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## Editorial

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# The JOURNAL of ACCOUNTANCY

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A. P. RICHARDSON, *Editor*

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## EDITORIAL

### A Splendid Accomplishment

During the hearings, conducted by the committee on banking and currency of the United States senate, upon the causes of the Kreuger & Toll disaster, Frank Altschul, chairman of the stock-list committee of the New York stock exchange, introduced in evidence a report prepared by a committee of the American Institute of Accountants. This committee, to which reference was made in these notes in February, is known as the special committee on coöperation with stock exchanges. Its labors have been consistent and tireless and, as our readers know, it is largely to the efforts of this committee that the tremendously important rule of the stock exchange requiring independent audit is due. The report to which we now refer is simply a carrying forward of the principles of sound and informative accounting, and it is consonant with the desire of the stock exchange that investors and others who have an interest, direct or indirect, in the companies whose securities are listed by the exchange shall be given all the information which is necessary to enable them (the investors and others) to appraise the values and to estimate the prospects of listed companies. The report was distributed to all members of the American Institute of Accountants on January 20th, four months after the date of its original presentation to the stock exchange. The delay in making public was intended to enable the stock exchange to bring the matter confidentially to the attention of accountants and of some corporations to the end that suggestions or criticisms might be presented and considered. When the document was introduced before the senate committee it became a matter of public record and the stock exchange con-

sented to general publication. In brief the report is summed up in its second paragraph which reads as follows:

“It (the committee) believes that there are two major tasks to be accomplished—one is to educate the public in regard to the significance of accounts, their value and their unavoidable limitations, and the other is to make the accounts published by corporations more informative and authoritative.”

**Two Plans Considered**

After reviewing some of the common causes of public misunderstanding of established accounting standards, the

committee proceeds:

“In considering ways of improving the existing situation two alternatives suggest themselves. The first is the selection by competent authority out of the body of acceptable methods in vogue today of detailed sets of rules which would become binding on all corporations of a given class. This procedure has been applied broadly to the railroads and other regulated utilities, though even such classifications as, for instance, that prescribed by the interstate commerce commission, allow some choice of method to corporations governed thereby. The arguments against any attempt to apply this alternative to industrial corporations generally are, however, overwhelming.

“The more practicable alternative would be to leave every corporation free to choose its own methods of accounting, within the very broad limits to which reference has been made, but to require disclosure of the methods employed and consistency in their application from year to year. It is significant that congress in the federal income-tax law has definitely adopted this alternative, every act since that of 1918 having contained a provision that the net income shall be computed ‘in accordance with the method of accounting regularly employed in keeping the books of such taxpayer’ unless such method does not clearly reflect income. In its regulations the internal revenue bureau has said: ‘The law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose.’ (Reg. 45, art. 24.) The greatest value of classifications such as those imposed on regulated utilities lies in the disclosure of method and consistency of method which they tend to produce.”

**Definite Proposals for Reform**

The report closes with a series of four specific recommendations as follows:

“To summarize, the principal objects which this committee thinks the exchange should keep constantly in mind and do its best gradually to achieve are:

“1. To bring about a better recognition by the investing public of the fact that the balance-sheet of a large modern corporation

does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

"2. To emphasize the fact that balance-sheets are necessarily to a large extent historical and conventional in character and to encourage the adoption of revised forms of balance-sheets which will disclose more clearly than at present on what basis assets of various kinds are stated (e.g., cost, reproduction cost less depreciation, estimated going-concern value, cost or market whichever is lower, liquidating value, et cetera).

"3. To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity; and to take the position that an annual income account is unsatisfactory unless it is so framed as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the year to which it relates.

"4. To make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance (see exhibit I attached) and, within the limits of such broad principles, to make no attempt to restrict the right of corporations to select detailed methods of accounting deemed by them to be best adapted to the requirements of their business; but—

"(a) To ask each listed corporation to cause a statement of the methods of accounting and reporting employed by it to be formulated in sufficient detail to be a guide to its accounting department (see exhibit II attached); to have such statement adopted by its board so as to be binding on its accounting officers; and to furnish such statement to the exchange and make it available to any stockholder on request and upon payment, if desired, of a reasonable fee.

