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PAUL F. GRADY AND THE DEBATE ON THE AUTHORITY OF THE APB

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Paul F. Grady is recognized in accounting history as a practitioner, a researcher, a scholar, and a public servant, (Previts, September, 1986); indeed, he epitomized the accounting professional. Grady began his professional career in 1923 and served as a partner in Arthur Andersen & Company (1932-1942) and Price Waterhouse & Company (1944-1960). During his career in public accounting, Grady served on many committees of the American Institute of Certified Public Accountants (Institute). He chaired the committee on auditing procedure (1944-1948) which developed and published *Generally Accepted Auditing Standards: Their Significance and Scope* and *Internal Control—Elements of a Co-Ordinated System and Its Importance to Management and the Public Accountant.*

Grady served on the special committee on research, established in December 1957, which led to the establishment of the Accounting Principles Board (APB, Board) and the Research Division of the Institute. He served on the project advisory committee for *Accounting Research Study No. 3, A Tentative Set of Broad Accounting Principles for Business Enterprises* conducted by Drs. Robert T. Spouse and Maurice Moonitz. His opinions concerning this study led to his research and publication of *Accounting Research Study No. 7, Inventory of Generally Accepted Accounting Principles for Business Enterprises in 1965.*

Grady accepted the position as director of research for the Institute in 1963. As Grady began his work as director, the Institute was involved in debate regarding the authority of the APB for generally accepted accounting principles. The result of this debate had a profound impact on the profession. This paper will review the events involving the issue of the APB's authority and the role Grady played in the solution.

The Issue of Authority

Dissension among Institute members and the continuing widespread adverse publicity regarding the accounting profession and the APB had in the view of many reached crisis level by 1963. Institute President, Robert Witschey sought to clarify the APB's objectives and establish procedures which would avoid in the future the adversities experienced with the investment credit issue. Subsequently, the Board narrowly approved recommendations that members of the Institute be required to disclose accounting principles used which materially varied from Board approved principles and that auditing standards of reporting and the Code of Professional Ethics be amended to assure compliance. (Carey, 1970)

Alvin Jennings (August, 1964), who succeeded Weldon Powell as chairman of the Board, said concerns by the Board regarding its responsibility to narrow differences and inconsistencies in accounting practice led to the discussions and subsequent proposals. The concerns were at least partly due to the developments after the issue of *Opinion No. 2* on the investment credit which emphasized a lack of agreement on what was meant by "generally accepted accounting principles" and created uncertainty about the status of the Board's pronouncements. As a result, the Board requested a revision of the standards of reporting to better relate to the pronouncements of the Board. Jennings, in communicating with the executive committee, pointed out that a better definition of "generally accepted accounting principle" was needed and that some action was necessary "to eliminate existing ambiguity with respect to the force of its pronouncement, . . ." (p. 28)

The executive committee, after much discussion decided that the vote of the Board was too close to justify sending the proposal to the Council. However, the executive committee agreed with the Board's objectives and tentatively approved a similar proposal which stated that the opinions issued by the Board should be regarded as generally accepted accounting principles and that auditors should justify in their audit opinions departures from these opinions. (Carey, 1970) This new proposal was exposed to the members of the principal Institute committees and resulted in much disagreement.

A special report entitled *Status of Pronouncements of Accounting Principles Board* (Carey, 1970) or "white paper" was approved by the executive committee of the Institute in March, 1964, to "establish the force and effect of pronouncements" issued by the APB. This modified proposal stated that APB pronouncements would become the only generally accepted accounting principles for the subject area involved for purposes of expressing an opinion on financial statements by members of the Institute. Unless the Council ordered otherwise, the authority of an APB Opinion would become effective after an eighteen month period following its release. After the waiting period, members would be required to direct attention in their reports to departures from the pronouncement as departures from generally accepted accounting principles. Previous ARBs and APB Opinions would continue in their current status unless reissued by the Board. ("Proposal to Council Would Define Authority of APB Pronouncements," April, 1964)

According to Jennings, (August, 1964), the Board had only intended that use of principles which materially varied from Board pronouncements be reported in some satisfactory manner. However, the executive committee decided to substitute the proposal that would bestow absolute authority to the APB pronouncements.

