect than criticism.

By way of background, the Board was organized in 1959 as a successor to the Committee on Accounting Procedure, which had been in existence for about twenty years. That Committee issued fifty-one bulletins during its tenure and, with minor exceptions, those bulletins have had a significant effect on the development of accounting principles. The profession concluded, however, that a greater effort, and particularly more thorough, independent research, was required in the development of accounting principles, so the Board and a new Accounting Research Division of the Institute were organized to fill these needs.

The members of the Accounting Principles Board are hard-working, dedicated men. The Board has already met five times this year [1968], and will meet at least two more times before the year is over. Generally, each meeting of the Board lasts three full days. In addition to meetings of the entire Board, numerous subcommittee meetings are necessary to develop materials for Board consideration.

But much of the work is done behind the scenes, so to speak. Each of the Board members has an imposing amount of homework to do; almost more, in fact, than one man can do alone, and the assistance of personal staffs is common. In my firm, for example, several partners and associates regularly devote a considerable part of their time to APB matters. Also, the Board has the assistance of a full-time administrative director and assistant, the co-operation of the director of accounting research of the American Institute of CPAs and the services of varied full-time and part-time Institute staffs.

To point out the care and attention the Board gives to its pronouncements, and to illustrate its constant seeking for guidance and advice from others, let me recite briefly the several steps through which a Board opinion is developed. Often the activities begin with the commissioning of a research study under the auspices of the research director of the American Institute, who may use his own staff or outside personnel from universities and other sources. A study may take several years to complete. Armed with the results of the study, which, by the way, is not an official pronouncement of the Board (or, for that matter, of the Institute),
a subcommittee of three to five members of the APB then proceeds to develop a "point outline" for the consideration, first, of the subcommittee, and then of the full Board. The point outline brings out the differing views and attitudes of the Board and is generally designed to expose any illogic or inconsistency in members' positions; ultimately, it guides the subcommittee in the preparation of the first draft of the proposed Opinion.

Generally, when the first draft comes out of subcommittee, it is presented to the full Board for its comments, after which it goes back to the subcommittee for another draft and later re-exposure to the Board. This process may be repeated several times before a consensus of the Board is reached. Meanwhile, discussions are held with industry groups and interested government agencies to determine their views and to incorporate certain of their suggestions in the successive drafts.

Ultimately, a draft of the proposed Opinion is exposed for general comment. This exposure draft receives a very wide distribution. A copy is mailed to the president of every company listed on the New York Stock Exchange, and to the presidents of a sampling of companies listed on the American Stock Exchange; to co-operating industry associations, government regulatory agencies, and deans of schools of business administration; to appropriate committees of state societies of CPAs; and to many others. The exposure draft of the Opinion on Accounting for Income Taxes was also mailed to every one of the then 61,000 members of the AICPA.

Every Board member receives a copy of each of the letters of comment on the exposure draft. (Concerning Opinion No. 11, there were more than a thousand such letters.) Each member then has an opportunity to re-evaluate the draft in light of the exposure comments and his own further consideration and to offer his suggestions for incorporation in a final draft for balloting by the Board.

WHAT HAS THE BOARD PRODUCED?

I don't have to spell out the product of the Board's work during these nine years of its existence; I'm sure you are all familiar with the twelve Opinions and one Statement that have been issued so far. The Board has been aware of the criticism made in the past about its pace in the issuance of opinions. In its early years, the Board was occupied with organizational and procedural matters, including initiation of research studies on subjects it wanted to consider. After these early problems were resolved
and the research on certain important topics was completed, the pace in issuing opinions accelerated considerably. For example, seven of the twelve Board opinions have been issued in the last three years.

THE SEARCH FOR ACCOUNTING PRINCIPLES

In addition to dealing with specific accounting problems, the Board is continuing to search for a broad framework of accounting principles. For if accounting principles are permitted to grow individually, each to meet a separate need, there is the inevitable danger that while each principle may appear to suit its purpose, together the several principles may prove to be inconsistent—perhaps even in conflict with one another. Yet each time the profession embarks on the task of codifying these principles, it comes back to a familiar problem: By making a statement of principles sufficiently broad to serve as a general framework suitable to all possible conditions, we find we have “generalized” our concepts out of all their practical utility.