"(b) To secure assurances that the methods so formulated will be followed consistently from year to year and that if any change is made in the principles or any material change in the manner of application, the stockholders and the exchange shall be advised when the first accounts are presented in which effect is given to such change.

"(c) To endeavor to bring about a change in the form of audit certificate so that the auditors would specifically report to the shareholders whether the accounts as presented were properly prepared in accordance with the methods of accounting regularly employed by the company, defined as already indicated."

**Some Fundamentals**

Attached to the report were two exhibits, to which reference was made in the foregoing excerpts, and their importance is such that it seems desirable to present them in full. Every accountant and every corporate officer will find in these

exhibits expositions of elemental factors far too great to be overlooked.

*Exhibit I*

"It is suggested that in the first instance the broad principles to be laid down as contemplated in paragraph 4 of the suggestions should be few in number. It might be desirable to formulate a statement thereof only after consultation with a small group of qualified persons, including corporate officials, lawyers and accountants. Presumably the list would include some if not all of the following:

"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 industries (such as the packing-house industry) in which owing to the impossibility of determining costs it is 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.

“The exchange would probably desire to add a rule regarding stock dividends.”

*Exhibit II*

“The statement of the methods of accounting contemplated in paragraph 4a of the suggestion would not be in the nature of the ordinary detailed classification of accounts, nor would it deal with the machinery of bookkeeping. It should constitute a clear statement of the principles governing the classification of charges and credits as between (a) balance-sheet accounts, (b) income account and (c) surplus account, together with sufficient details of the manner in which these principles are to be applied to enable an investor to judge of the degree of conformity to standard usage and of conservatism of the reporting corporation. Its content would vary according to the circumstances of individual companies, but some of the more important points which would be disclosed thereby would be as follows:

“The general basis of the accounts:

“Whether the accounts are consolidated, and if so, what rule governs the determination of the companies to be included in consolidation; also, a statement as to how profits and losses of subsidiary and controlled companies not consolidated are dealt with in the accounts of the parent company.

“The balance-sheet:

(a) In respect of capital assets, the statement should show:

“ (1) What classes of items are charged to property account (whether only new property or also replacements and improvements);

“ (2) Whether any charges in addition to direct cost, either for overhead expense, interest or otherwise, are made to property accounts;

“ (3) Upon what classes of property, on what basis and at what rates provision is made for or in lieu of depreciation;

“ (4) What classes of expenditures, if any, are charged against reserves for depreciation so created;

“ (5) How the difference between depreciated value and realized or realizable value is dealt with on the sale or abandonment of units of property;

“ (6) On what basis property purchased from subsidiary companies is charged to property account (whether at cost to subsidiary or otherwise).

“(b) In respect of inventories: The statement should show in fairly considerable detail the basis of valuation of the inventory. The statement under this head would be substantially a summary in general terms of the instructions issued by the company to those charged with the duty of preparing the actual inventories. It would not be sufficient to say that the inventory was taken on

the basis of cost or market, whichever is lower. The precise significance attached to these terms should be disclosed. . . .

"The statement should include a specific description of the way in which any inter-company profit on goods included in the inventory is dealt with. It should show under this head, or in relation to income or surplus account, exactly how reductions from cost to market value are treated in the accounts and how the inventories so reduced are treated in the succeeding period. It is, for instance, a matter of first importance to investors if inventories have been reduced to cost or market at the end of the year by a charge to surplus account and the income for the succeeding year determined on the basis of the reduced valuation of the inventory thus arrived at. Obviously, under such a procedure the aggregate income shown for a series of years is not the true income for the period.

"(c) In respect of securities: The statement should set forth what rules govern the classification of securities as marketable securities under the head of 'current assets' and securities classified under some other head in the balance-sheet. It should set forth in detail how any of its own securities held by the reporting corporation or, in the case of a consolidated statement, any securities of any company in the group held by that or any other member of the group are dealt with in the balance-sheet. (Stock of subsidiaries held by the parent will of course be eliminated in consolidation). . . .

"(d) Cash and receivables present few questions, though where sales are made on the instalment plan, or on any other deferred basis, their treatment should be fully set forth, including a statement of the way in which provision is made for future collection or other expenses relating to sales already made but not liquidated, and to what extent deferred accounts are included in current assets.

