Accounting Research Program

American Institute of Accountants

ACCOUNTING RESEARCH PROGRAM
AMERICAN
INSTITUTE OF ACCOUNTANTS
1947

Entered in the Distinguished Service Contest for 1947

of

The American Trade Association Executives

Classification IA

American Institute of Accountants
13 East 41st Street, New York 17, N. Y.

THE ACCOUNTING RESEARCH PROGRAM
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS
1947

"The test of.....corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole -- not from that of any one group of interested parties."

Accounting Research Bulletin No. 1, 1939, Committee on Accounting Procedure, American Institute of Accountants.

CONTENTS

The Program

Exhibits

THE ACCOUNTING RESEARCH PROGRAM
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The American Institute of Accountants

The American Institute of Accountants is the national professional society of certified public accountants. Founded in 1887, it has more than 11,000 members. The majority are in public accounting. Others hold positions in private business and government.

The purposes of the Institute are to unite the accountancy profession in the United States, maintain and promote high professional standards, and advance the usefulness of accounting.

The Accounting Research Program

The American Institute accounting research program benefits not only Institute members, but also the entire accounting profession, business and industry, and the public.

The Institute's Committee on Accounting Procedure, made up of twenty-one leading certified public accountants, oversees the program. Technical research is done by a five-man research department. Its director, a former university professor and partner in a prominent public accounting firm, was the first chief accountant of the Securities and Exchange Commission. The department has at its disposal the Institute library of more than 20,000 publications on accounting.

The committee's Accounting Research Bulletins -- the end product of the research program -- are distributed to the Institute membership and to groups representing management, government, accounting education, banking, and the financial press. These pronouncements on accounting questions are of a continuing nature. Each in itself is an addition to the existing body of literature on accounting principles and procedures. Collectively, they constitute a major contribution to the development of accounting theory and practice.

Need for Accounting Research

Accounting is the means for measuring -- and the language for expressing -- the results of business operations. The constantly widening public interest in business profits demands that accounting principles, procedures, and forms of presentation be useful to all segments of society.

Until some thirty years ago, accounting was of interest mainly to business managers and owners. Accounting developments were directed to their needs. But as credit expanded and ownership of corporate securities became more diversified, accounting reports assumed greater significance for bankers and investors. Individual certified public accountants and public accounting firms worked toward increasing the usefulness of accounting to these people.

The 1929 stock market crash and the federal government's establishment of the Securities and Exchange Commission in 1934 focused attention sharply on this need for clarity and consistency in accounting and financial reporting. In the belief that healthy development should come from the accounting profession itself, the American Institute of Accountants intensified its accounting research program. The Institute committees and staff have kept in close touch with the Securities and Exchange Commission, and although the Commission has the power to set more rigid accounting regulations, it has not felt it necessary to do so.

Today the interest in accounting is keener than ever before. Capital, management, labor, consumer, and government have conflicting claims on the proceeds of business operations, and full and fair disclosure of the financial results of business enterprises is important to each of them. Government, in its taxing programs, control of securities markets, regulation of public utilities, and collection of industrial statistics, must have extensive financial information. Stockholders and creditors far removed from management base decisions on what is shown in financial statements. Labor wants financial date for use in wage negotiations. Economists and statisticians need profit figures they can rely on. The consumer wants to know that he is paying a fair price which results in a fair profit to business.

"Net income for the year", or net profit from the year's ordinary business operations, is the accounting result most significant to all interested parties. A primary social goal of the Institute's research program is to sharpen the concept of net income for the year.

Purpose and Organization of the Research Program

Accounting is not an exact science. Judgment and estimate necessarily enter into determination of such items as, for example, inventory values. But a certain degree of uniformity is essential if the financial statements of different corporations are to be satisfactorily comparable and if they are to be meaningful to everyone for whom they are intended.

The purpose of the Institute's research program is to develop greater consistency and clarity in accounting by the extension of the existing orderly body of accounting principles, the reduction of varieties of practice, and the establishment of sound criteria against which accounting judgment may be tested.

In 1939 the research program was accelerated by the establishment of a permanent Accounting Research Department and initiation of the series of Accounting Research Bulletins. The department undertakes specific studies at the direction of the Committee on Accounting Procedure. The committee's twenty-one members, from various parts of the country, represent different viewpoints within the profession. Appropriations from the Institute's annual income, which is derived principally from membership dues, finance the program.

The Accounting Research Bulletins present the committee's recommendations on important accounting questions. Twenty-seven were published from 1939 to 1946, and six were published in 1947. Before a bulletin is published, the committee customarily offers opportunity for comment to other interested groups, such as the Securities and Exchange Commission, the New York Stock Exchange, the Controllers Institute of America, the National Association of Cost Accountants, and different industrial, banking, and credit associations. Issuance of a bulletin requires approval by at least two-thirds of the committee members.

1947 Accomplishments

Although part of a continuing series of pronouncements, the six Accounting Research Bulletins issued in 1947 stand out collectively as a major accomplishment, particularly in narrowing the concept of net income. Work on this problem had been hampered during the war because attention was then focused on specific wartime accounting questions.

