Accounting Historians Journal

Volume 12
Issue 1 *Spring 1985*

Article 7

1985

Story of the sixth rule

Benny R. Copeland

Follow this and additional works at: https://egrove.olemiss.edu/aah_journal

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Copeland, Benny R. (1985) "Story of the sixth rule," *Accounting Historians Journal*: Vol. 12 : Iss. 1 , Article 7.
Available at: https://egrove.olemiss.edu/aah_journal/vol12/iss1/7

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Accounting Historians Journal by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

The Accounting Historians Journal
Vol. 12, No. 1
Spring 1985

Benny R. Copeland
NORTH TEXAS STATE UNIVERSITY

THE STORY OF THE SIXTH RULE

Abstract: This paper traces the development of the "sixth rule," the last of the six rules which the membership of the American Institute of Accountants approved at the 1934 annual meeting. The sixth rule appeared suddenly in the Report of the Special Committee on Development of Accounting Principles. It was added, almost at the last moment, in response to the issuing of a "Stop Order" by the Federal Trade Commission (FTC) against the registration statement of Unity Gold Corporation. The profession joined the FTC in criticizing the method of accounting employed by Unity. And, as a result, the sixth rule was added.

At the 1934 annual meeting of the American Institute of Accountants (predecessor organization of the American Institute of Certified Public Accountants), held October 15-18 in the Stevens Hotel in Chicago,[1] the membership formally adopted six "Rules" of accounting:

> 1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in which owing to the impossibility of determining costs it is

---

ACKNOWLEDGMENTS: The author wishes to express his appreciation to the following NTSU professors who reviewed earlier drafts of this article: Drs. Teddy Coe, Bruce Koch, Barbara Merino, and Ted Skekel. Any deficiencies which remain are the sole responsibility of the author.

Also, the author is grateful to the American Institute of Certified Public Accountants for permission to quote materials cited in Footnotes 2, 6, 17, 19, 22, and 23; Copyrighted 1934, 1969, and 1973 by the American Institute of Certified Public Accountants, Inc. In addition, the author expresses his appreciation to the Scholars Book Co. for permission to use the material cited in Footnotes 7, and 11; Copyrighted 1971, and 1975 by Scholars Book Co.

a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.[2]

These are the first accounting principles promulgated by the profession, and the only accounting principles ever promulgated upon the basis of a vote by the Institute membership.[3]

The first five of these rules had an extensive history and were

well known to the membership. The rules had been developed over a period of several years as a result of correspondence between the New York Stock Exchange's Committee on Stock List and the Institute's Committee on Cooperation with Stock Exchanges. They first appeared in a letter dated September 22, 1932, from the Institute committee to the Exchange committee. Subsequently, this letter was included in a pamphlet published by the Institute entitled *Audits of Corporate Accounts*.[4] This pamphlet was published January 21, 1934.[5]

Although the promulgation of six rules is well documented in the professional standards, no mention of the sixth rule was found in the basic historical literature. Only references to the first five rules were found.

For example, Carey refers to the "five basic principles" of accounting which were approved by the membership at the annual meeting of 1934:

> All the material described above was included in the pamphlet, "Audits of Corporate Accounts," sent to all members. The "five basic principles" of accounting were approved by the Council of the Institute on October 15, 1934—more than a year after passage of the Securities Act of 1933.[6]

Reference to the material cited by Carey, *Audits of Corporate Accounts,* also revealed no mention of the sixth rule. Between January, 1934, when the pamphlet was published, and October, 1934, when the rules were submitted to the membership for approval, the sixth rule had been formulated. Why was this rule added? What event gave rise to its creation?

Further investigation into the matter revealed a most interesting story behind this "sixth rule." Because this "rule" stands today as a GAAP, unchanged after fifty years, it is a story which deserves to be told.

This paper will trace the story of the sixth rule, from the passage of the Securities Act of 1933 to the 1934 annual meeting of the Institute.

An examination of the story behind the Sixth Rule will first describe the environmental conditions which existed during the years prior to 1934 when the rule was promulgated. Next, the accounting regulations of the Securities Act of 1933 will be reviewed, as it was an enforcement action under this act which instigated action by the profession for promulgation of the rule. And finally, the specific accounting practices of the Unity Gold Corporation will be de-

scribed. The cumulative effect of these three elements will then be examined as a whole, to show the historical significance of the interrelated elements.