Certainly we can’t be specific in a statement of accounting principles and their applicability; we are not trying to write a rule book to fit each and every situation. Still, in some cases, general principles do not adequately define a situation, or point us in a particular direction, sufficiently to permit only one solution to a particular accounting problem to emerge. For example, take the “matching” principle, which calls for the matching of revenues and their related costs. Certainly, this principle has served us well; still, in recent years it has proven to be too broad to resolve, say, the question of whether the investment credit should be accounted for by the spreading method or the flow-through method. As you know, advocates of both methods have offered the matching principle in support of their positions.

Despite the obvious difficulties involved, the Board determined to pursue its search for a set of general principles that can be agreed upon as a basis for future opinions on specific accounting problems and that will provide consistency among the opinions. An important point to keep in mind about this search for an accounting framework, or structure, is the very nature or substance of accounting principles. Accounting principles are not absolute laws, like the laws of nature, which can be “discovered.” “Ideas and procedures become ‘gen-
erally accepted accounting principles' by agreement rather than by formal logical derivation from a set of postulates or basic concepts. These 'prin­ciples' are based on experience, reason, custom, usage, and, to a signifi­cant extent, practical necessity." They are rules developed to serve a utilitarian need in the economic environment of the day.

THE ENVIRONMENT

We are today witnessing at first hand just such a development of accounting principles in response to the needs of the economic environ­ment. Until recently, most accountants felt that the extent of inflation in the United States did not require the use here of price-level—adjusted financial statements. But our environment has been changing. Inflation is clearly a part of our everyday economic life. Relatively unimportant in any one year, it has been recurring, and cumulatively it is now signifi­cant. Still, because our environment has not been characterized by the drastic inflation found in so many other countries, changes in our ac­counting will also be less drastic.

The Board, responding to these changes in our environment, is close to the point of exposing an opinion on financial statements restated for price-level changes. Because this opinion represents such a considerable break from convention, the draft, besides going through the processes of study and exposure I have already described, is also undergoing exper­i­mentation by approximately a dozen U.S. companies. These companies have agreed, as a test, to apply the procedures recommended in the pro­posed Opinion to their 1966 and 1967 financial statements. In effect, they are helping to de-bug the Opinion before its general exposure.

The Board's recommendation probably will be that price-level—ad­justed financial statements, or data taken from such statements, may be set forth as supplementary presentations to the basic financial statements, which will remain on a historical basis. This should meet the needs of our present environment. If our environment at some future time, how­ever, should be characterized by the same runaway inflation now char­acterizing the economic environments of other nations, then the Board may recommend that price-level—adjusted financial statements become the primary financial statements.

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THE COMPLEX NEW ENVIRONMENT

Inflation is just one of the many complexities in our present environment that make for complex accounting problems and controversial solutions. Think back fifteen or twenty years, and you will see what a variety of accounting problems our environment has spawned. For example, how prevalent twenty years ago was the use of leases in lieu of outright purchase or direct financing or the sale-and-leaseback transaction or the industrial revenue bond? We did not have accumulating convertible preferred stocks; nor did we have an interested public that put so much emphasis on earnings-per-share figures. The merger and acquisitions boom and the concept of pooling of interests were not fully upon us; nor was the problem of reporting by diversified companies.

And now into what still more complex accounting problems are we headed? We are thinking of the possibility of using market values in place of, or along with, acquisition costs; of the use of discounted present-value concepts in accounting for long-term assets and liabilities; of recording implicit interest and discount, and perhaps other implicit costs; and of broadening measurement and recognition criteria to bring contracts, commitments, leases, and other executory contracts onto the balance sheet. Even the basic accounting equation—assets equal liabilities plus equity—is now in flux. As the abundance of convertible debt and convertible preferred stocks blurs the distinctions between debt and equity, some accountants talk now about a special balance sheet category for “quasi-entities.”

These problems are just signs of the coming times.

THE PLACE OF LOGIC

How do we proceed to develop accounting solutions for the novel situations with which we are confronted? Well, some have suggested that accounting solutions be based solely on logic. They contend that generally accepted accounting principles are not good principles if they are not logical. At first glance, this approach sounds ideal. All of us, as accountants, pride ourselves, I think, on our ability in logic. Things must, after all, make good sense. According to the advocates of this approach, basing accounting principles on logic would eliminate the possibility of having so many alternatives; those having no foundation in logic simply
would not survive. Moreover, the ready acceptability of a practice or method founded on logic would be assured. Once you see the logic behind an accounting method, and see that that method is better than any other, then surely that method would receive universal acceptance. No longer would we need to bully one another with recitations of accounting principles; we would only need to convince one another of the logic of our premises.