The 1947 bulletin on Income and Earned Surplus is perhaps the most important that the committee has issued. It sets up criteria which make for greatly increased comparability in the reporting of net income by different companies.

Other subjects on which the committee issued bulletins in 1947 were: Accounting Treatment of General Purpose Contingency Reserves; Inventory Pricing; Current Assets and Current Liabilities -- Working Capital; Inventory Reserves; and Depreciation and High Costs. Each of these except Current Assets and Liabilities has direct bearing on net income determination. They are discussed individually in the exhibits section of this presentation.

Benefits to Members, Industry, and the Public

Because judgment enters so importantly into accounting, the individual accountant must have standards on which to base his decisions. Otherwise chaos instead of consistency would result. A large body of generally accepted principles and procedures has been developed during the history of accounting. But in accounting, as in other professions, differences of opinion exist and new problems arise. The Institute's Accounting Research Bulletins satisfy two needs: resolving existing differences of opinion and effecting consistent solution of new questions.

Although not mandatory, the bulletins carry authority which is generally recognized by the Institute membership. The burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Where differences of practice have previously existed, the bulletins provide the individual Institute member with responsible decisions reached collectively by representative members of his profession.

Experience shows that the bulletins receive wide acceptance in management, government, banking, and other circles, and among financial editors of the daily press and business and financial magazines. The bulletins present principles and procedures applicable throughout the business world. When the certified public accountant recommends to management certain accounting procedures and forms of presentation of financial statements, the bulletins serve as authority to back up his judgment.

The benefit of the Institute's research program to the general public is indirect. As independent auditor, the certifed public accountant occupies the position of financial interpreter and judge. His unqualified certificate on financial statements is an assurance to persons other than the management, which prepared the statements, that they fairly represent financial position and results of operations. The fact that the independent auditor bases his decisions on reliable standards gives added protection of the public's interest, and the basic accomplishment of the research program is to increase the areas covered by generally accepted standards.

EXHIBITS

Consistency in determination of net income for the year is the theme of the accounting research program in 1947.

Bulletin 32, Income and Earned Surplus, is the culmination of some five years of study and discussion by the Committee on Accounting Procedure and the research department. The question is how a company's net income for the year can most usefully be reported. Should all items of gain or loss be included in determination of the year's net income? Or should extraordinary items, unrelated to the year's operations, be excluded because they result in a misleading net income figure? Bulletin 32 takes the latter stand. To promote uniformity, it lays down criteria to govern the accountant's judgment on what should or should not be excluded.

Bulletins 28, 31, and 32, on General Purpose Contingency Reserves, Inventory Reserves, and Depreciation and High Costs, deal with accounting practices which permit distortion of reported net income. They show the committee's opposition to procedures which allow net income to be varied according to different whims or desires of different managements.

The other two bulletins, 29 and 30, treat inventory pricing and current assets and liabilities, subjects on which considerable differences of theory and practice have existed for some time. Inventory pricing enters into income determination, while the classification of assets and liabilities is solely a balance sheet problem.

Each of the attached bulletins is accompanied by a brief, non-technical explanation of the contents.

Accounting Treatment of General Purpose Contingency Reserves

Bulletin No. 28

Uncertainties about costs, prices, and wages after the war were reflected in financial statements by the growing use of such reserves as those for "general contingencies". The Institute research department found in a study of fifty representative corporate financial statements that all but seven contained general reserves, contingency reserves, or inventory reserves.

Many were unsound. Charges to current revenues were being made for a wide variety of indefinite possible future losses concerning whose amounts there was only a limited knowledge or a vague foreboding. As a result, a company which made a high profit in one year might reduce its reported profit by setting up out of current income a sizeable contingency reserve, desired "because of the uncertainties of the present abnormal period". Or on the other hand, in an unprofitable year a company might show a profit by dipping into a large contingency reserve set up in a previous year.

Such practice gave substance to charges that income could be reported according to management whim, and that there was no satisfactory body of accounting principles to safeguard the interests of the user of financial statements.

Bulletin 28 was issued to prevent the misuse of contingency reserves. (Inventory reserves were dealt with separately in Bulletin 31). The bulletin carefully defines general purpose contingency reserves. It advises that under no circumstances should charges or credits relating to them be permitted to enter into determination of net income. It helped sharpen the concept of net income and support the integrity of financial statements by removing one more item that could be taken from or left in income on a purely arbitrary basis.

Inventory Pricing

Bulletin No. 29

The method of inventory pricing used by a company enters directly into determination of cost of goods sold. Since cost of product is the major cost in manufacturing industries, inventory pricing is of fundamental importance in arriving at net income for the year.

In Bulletin 29 the committee undertook to narrow the area of inventory pricing treatment by defining basic terms and codifying the pertinent generally accepted accounting principles. The bulletin emphasizes that cost is the proper basis for pricing inventories and products unless the usefulness of the inventory is no longer as great as its cost. In that case, the bulletin states, a departure should be taken from strict cost to "cost or market, whichever is lower". Since numerous conceptions of the meaning of the term "market" had existed, the bulletin gives a clear-cut definition of the term.