Accounting Environment

Accounting practices prior to the Great Depression and subsequent securities legislation were far more unfettered than they are today. This fact may be illustrated by reference to the "Treasury Stock Ploy" referred to by Arthur Lowes Dickinson in 1913. By 1913, many states had enacted laws prohibiting the sale of common stock at a discount. However, the practice of issuing no-par stock was not yet widespread, permitting the use of the "Treasury Stock Ploy" to issue stock below par:

> As an instance of such a device, it is found that on the purchase of an undertaking by a corporation a large block of stock is issued to the vendor, of which a proportion is returned to the corporation as a gift . . . the ultimate effect is that, in spite of the law to the contrary, the stock is sold by the corporation at a discount and the discount charged to cost of property, which is thus considerably inflated.[7]

Such actions did not go unnoticed by accounting critics of the times. Perhaps the most eloquent of the critics was Professor William Z. Ripley. His article entitled, "Stop, Look, Listen!: the Shareholders Right To Adequate Information," which appeared in the September, 1926, issue of the *Atlantic Monthly,* denounced the poor reporting practices of the times, and called for government action under the Federal Trade Commission Law of 1914.[8] This law, in Section 6, provided authority for the FTC to force large corporations to file annual reports with the Commission. Had the FTC accepted this suggestion, the speculative madness of the 1920s might have been somewhat reduced, with perhaps an attendant reduction in the subsequent correction known as the Great Depression.

The accounting profession responded defensively to the Ripley article. George O. May, a leader in the profession and in the Institute at the time, took the lead. May criticized the article in a letter to the New York Times dated August 27, 1926, and in an address at the 1926 annual meeting of the Institute, held in Atlantic City, New Jersey, on September 22.[9] Some weeks later, May again rose to the defense of the profession in an address delivered to the Society of Public Accountants of the State of New Jersey.[10]

While May objected to having the FTC play a more active role in setting accounting principles, he was also concerned about the profession's inability to assume a leadership role. Speaking at the annual meeting of the Institute in Kansas City, Missouri, October 18, 1932, he lamented:

> It is quite true that the public accountant has no power to initiate improvements in corporate methods of accounting or reporting, nor to exercise pressure to bring them about.[11]

The profession at this time apparently did not see any possibility of establishing "Generally Accepted Accounting Principles" without some "legalistic" basis of authority. It was not until the government enacted the Securities Acts of 1933 and 1934 that the profession was willing to allow the Institute to promulgate accounting principles as a preferable alternative to having them set by the Securities and Exchange Commission.

Securities Act of 1933

The events which culminated in the Great Depression led to passage of the Securities Act of 1933. This legislation, which became law on May 27, 1933, required the registration of securities sold in interstate commerce and through the mail and specified requirements for the registration statement and prospectus which were to be filed with the "Commission." This reference was not, however, to the Securities and Exchange Commission (SEC). The SEC was not created until some 12 months later, by the Securities Exchange Act of 1934. When the accountants of 1933 spoke of the "Commission" they were referring to the Federal Trade Commission (FTC). For a period of approximately one year it was this body which had the responsibility for administering the Securities Act of 1933. And it was this commission which was responsible for adding the "sixth rule" to the body of generally accepted accounting principles.

Unity Gold Corporation

Pursuant to the 1933 Act, the FTC filed a "Stop Order" on the registration statement of Unity Gold Corporation as of June 27, 1934. According to the registration statement filed December 28, 1933, Unity acquired all of the assets of the Industrial Gold Mining Company for $5,000 cash and 599,995 shares of capital stock, valued at the par value of $1 per share. However, in accordance with

the purchase contract, Industrial immediately donated 475,000 of the shares back to Unity.[12] The FTC raised several questions about the registration statement. However, the only pertinent question of the moment concerns the accounting treatment to be applied to the donated shares. The FTC investigation revealed that Industrial at no time had *jus disponendi* over the shares. Indeed, evidence indicated that there was not even a transfer and retransfer in form only. Unity Gold Corporation had only made a book entry for the additional 475,000 shares of stock. Minutes of the Industrial Company dated August 18, 1932, as cited in the FTC Opinion, reported that:

> the deal as closed, consummated the sale of all assets of the Industrial Gold Mining Company to the Unity Gold Company [sic] for the sum of $5,000 in cash and 15,560 shares of capital stock of the Unity Gold Company, par value $1 per share.[13]

The "Treasury Stock Ploy" attempted to accomplish two things. First, the assets acquired by Unity would be increased by the par value of the additional 475,000 shares. And second, treasury shares would be "fully paid," thereby exempting subsequent purchasers of the stock from assessment if the shares were later sold at a price below par value.