All well and good—in theory. But, in practice, the theory breaks down when the question of whose logic should be followed arises. We need only look to what has happened with the investment credit as an example. The investment credit works in just one way, for all companies; there is just one set of circumstances to account for. Everyone is agreed that there is no valid reason in logic to account for the investment credit in more than one way. And yet there exist two quite divergent schools of thought on how to account for the investment credit: There are those who favor flow-through and those who favor the spreading method. Solve the problem on the basis of logic? Surely—but whose logic?

If any of you have seen the musical *Fiddler on the Roof*, you may recall a scene at the very beginning of the show that perfectly characterizes the present situation. Tevye [Tev-yuh], a dairyman, is on stage. He is a poor peasant, living in a small village in czarist Russia, just before the beginning of the Communist revolution. From one side of the stage comes a friend, caught up in the Communist spirit, who speaks to Tevye critically of the Czar. “The Czar is an oppressor of the people. He takes our finest young men from the farms, where they are sorely needed, and puts them in his army, where they are trained only to bully and abuse us. The Czar’s policies permit us no land and no freedoms. We are nothing more than slaves, bound to a land we do not own. We must overthrow the Czar.” Tevye, listening carefully, nods his head and says, “You’re right!”

Then another friend, this one still loyal to the Czar, comes from the other side of the stage and speaks to Tevye. “The Czar is the protector of the people. Certainly he takes our best young men into the army, but let’s face it: They live and eat better in the army than they ever could at home. Moreover, the army preserves law and order within the land, and protects our borders from the armies of alien nations. For our own
safety, the Czar must have our every loyalty.” And Tevye, again listening carefully, nods his head and says, “You’re right!”

Now a third man, who has been standing by and has heard both conversations, comes over, clearly vexed. “What’s the matter with you?” he says to Tevye. “One fellow comes up and says he wants to overthrow the Czar; you hear him out and say he’s right. Then the other fellow comes up and tells you how wonderful the Czar is, and how we must preserve him, and you tell him he’s right. Now tell me, how can they both be right?” And Tevye thinks a moment, and says, “You know something? You’re right too!”

That story is an excellent illustration of the quandary in which the accounting profession finds itself today with respect to the investment credit. Each side is right, so to speak, and what each side says is logical. But how can they both be right? So logic alone is not a panacea for all accounting problems.

Accounting principles rest only in part on demonstrable truths to which logic can be applied. They must rely heavily on conventions—propositions that are acceptable but cannot be proved to the exclusion of all others. The process is to reach a consensus on conventions that cannot be proved categorically. The Board is attempting to follow this procedure in its approach to the development of accounting principles. Although some continue to criticize this approach, these critics have not offered an acceptable alternative.

THE ROLE OF INDUSTRY

Up until very recently, the CPAs in this country, through the AICPA—and particularly through the Accounting Principles Board and its predecessor, the Accounting Procedure Committee—have clearly been the leaders in the search for accounting principles. The American Accounting Association has also contributed significantly, although more in terms of the profession’s long-range objectives. The National Association of Accountants, of which I am sure many of you here are members, also has contributed greatly by setting down, in their research and practice reports, the techniques of industry in a variety of areas.

And, of course, we must not forget the contribution to reporting standards made by the stock exchanges; and most especially, the contributions of the SEC, which, through Regulation S-X, Accounting Series
Releases, pre-filing conferences, deficiency letters, and sometimes, just as important, moral suasion, has become an important contributor to accounting practice and reporting.

And now, we hear clearly the voice of the industry. Of course, that voice has always been heard on the Accounting Principles Board and through the Board’s extensive exposure process; comments on exposure drafts come regularly from the thousands of industry representatives on the Board’s mailing list. I should like to clarify one thing about the exposure process for the sake of those who, to support their contention that the Board is not responsive to industry’s position, quote statistics on the volume of positive or negative letters the Board receives. While the Board respects the comments of management, it cannot always be impressed by the sheer weight of numbers in support of a particular position. It is impressed, however, by comments that include thoughtful, objective reasons for supporting a particular position. Further, although the views of individuals are helpful, the Board obtains substantial benefits from comments that represent the collective thinking of interested organizations, particularly the FEI.