The bulletin describes situations in which the rule of "cost or market, whichever is lower" should be applied to categories of inventory or to the inventory as a whole, rather than to individual items, in order that periodic income may be most clearly reflected. It also discusses the accountant's responsibility for disclosing in financial statements what method of inventory pricing has been applied, and, when a significant change is made, showing the nature of the change and any material effect on income.

This bulletin establishes a common basis for use by corporations and professional accountants. By aiming at greater uniformity in inventory pricing, it contributes to uniformity in income determination.

Current Assets and Current Liabilities - Working Capital

Bulletin No. 30

The working capital of a prospective borrower has always been of prime interest to credit grantors. Since it furnishes a basis for analyzing the current financial status of a business, working capital also is a major concern of present and prospective stockholders. Despite this importance, considerable variation and inconsistency have existed in the accounting classification and display of current assets and liabilities -- the items from which working capital is determined.

In Bulletin 30 the committee holds that past definitions of current assets and liabilities have tended to be overly concerned with immediate or forced liquidation values. The tendency in recent years has been to emphasize the ability of a concern to pay its obligations out of the proceeds of current operations. Accordingly, the bulletin departs from any "one-year" interpretation of current assets and liabilities; the objective is to relate them to the operating cycle of the business.

The committee defines current assets to mean cash and other assets or resources which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. The term current liabilities is used, in the same spirit, to designate debts or obligations whose liquidation or payment is expected to require the use of current assets or the creation of other current liabilities. The bulletin sets up criteria for the classification of current assets and current liabilities based on these concepts.

Inventory Reserves

Bulletin No. 31

Bulletin 31 treats reserves "designed to set aside a part of current profits to absorb losses feared or anticipated in respect to inventories on hand, or in connection with future purchases". The bulletin bars the practice of permitting such reserves to enter into the determination of net income or to relieve the income account of any year.

Use of this type of inventory reserve increased after the war because of the fear of inventory losses in a presumed future deflation following inflation. Although the committee recognized their propriety in certain circumstances, it objected to letting the reserves affect reported net income. Computations of reserves for future decline in inventory prices, the bulletin states, have to be based on "speculative guesses" about future price levels and other unknown factors, and represent "mere conjecture". If charged or credited to income they tend to shift profit from one year to another without accounting justification.

When such reserves are set up, the bulletin recommends as preferable the procedure of charging them to surplus, and then returning them to surplus when no longer considered necessary.

The policy expressed in Bulletin 31 is much the same as that of Bulletin 28 on general purpose contingency reserves. Both are in accordance with the committee's statement in a 1942 bulletin that reserves should not be created for the purpose of equalizing reported income.

Income and Earned Surplus

Bulletin No. 32

The question of what constitutes the most practically useful concept of income for the year has troubled the accounting profession and business for a generation. One concept is that income for the year is simply what is left over when accumulated net income at the beginning of the year is subtracted from the amount accumulated at the end of the year. Another, entirely different, emphasizes the relationship of financial transactions to the operations of the year. Its advocates contend that net income for the year should show what a company was able to earn from its usual business operations under that year's conditions, with material unusual and non-recurring gains and losses excluded from determination of net income for the year. This requires an income statement designed on a "current operating performance" basis.

Bulletin 32 represents the committee's advocacy of the latter concept. The bulletin establishes criteria for uniform determination of material extraordinary gains, losses, and expenses which may be excluded from income for the year, and which definitely should be when their inclusion would encourage misleading inferences about the year's profits. The bulletin urges that "income-per-share" data reported in newspapers, investors' services, annual reports, and elsewhere be related to net income, and that the corresponding total or per share amount of any special charges or credits be reported separately and simultaneously.

Depreciation and High Costs

Bulletin No. 33

Inflation has brought to business management the problem of providing for replacement of plant and machinery at costs much greater than those for the facilities now in use. To meet the problem, some companies in their 1947 quarterly financial reports increased depreciation charges against current income. It was immediately evident that a wide variety of unsound practice might follow if the concept of depreciation as an amortization of cost were discarded. No specific index existed for deciding how much too high current prices were and how much additional depreciation should be charged. Nor was there any indication whether the proposed new policies were to be followed year after year, regardless of profits, or whether the idea was purely to build up a replacement fund only in profitable years. The immediate effect of such charges was to reduce current reported profits. Obviously the variety in practice would add confusion to income statements, permitting net income to be varied according to the different judgments of different managements.

Bulletin 33 established the committee's opposition to these proposals for charging depreciation on uncertain replacement values. It explains that steps to recognize current prices in providing depreciation must be taken in an orderly, consistent, continuous way, based on objective evidence. In the absence of any objective evidence, the committee felt that the time had not come to abandon the historical concept of depreciation on original costs. The bulletin points out that existing accounting principles permit a company to cover anticipated replacement costs by making annual appropriations of net income or surplus.