According to Richardson,[14] then editor of *The Journal of Accountancy,* the FTC's Opinion on the Unity case was written by James M. Landis, Chairman of the FTC:

> That these 475,000 shares could not be regarded as being part of the cost of the lease and option on the ground that the registrant parted with these shares in order to obtain the property, seems hardly open to question. The "donation" back to the registrant of these shares was concurrent with the purchase of the property itself.[15]

Thus, the stop order was issued and the registration statement was suspended until the financial statements could be amended.[16]

Response by the Profession

Richardson, as editor of the *Journal,* the "Official Organ of the American Institute of Accountants," spoke for the Institute concerning the matter:

> We feel that Commissioner Landis deserves high commendation for the soundness of the decision and for his ability to sweep aside any dependence upon precedent and to

> go to the very heart of the matter. . . . It is the accountant's duty to state the facts, and if the facts presented for his investigation and approval do not fairly represent the facts we can not believe that there is any excuse for accepting a method of computation of which he disapproves.[17]

It is doubtful that Richardson would have taken such a forceful position without strong support from Institute officers and leaders of the profession such as George O. May. May, who had chaired the Institute's Committee on Cooperation with Stock Exchanges which developed the first five rules, was also chairman of the Institute's Special Committee on Development of Accounting Principles. This committee had been created in response to a presentation given by J. M. B. Hoxsey of the New York Stock Exchange at the 1930 annual meeting of the Institute.[18]

In its report to the Institute Council dated October 4, 1934, the Special Committee responded to the Unity situation with a recommendation as to the appropriate accounting treatment of the sale and simultaneous donation back of capital stock:

> In the past it has not been uncommon, especially in the case of corporations formed to develop a new mine, to charge the par value of the stock issued to property account and to credit to surplus the cash received from the sale by the corporation of the stock donated to it. It is clear, however, that such a procedure results in an overstatement of the property account and of the surplus account.
>
> During the year, a registration statement in which this procedure had been followed was disapproved by the federal trade commission, and the committee believes that the Institute should also indicate its disapproval. Your committee therefore recommends that the following rulings on this point should receive the formal approval of the Institute.
>
> > If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently

Accounting Historians Journal, Vol. 12 [1985], Iss. 1, Art. 7

> sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.
>
> Your committee believes that members of the Institute should recognize an obligation in any case in which they are called upon to prescribe or pass upon the treatment of capital stock donated to a corporation to satisfy themselves that the transaction is a gift in good faith and is not an artificial or unsubstantial transaction designed to create an improper credit to surplus.[19]

The Council unanimously[20] approved the recommendations of the Special Committee on October 15,[21] and submitted the report to the full membership of the Institute for approval at the 1934 annual meeting. The membership did approve all six rules, probably on October 16. Although no firm evidence has been found to set this date, it is logical to assume that the business meeting would be set for one day following the meeting of the Council. And as the following discussion will show, members meeting at a round table discussion on October 17 referred to passage of a new rule regarding proper accounting for donated treasury stock.

Interestingly, at the "Round Table on Reacquired Stock" held on October 17 as part of the annual meeting, Maurice E. Peloubet, for one, seemed much perplexed by the new rule on donated stock:

> It seems to me, unless we consider that donated stock is actual surplus when it is donated, we are putting ourselves in a very difficult position in the valuation of that property. The Institute made some ruling on that, but I am still not at all clear as to how the thing is ever going to be applied, because they seem to imply you should deduct your donated stock from the value of the property; or, in other words, you should deduct from your stated capital, which involves deduction from your property. It is a very confusing thing as to how that would work, and I would like to know whether your committee has given any thought to that point of view.[22]

The Round Table participants discussed the Unity matter until well beyond the planned adjournment time, noting: "The Commission may be consistent with this Unity case from now on, but it certainly is contradictory to their previous practice."[23]

Summary and Conclusions

On October 16, 1934, the Institute adopted the first promulgated

GAAP; six rules of accounting which were formally approved by the members of the Institute at the 1934 annual meeting. In the years since, the list has grown long and the issues complex. Frequently, the principles have been born amid controversy, but none has been proposed with less certain chance of acceptance or of permanence than the first promulgated standards. However, almost fifty years later, those standards remain in effect—and remain essentially unmodified, except for rule 3, which concerns the retained earnings of a subsidiary in a pooling.

Of even greater importance than the particular rules which were approved in 1934 is the concept of promulgated accounting principles, initiated with the approval of these six rules. Before then, the profession did not assume responsibility for participating in the development of generally accepted accounting principles. Thus, the FTC, by its action, perhaps encouraged a direction that has profoundly affected the course of the accounting profession, the adoption of "The Six Rules."

FOOTNOTES

[1]American Institute of Accountants, *Round Table on Reacquired Stock,* p. 164.