"(e) Deferred charges: The statement should set forth what classes of expenditures are in the company's practice deferred and what procedure is followed in regard to the gradual amortization thereof. (This question is of considerable importance as substantial overstatements of income may occur through deferment in unprosperous periods of expenses ordinarily chargeable against current operations, possibly followed by writing off such charges in a later year against surplus account.)

"(f) Liability accounts: There is normally less latitude in regard to the treatment of liability accounts than in respect of assets. The statement should clearly show how unliquidated liabilities, such as damage claims, unadjusted taxes, etc., are dealt with. The statement should disclose whether it is the practice of the company to make a provision for onerous commitments or deal with such commitments in any way in the balance-sheet.

"(g) Reserves: A statement of the rules governing credits and charges to any reserve account (including both those shown on the

liability side and those deducted from assets) should be given in detail. It is particularly important to know whether losses, shrinkages or expenses which would otherwise be chargeable against income accounts are in any circumstances charges against contingent or other reserves, and whether such reserves are built up partly or wholly otherwise than by charges to income account.

“The income account:

“An adequate statement in regard to the treatment of balance-sheet items discloses by inference what charges and credits are made to income account or surplus. The additional points required to be disclosed are the principles followed in allocating charges and credits to income account and surplus account respectively and the form of presentation of the income account. The form should be such as to show separately (a) operating income; (b) depreciation and/or depletion if not deducted in arriving at (a), in which case the amount of the deduction should be shown; (c) income from companies controlled but not consolidated (indicating the nature thereof); (d) other recurring income; (e) any extraordinary credits; (f) charges for interest; (g) income taxes; and (h) any extraordinary charges.

“The company’s proportionate share of the undistributed earnings or losses for the year of companies controlled but not consolidated should be disclosed in a note or otherwise on the face of the income account. Stock dividends if credited to income should be shown separately with a statement of the basis upon which the credit is computed.”

### **Toward a Better Understanding**

There will no doubt be some who will look on the recommendations with distrust or disappointment. Those who pray for certainty and who like to look on balance-sheets and income accounts as statements of absolute facts will resent the destruction of their comfortable beliefs, even though they may be forced to realize that in the nature of things there can be no such certainty. Others, who are guided by tradition and are content to follow precedent without pausing to inquire just how significant are the results, may resent the questioning of traditional practices. Some will be concerned that the report tends to destroy the faith of the public in accounts; and there is no doubt some force in the argument that it may be desirable to preserve faith in institutions even if the hierarchy has its own reservations as to the soundness of their foundations. But we believe the ultimate verdict will be that the report is a step toward a desirable definition and understanding



of accounts, their value and the limits on their significance; and if the current form of presentation of accounts does result in a large degree of misunderstanding by the public, the question of a change of form is one that should be faced. To us, it seems evident that it will be a great advance if corporations undertake to make clear to the public what is meant by the accounts which they issue. Really, it does not matter much whether the interpretation of a phrase is one thing or another so long as everybody knows what definition is adopted in each case. What a corporation will be required to do under the new proposals is to tell its shareholders and the general public what it means when it issues a statement, and then, in the coming years, it will continue to mean the same thing, unless somewhere along the line of march there seem to be necessity to change the definition—and in that case everyone who could possibly be concerned must be given notice. Although the recommendations of the committee may well produce accounts having differences of form they are not directed toward any change in the fundamental principles that have been accepted by the accounting profession. Those principles are not subject to change. The committee itself points this out, saying that it aims at the universal acceptance of broad principles that have already won fairly general acceptance.

**Competitive Bidding** We have received advice from a correspondent in North Carolina that an amendment to the by-laws of the North Carolina Association of Certified Public Accountants prohibiting competitive bidding is "in full force and effect." It is reported to us that an officer of the society has expressed the opinion that the amendment has already produced good results. This amendment was published in the *Bulletin* of the American Institute of Accountants on December 15, 1932, but we refrained from comment upon the rule pending definite advice that it had been adopted. It is, however, of the utmost importance as it establishes a precedent. So far as information is available it appears that this is the first definite rule against competitive bidding adopted by any society of accountants in the United States. There has always been a repugnance to competitive bidding except in cases of men who were not fully conversant with the principles of professional ethics. Some worthy citizens have bid for professional work in the past, but they have done so with a feeling of reluctance and a

silent prayer that the necessity, so called, of this method of obtaining engagements might soon pass. The North Carolina association has now adopted and put into effect the following article VII of its by-laws:

"SECTION I.—Competitive bidding is declared to be inconsistent with the practice of a profession and the best interests of the public which it serves.

