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Current Work of the Accounting Principles Board: Report to Meeting of Council, American Institute of Certified Public Accountants, May 6, 1969

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American Institute of Certified Public Accountants. Accounting Principles Board

American Institute of Certified Public Accountants. Council

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REPORT TO MEETING OF COUNCIL
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
BY LEROY LAYTON - MAY 6, 1969
ON
THE CURRENT WORK OF THE ACCOUNTING PRINCIPLES BOARD

INTRODUCTION

You have just heard the Institute's Executive Vice President speak on "The Road to Progress in Accounting."

Believe me, members of the APB are well aware:

- . of just how rocky that road is,
- . of the current ferment over the usefulness of
of financial statements and the accounting
principles behind those statements,
- . of the sometimes uncomfortable spotlight of the
public press, and
- . of the ever present specter of litigation.

Yes, we are well aware of all of these pressures.

PROGRESS - TIME LIMITATION

To most of you, the progress of the Board must seem painfully slow. To Board members it is painful, but not slow. Time is our greatest problem; the limiting factor in our efforts.

We have met eight times since this Council met in Boca Raton one year ago. Our meetings have been stepped up to full 3 days each, with some running 4 days. Many meeting days of the full Board start at 8:00 a.m. and run to 6:30 or 7:00 p.m. Subcommittees often continue right on with dinner meetings that last until midnight. While eight meetings per year is not enough, time must be allowed for the great amount of homework that has to be done, and it is not practical to reduce further, the time intervals between meetings.

The work done in these intervals consumes more time than the meetings themselves and consists of reading, answering or writing:

- . Questionnaires or point outlines which develop the foundations for opinions.
- . Opinion drafts.
- . The many responses to exposure drafts of opinions.
- . Research studies and public responses to them.
- . Statements of personal viewpoints.
- . General correspondence.
- . Current articles on matters under Board consideration, etc.

When the work on subcommittees is added to all of this, you have some idea of the considerable burden now being borne by Board members.

IMPROVEMENTS

At least once each year we examine our methods of operation, and the needed greater output will have to come from more effective use of our time not from increased time. Many Board members are involving others in their firms as advisors or assistants and they are sharing the burden. We have begun appointing non-Board members to our subcommittees as many members are spread too thin in this important area.

There has been a much needed increase in Institute staff that serves the Board in the areas of research, administration and implementation or interpretation of opinions. I believe there is still need for further strengthening of this support.

The constant attention of the Institute's Executive Vice President, on an almost daily basis, to the Board's problems, its progress and its relations with the press has been invaluable.

INVOLVEMENT OF OTHER GROUPS

As a result of a program started several years ago, we have been able to involve other groups this year to a much greater degree in our deliberations. For example:

- . The Financial Executives Institute (FEI) has a committee on Corporate Financial Reporting that is somewhat comparable to our Board. They have appointed sub-committees that parallel ours on each project in which they are interested.
- . The Financial Analyst Association (FAA) and the Robert Morris Associates (RMA) are in the process of structuring themselves similarly to the FEI.
- . Other groups such as the National Association of Accountants (NAA), the American Accounting Association (AAA), the Investment Bankers Association (IBA), the stock exchanges, the American Petroleum Institute and many other groups have expressed a keen interest in the work of the Board.
- . The SEC has always been directly interested in our deliberations and there has been continuing close cooperation with them.

- . All interested groups are receiving point outlines and questionnaires, used by the Board in developing the foundations for opinions, and their answers and viewpoints are being considered along with Board members'.
- . Conferences of representatives of all interested groups have been held. The interplay of the divergent ideas and viewpoints of each group has been helpful to each in understanding the problems of the others.
- . Several of the other groups have initiated research on areas under Board study.
- . There appears to be a general consensus, at least at the present time, that the APB should be the body to make final decisions and issue opinions. Each group, however, has expressed a desire to be heard early in our deliberations. This may extend somewhat the time it takes to develop opinions, but should be well worth it.