The motion presented for discussion at the Council meeting on May 4-7, 1964, was as follows:

> A pronouncement of the Board constitutes the only generally accepted accounting principle for purposes of expressing an opinion on financial statements, unless and until rescinded by Council. (Carey, 1970, p. 113)

The motion (Carey, 1970) was said to give greater authority to opinions of the Board, to define more clearly the profession's leadership role in the development of accounting principles, to provide and strengthen the meaning of the concept of "generally accepted accounting principles," and to help eliminate undesirable and unnecessary variations in accounting practice.

Proponents of the motion believed that if action was not taken to deal with the widespread criticisms, public pressure could force the Securities and Exchange Commission (SEC) to exercise its authority. The motion would clearly establish that generally accepted accounting principles were those established by the national organization of Certified Public Accountants. The compulsion issue regarding the motion would simply require disclosure of "...deviation from generally accepted accounting principles as the profession itself will have defined them after consultation with representatives of management, the SEC, the stock exchanges, analysts, bankers and anyone else who is interested...." (Carey, 1970)

Grady's Position

In a speech delivered at the University of Illinois, Grady (October 20, 1966) stated that:

> ....In this kind of climate, it should not be surprising that impatient, irresponsible, and sometimes misguided critics of the APB and of the accounting profession have found it easy to make spectacular headlines by proposing uniformity in accounting, to a degree not compatible with the "facts of life" in our economy, together with authoritarian measures in the development and enforcement thereof.

He believed the existing pattern of reporting to investors provided a system of checks and balances whereby the primary responsibility and authority of the directors and officers of an enterprise to select accounting principles and methods were balanced by the secondary responsibilities of the stock exchanges, regulatory agencies, and independent public accountants. "..., this system is ideally fitted to serve the public interest in the processes of meeting fiduciary accountabilities for investor-owned business enterprises." In a paper delivered to the American Petroleum Institute's Division of Accounting and Finance in June, 1964, Grady said that the Board and Research Division tried to promote the widest possible participation practical by interested parties leading to the "enlightened development and clarification of generally accepted accounting principles...which reflect the degree of wisdom and persuasion to merit confidence and general acceptance." (August, 1964, p. 58)

Grady strongly opposed the concept of uniformity as a goal in developing accounting principles, and he stated, when he accepted the position as director of research, that he would oppose any action that would lead to uniformity in accounting principles. Grady believed that the authority of the APB should result from the consensus of the profession as evidenced by use of the pronouncements and that if the Board exercised its powers sensibly and cooperated with and educated interested groups, the Board would not encounter any serious problems in achieving acceptance of its pronouncements. (Zimmerman, 1978)

Many companies had not followed the Board's position in *Opinion No. 2*, and the auditors had not qualified their audit opinions. In the heated debate, some firms were criticized for regarding themselves as being above the Board's pronouncements. Grady considered the opinion on investment tax credit to be a serious error in judgment because the Board should have known that most businesses would want to use the "flow through" approach. The issuance of *Opinion No. 4* in March, 1964, was also extensively criticized and detrimental to the Board's image. (Grady, April 27-28, 1979) Grady considered the opinions on investment tax credit to be good examples of why granting of absolute authority to the opinions of the APB was a mistake.

Grady (Minutes: Spring Council Meeting) defended his opposition to the motion in a paper presented to the Institute's Council. Grady stated that the motion would provide the APB with even more authority than was asked for in its charter and would produce other unsatisfactory results. First, authority would be vested in the APB. The membership and Council would surrender the authority to approve statements on accounting principles which would be binding upon the membership. Second, a very cumbersome qualification in the auditor's reports would be required for accounting practices for which the CPA, after investigation, may have found substantial authoritative support. This requirement would lengthen and complicate the auditor's reports. Thus, he concluded that the standard wording of the opinion, "the statements fairly present...in conformity with GAAP," would no longer be usable which would eradicate a major achievement made thirty years before with the development of a standard opinion.

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Third, if accepted, the motion would lead to confusion with regard to prior pronouncements. This confusion, Grady stated, would result in the profession losing rather than gaining standards and quality of performance.