"In order to abolish the practice and to discourage the public from seeking bids for accounting service the following shall be a rule of this association:

"(a) No member shall offer to perform any accounting service for a fee that, in total or by its basis of computation is less than that which was last received by another member for services rendered of substantially the same nature and scope.

"(b) Lack of sufficient knowledge and understanding of the work undertaken upon which the last fee received was based shall not constitute an excuse for violating this rule.

"SECTION II.—Penalty for violation of section I of this article:

"(a) All charges of violation of section I of article VII shall be referred by members to the board of directors in a written report.

"(b) The board of directors shall consider this report and if, by a unanimous vote of its members, probable guilt is not shown the case shall be dismissed. When probable guilt is shown the board shall, on due notice of not less than fifteen days to the accused, convene as a trial board of at least five members for the purpose of hearing the accused member and any others interested. Upon the unanimous recommendation of such trial board the board of directors may, on a unanimous vote, dismiss the case; otherwise, the board of directors shall make report of its conclusions and recommendations to the next regular or special meeting of the members of the association for final action by the membership.

"(c) Any member may be expelled from the association for infraction of the rules of article VII by a two-thirds vote of all members present at any regular or special meeting of the association."

### **The Machinery Slow Moving**

This new by-law is excellent in principle, and it would be eminently desirable to have it adopted in every society of accountants throughout the United States. There may, however, be some doubt as to its efficacy. The method of inflicting discipline seems to be somewhat roundabout and apt to permit a great deal of procrastination. Experience in other organizations has shown that the best exercise of discipline is that which is most direct. For example, if the rule of the North Carolina association were to permit the trial board to inflict whatever punishment seemed to be deserved, there would be a far better chance of disciplinary action in the case of guilt than there will be under the plan provided by the by-law. It is always difficult to inflict a penalty by vote of a large number of persons. Even our higher courts, with their memberships of five or seven, are much given to disagreement and a unanimous verdict seems rarer than a divided opinion. So, in a society, the greater the number of judges

the less probability of conclusive action, even where such action is obviously demanded.

**A Rule Salutary in  
Every Way**

That, however, is really a minor point in the present consideration. The great value of the by-law is, as has been said, its establishment of a precedent. It follows in general the principles adopted by the engineering societies and by other professional organizations. It indicates an awakening to the evils of professional competition and, whether it can be rigorously enforced or not under the procedure laid down, it, nevertheless, is an entering wedge. As such it is acceptable to everyone who has the welfare of all professional life at heart. It has been averred quite justly that in many cases the enactment of a law or the adoption of a ruling is certain to be followed by violation. However, there is this much to be said in favor of rules and laws: they express a striving after better things if their purpose is to raise standards of morality or of civic life. No law was ever obeyed to the strict letter by everyone subject to its operation; and, if the fact of violation were to be an effective argument against enactment of laws, we should be obliged to adopt the principles of anarchy. There are professional men who advocate openly the abolition of all rules for professional practice, and they would have everything left to the personal conscience or predilection of the practitioner, but that presupposes a state of grace in which no profession at present lives. Consequently, while in theory it should be unnecessary to have a rule inhibiting competitive bidding, the unvarnished truth is that a rule will be needed so long as there are souls in the outer darkness who require the light of a rule to show them the way to better things.

**Just Cause for Pride**

A correspondent writes to inquire why THE JOURNAL OF ACCOUNTANCY has not discussed the question of "technocracy." There are several reasons for this splendid record. In the first place, we have yet to discover any one who knows what it is all about. In the second place, temporary fads seem to have no place in so solid and pragmatic a realm as that of accountancy. And in the third place—and this the greatest of all—we believe entirely in the doctrine enunciated in *The Acts of the Apostles*, chapter V, verses 34 to 39, inclusive.