[2]American Institute of Certified Public Accountants, *APB Accounting Principles,* p. 6007.

[3]The membership of the Institute did approve a resolution regarding the capitalization of interest at the annual meeting of 1918, but that resolution did not find its way into officially promulgated accounting principles. See Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 34,* Appendix A, Footnote 5, p. 13.

[4]American Institute of Accountants, *Audits of Corporate Accounts,* pp. 10-11.

[5]Carey, 1969, p. 175.

[6]Carey, 1969, p. 179.

[7]Dickinson, pp. 131-132.

[8]Ripley, p. 398.

[9]May, pp. 49-52 and 53-59.

[10]May, pp. 40-48.

[11]May, p. 92.

[12]Federal Trade Commission, pp. 650-652.

[13]Federal Trade Commission, p. 655.

[14]Richardson, October 1934, p. 243.

[15]Federal Trade Commission, p. 655.

[16]Federal Trade Commission, p. 662.

[17]Richardson, October 1934, p. 243.

[18]Carey, 1969, p. 165.

[19]Special Committee on Development of Accounting Principles, pp. 277-278.

[20]Richardson, December 1934, p. 408.

[21]Carey, 1969, p. 179.

[22]American Institute of Accountants, *Round Table on Reacquired Stock,* pp. 197-198.

Accounting Historians Journal, Vol. 12 [1985], Iss. 1, Art. 7

[23]American Institute of Accountants, *Round Table on Reacquired Stock*, p. 199.

BIBLIOGRAPHY

American Institute of Accountants. *Audits of Corporate Accounts: Correspondence between the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange* New York: American Institute of Accountants, 1934.

American Institute of Accountants. *Round Table on Reacquired Stock*, notes on a meeting Wednesday afternoon, October 17, 1934, held in connection with the Annual Meeting of the American Institute of Accountants at the Stevens Hotel, Chicago, Illinois, October 15-18, 1934. New York: American Institute of Accountants, Undated, pp. 164-202.

American Institute of Certified Public Accountants, Inc. "Chapter 1: Prior Opinions, Section A—Rules Adopted by Membership: Accounting Research Bulletin No. 43." *APB Accounting Principles: Original Pronouncements.* New York: Commerce Clearing House, Inc., 1973.

Carey, John L. *The Rise of the Accounting Profession: From Technician to Professional, 1896-1936.* New York: American Institute of Certified Public Accountants, 1969.

Carey, John L. "The CPA's Professional Heritage, Part II: The Era of Initial of [*Sic*] Stock Exchange Regulation." In *The Academy of Accounting Historians Working Papers Series.* Vol. 1, Working Papers 1-20, pp. 48-59. Edited by Edward N. Coffman, The Academy of Accounting Historians, 1979.

Dickinson, Arthur Lowes. *Accounting Practice and Procedure.* 1913. Reprint ed., Houston, Texas: Scholars Book Co., 1975.

Federal Trade Commission. *Federal Trade Commission Decisions,* Vol. 18, 1934. Washington, D.C.: U. S. Government Printing Office, 1935.

Financial Accounting Standards Board. *Statement of Financial Accounting Standards No. 34.* Stamford, Connecticut: Financial Accounting Standards Board, 1979.

May, George Oliver. *Twenty-Five Years Of Accounting Responsibility: 1911-1936.* 2 vols. 1936. Reprint ed. (2 vols. in 1). Edited by Bishop Carleton Hunt. Houston, Texas: Scholars Book Co., 1971.

Richardson, A. P. "Editorial." *The Journal of Accountancy* (October 1934), pp. 241-244.

Richardson, A. P. "Editorial." *The Journal of Accountancy* (December 1934), pp. 407-408.

Ripley, William Z., "Stop, Look, Listen!: The Shareholder's Right to Adequate Information." *Atlantic Monthly* (September 1926), pp. 380-399.

Saito, Shizuki. "Asset Revaluation and Cost Basis: Capital Revaluation in Corporate Financial Reports." *The Accounting Historians Journal,* Vol. 10, No. 1 (Spring 1983), pp. 1-23.

Securities Act of 1933, Public Law No. 22-73D Congress. Washington, D.C.: U. S. Government Printing Office, 1976.

Securities Exchange Act of 1934, Public Law No. 291-73d Congress. Washington, D.C.: U. S. Government Printing Office, 1979.

Special Committee on Development of Accounting Principles. "Report of the Special Committee on Development of Accounting Principles." *American Institute of Accountants Year-Book.* New York: American Institute of Accountants, publication undated but report placed in 1934 through contents, pp. 276-279.