Finally, Grady said that the most serious result of the motion's acceptance would be the reversal of the philosophy that in the advancement of the written expression of what constitutes generally accepted accounting principles, reliance should be placed on persuasion rather than compulsion. Grady declared that compulsion would be a "colossal mistake." He identified the following three serious dangers of compulsion. First, the APB and the entire profession would lose much of the support and cooperation now given by business executives. Such an authoritative approach would lead businessmen to insist on a much greater role in the standard setting. Second, a situation of direct confrontation between the Institute and the SEC would be created. Grady questioned how pronouncements of the SEC which differed from the APB would be handled by auditors. A conflict between the Institute and the SEC could lead the SEC to use its full statutory powers. Third, compulsion would not enhance the standing of the APB and might cause heated resistance to its opinions and pronouncements.

The Resolution

In one of the longest debates in the history of the Council, forty-three members, including members of the Board who were invited, participated. Although the proposal dealt with a statement of principle, much of the comments concerned alternative methods of implementation. ("Council Adopts Resolution on APB Opinions," June, 1964) Jennings (August, 1964) said that, although the executive committee's intent was merely one of disclosing material variations from Board pronouncements, opponents had more broadly interpreted the motion. The debate made it clear to proponents and opponents of the motion that something needed to be done to clarify the situation. Thus, the Council was psychologically prepared for the resolution submitted by former president Louis H. Penney. The resolution was an amendment or substitute for the motion before the Council. Penney's resolution was:

> ...That it is the sense of the Council that reports of members (on financial statements) should disclose material departures from opinions of the Accounting Principles Board, and that the President is hereby authorized to appoint a special committee to recommend to Council appropriate methods of implementing the substance of this resolution. ("Council Adopts Resolution On APB Opinions," June, 1964, p. 9)

Jennings (August, 1964) believed the resolution was a compromise. While it specifically recognized that acceptance of an obligation to report departures was the most important issue, substantial authoritative support for a principle not accepted by the Board was not ruled out. A somewhat higher status was clearly perceived for opinions of the Board and is justified because of the careful research supporting the opinions.

Undoubtedly there was some misunderstanding of the motion. However, it does not appear that the opponents had misinterpreted the authoritative philosophy of the motion. The resolution was fundamentally the same as that originally passed by the Board in 1963 and later tentatively approved by the executive committee. In addition, Rule 2.02(e) of the Code of Professional Ethics already stated that a member or associate would be guilty of an act discreditable to the profession if he failed to direct attention to material departures from generally accepted accounting principles.

The Council adopted the resolution, and

president Heimbucher quickly appointed a special committee. The committee was chaired by William W. Werntz and included Albert J. Bows, Paul Grady, John R. Ring, J. S. Seidman, Maurice Stans, and Glenn A. Welsch. Its charge was to recommend appropriate methods of implementation of the resolution. ("Committee Appointed to Implement Council Resolution of APB," August, 1964) As the committee began its deliberations, Mr. Werntz died, and Mr. Seidman was named chairman of the committee. The committee would become known as the Seidman committee. Apparently Carman G. Blough was added to the committee as Carey identifies (Carey, 1970) Mr. Blough as a member.

Other leaders in the profession of accountancy, such as Weldon Powell, (September, 1964), and Carmen Blough (Minutes: Spring Council Meeting), also spoke against uniformity and absolutism. Powell, a senior partner of Haskins & Sells and an acknowledged authority on accounting theory, (Carey, 1970) had served as the chairman of the special committee on research program which led to the establishment of the Accounting Principles Board, ("Special Committee on Accounting Research Program," August, 1958) and served as the first chairman of the APB, 1962-1963. Powell was also a close friend of Grady from their days as fellow students at the University of Illinois.

The strong stance of Grady before the Council significantly contributed to the substitute resolution and the establishment of the special committee on accounting principle board opinions. Grady apparently agreed with, or at least accepted, the resolution. His primary opposition was to the position that only pronouncements of the Board were generally accepted accounting principles. His experience in the establishment of auditing standards, lead Grady to believe that final approval of principles resided with the members of the Institute. Failing a general vote, approval by the Council was the best alternative. (Previts, 1986)

<u>Grady's Dissent</u>

The special committee adopted a position which Grady believed would have vested total authority in the Board and compulsion to assure adherence. Grady was the only dissenting member. He discussed the issue with the president-elect of the Institute, Thomas Flynn, and convinced Flynn that he was right and the rest of the special committee was wrong. Flynn supported Grady's position and proposed formal amendments to the special committee's report at the Institute's Council meeting. (Zimmerman, 1978)