I am glad to see that, through its research foundation and committees on accounting, the FEI has joined in the common search for accounting principles. I note that your Committee on Corporate Reporting has already established subcommittees on business combinations, convertible securities, conglomerates, the investment credit, and accounting changes, in most cases paralleling subcommittees of the APB. This is an encouraging sign.

I am particularly impressed with the FEI’s significant contribution to the research on so-called conglomerate companies. This was truly a collective project adjusted not to the needs of any particular company or industry, but to the broad reporting problems of business in general. The SEC’s recent proposals to require disclosure of additional information concerning a registrant’s various lines of business were based, in part, on the study sponsored by your research foundation. This study and the work done by other groups will be helpful to all of us in evaluating the SEC’s proposals and in commenting on them. More of this kind of collective research is needed in other areas of accounting, and the Board welcomes your contributions to such research.
WHAT EACH INDIVIDUAL CAN DO

Now what can you, individually, do to help formulate sound accounting principles? First, take a sincere interest in developing those principles. In a few words: Don't just complain; if there's something you don't like about the way things are going, do something about it. You can do this on a personal basis, by responding in a reasoned way to the Board during its exposure process; or through your industry and business organizations, including the FEI, both before and after the exposure process. Give advance personal consideration to APB pronouncements. There is no reason to be caught napping on this. The projects with which the Board is now working are well known. Our timetables are such that months, and on projects in the research stage, sometimes years, will elapse before Opinions will be issued on particular subjects. Surely, the time to begin developing your own conclusions on these subjects is now, and not just at the time of the exposure process.

Second, you must exercise some form of self-regulation or self-restraint in selecting accounting methods within your company. Undesirable alternatives should be weeded out and discarded. This will require great constraint on your part. You know that you have been accused by some of developing and applying accounting principles with an eye on your earnings-per-share figures, and not on the soundness—or applicability—of those principles. The counterargument often raised, of course, is that you are fully justified in doing this; more than that, that it is your responsibility to present the most favorable results possible within currently acceptable limits. I will not argue this. But this kind of self-indulgence can only lead to criticism by ever broadening stockholder groups, and ultimately to some kind of government or regulatory intervention. If you do not set your own house in order, the public will press the government to do it for you. Restraint is clearly the order of the day.

Third, I encourage you to develop the attitude, which I believe is held without exception by every member of the Accounting Principles Board, that Opinions of the Board should be supported, even if you are not personally in agreement with the Board's conclusions. Maintaining the integrity of the Board, and supporting attempts at self-regulation, are important to the orderly development of accounting principles. To ignore those rules with which you do not agree, and abide only by those with
which you do agree, can lead only to a complete breakdown of our financial order. The parallels elsewhere in our society are clear.

In addition, you must apply the Board's Opinions in good faith. Some companies have adopted APB recommendations in their financial statements that are covered by the opinion of the independent auditor, but then have used conflicting methods in other parts of their annual reports, such as the president's letter or highlights; or in unaudited interim reports; or in figures released to the press.

Fourth and last, support your FEI and the industry groups attempting to come to grips with accounting problems. Provide them with manpower and money; both are needed. And do not think these problems are not of interest to non-financial management in your companies. That interest is quite clear to me from the many contacts I have with management in the course of my firm's business, and from the responses the Board gets to its exposure drafts. And I am not talking about letters drafted by financial executives for the signatures of top executive officers, perhaps to lend additional prestige to the replies; I am referring to the genuine interest these officers have in the very same accounting principles with which you tangle each day. Your expenditures of time, effort, and money will, I am sure, be supported at all levels as being in your companies' best long-range interests.

CONCLUSION

The Accounting Principles Board welcomes your co-operation. The Board is sincerely interested in involving business management, to a far greater extent than heretofore, in the development of accounting principles. The Board needs the benefit of both your experience and advice. We want especially to demonstrate to you that the Board does not act without adequate attention to accounting research or without sufficient attention to the utilitarian nature of its Opinions, or to the practical problems encountered in implementing those Opinions.

The accounting profession and industry obviously have a community of interest in the development of accounting principles. Some of the past misunderstanding between these groups arose because industry had no organization through which effective communication with the accounting profession could be maintained. The Financial Executives Institute
comes closer than any other organization to filling this need, so a close working relationship between your organization and our profession is especially important. Together we may bring about a consensus on accounting principles that neither group could attain alone.