The amendments proposed by Flynn were discussed with and approved by president Heimbucher and the executive committee prior to the meeting of the Council in October, 1964. The first amendment called for further study on whether disclosure provisions should be made enforceable under the Code of Professional Ethics. There was no dissent on this amendment. The second amendment provided that disclosure of departures might be made in footnotes to the financial statements, in which case no disclosure was necessary in the auditor's report. This amendment received much discussion. ("American Institute Council Acts on Recommendation For Disclosure of Departures from APB Opinions," November, 1964)

The amended report of the special committee included several key points:

1. Generally accepted accounting principles were those which have substantial authoritative support.
2. Opinions of the Accounting Principles Board constitute substantial authoritative support.
3. Substantial authoritative support can exist for accounting principles that differ from Opinions of the Board.

4. No distinction should be made between Accounting Research Bulletins and Opinions of the Board.
5. If an accounting principle which differs materially from an Opinion is used in financial statements, it must be determined if the principle has substantial authoritative support and is applicable in the circumstances.
   a. If it does not, the member would either qualify his opinion, disclaim an opinion, or give an adverse opinion as appropriate.
   b. If it does have authoritative support, an unqualified opinion would be given and the fact of the departure from the Opinion would be disclosed in a separate paragraph in the report or in a footnote to the financial statements.
6. A notation should be included in each Opinion of the Board that material departures therefrom should be disclosed.
7. Failure to disclose a material departure from an Opinion is deemed to be substandard reporting.

As a result of the overwhelming approval of the amended report, Grady believed that his position was supported by the Council. This led Grady to conclude that the special committee had been "stacked" to achieve compulsion, but that he had successfully thwarted their efforts. (Zimmerman, 1978) He (October 20, 1966) stated that the amended report "recommended no substantive change in the authority of the APB and, in effect, reaffirmed the statement of the 1958 committee, included in the board's charter,..." Grady had been a member of the special committee on accounting research program which led to the establishment of the APB and its charge "to determine appropriate practice and to narrow the areas of difference and inconsistency in practice" and to accomplish its goals by reliance "on persuasion rather than on compulsion." Grady said that the profession should be thankful that the members of the special committee and Council "had the common sense and good judgment not to follow the substantial step toward compulsion recommended by the Executive Committee of the AICPA."

The amended proposal was approved on October 2, 1964, and was attached (Appendix A) as a special bulletin, entitled, "Disclosure of Departures From Opinions of Accounting Principles Board," to *APB Opinion No. 6*, "Status of Accounting Research Bulletins." Effective December 31, 1965, members of the Institute were required to disclose departures from APBs and ARBs which would materially affect the financial statements as a separate paragraph in the opinion or as a footnote. This was not included in the Code of Professional Ethics until 1972 with the adoption of Rule 203 requiring all members to disclose and justify departures from the Opinions of the APB.

Conclusions

The actions taken by the Council in 1964 do indicate a change in attitude toward the authority of the APB. The APB had been essentially operating under the same authority as had existed for the pronouncements of the committee on accounting procedure. With exception of cases in which formal action was taken by the Institute membership, the authority of opinions rested on their "general acceptability." The committee on accounting procedure stated that "...the burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment." (*Accounting Research Bulletin No. 43*, p. 9) The position that the opinions of the APB constitute substantial authoritative support and departures having a material effect on financial reporting must be disclosed clearly strengthened the authority of the APB. Certainly, pronouncements were no longer completely dependent on "general acceptability" nor persuasion or influence. However, uniformity and compulsion were not achieved to the extent that the motion before the Council would have indicated to be feasible.

The compulsory approach appears to have been an overreaction to the problems and criticisms faced by the APB and would likely have been a poor decision on the part of the Institute. As Powell (September, 1964) had indicated, the time was not right to make the APB pronouncements binding. Despite the differences of opinion regarding the committee report, the final vote on the amended report was unanimous, and members of the Council, on both sides of the debate, agreed that it was a significant step toward improvement of financial statements. ("American Institute Council Acts on Recommendation For Disclosure of Departures from APB Opinions," November, 1964)

It would be difficult to believe that the special committee had been intentionally "stacked" given the professional character of the men involved. In addition, the nature of the amendments proposed by Flynn do not appear to be as significant as indicated by Grady's comments. However, Grady (October 20, 1966) stated that "the contest of persuasion vs. compulsion...has been resolved in a fully satisfactory manner."

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