PAST YEAR

Considerable time in the past year has been devoted to what might be called unfinished business. Two opinions have been issued and a third approved:

- . No. 13, Amending paragraph 6 of APB Opinion 9, making it applicable to commercial banks.

- . No. 14 on Accounting for convertible debt and debt issued with stock purchase warrants.

EARNINGS PER SHARE

Last Friday we finally put to bed an opinion that has been one of the toughest we have ever tackled - Earnings Per Share. It went to press yesterday and should be in your hands in about 10 days.

I shall make no attempt now to explain the features of this opinion, other than to point out:

- . It requires reflection of primary earnings per share and fully diluted earnings per share on the face of the income statement, making both subject to the auditor's opinion.
- . For the great majority of your clients with fairly simple capital structures, the opinion should pose no problem and should prove helpful.
- . However, for those clients with extremely complex capital structures, the opinion will prove equally complex. If some of its provisions seem arbitrary, they are.

After an exhaustive two year effort by one of the finest subcommittees we have ever had, after thorough discussions with interested groups (FAF, IBA, FEI, SEC, stock exchanges, and others) and after two exposures, we are fully convinced that this opinion has to include some arbitrary rule making. We hope though that there will not be many other opinions like it.

The sacrifice in personal time and Board agenda time for this one opinion has been horrendous.

INCOME TAX OPINION

While still on the subject of unfinished business, Opinion No. 11 on accounting for income taxes left a number of special areas open for further study. These include the applicability of income tax allocation in the following situations:

- . Undistributed earnings of subsidiaries in consolidated financial statements.
- . Intangible development costs in the oil and gas industry.
- . General reserves for stock savings and loan associations.
- . Policyholders' surplus by stock life insurance companies.
- . Deposits in statutory reserves of U.S. steamship companies.

Each of the above industries or situations is under general study by other committees of the AICPA or is being researched, and a subcommittee of the Board has been appointed to coordinate the income tax allocation features of these separate studies.

ACCOUNTING CHANGES

The issuance of Opinion No. 9 on reporting the results of operations has focused attention on the question of how to account for the past, present and future effects of changes in accounting methods. In other words, under what circumstances should they be reflected, for example: retroactively, currently as an extraordinary item, currently in regular operations, prospectively or possibly by disclosure only. This situation is aggravated by the number of alternative accounting practices now in use and the belief that the switching of accounting methods in some situations has been motivated by a desire to increase earnings or improve the earnings trend.

Conceptually, if the change is to a more appropriate method, retroactive treatment which puts all years' earnings on a comparable basis would seem preferable. On the other hand, there is a belief that this treatment might invite a greater number of changes, thus: (1) causing loss of investor confidence in ever-shifting financial statements, (2) causing the ire of some investors who made decisions based on prior years' reported earnings, (3) making it easier not harder to manage reported earnings.

Of course, we all hope that the day will come when under a given set of circumstances we can expect companies to follow similar accounting methods. Meanwhile, we hope that this Opinion, expected late in 1969, will solve many of the immediate problems.

BUSINESS COMBINATIONS, POOLINGS, GOODWILL

Our hottest subject, and the one which is being given top priority, is business combinations, which includes a reexamination of the pooling of interests concept, a review of problems inherent in the purchase concept and a hard look at accounting for goodwill.

All of you are aware of the different answers that can be obtained from structuring an acquisition as a pooling instead of a purchase, or vice versa.

The pooling concept seemed to be the answer to many problems - such as:

- . The elimination of unwanted goodwill, an account in ill repute in the minds of most readers of financial statements.
- . The reflection of continuity and comparability of operations.
- . Elimination of the need to re-evaluate assets acquired.

The concept is under attack. Criteria for determining a pooling have eased considerable over the past decade, and some have taken advantage of the concept.

Two research studies: one on business combinations finished several years ago and the second on accounting for goodwill - just finished, have found little basis for the pooling of interests concept.

The latter also recommends that goodwill be reflected immediately as a reduction in stockholders' equity.

Our present subcommittee of 6 represent about as many different views - as such they reflect the differing viewpoints of the Board itself and the public.

- . Some believe that poolings must go.
- . Others believe there is conceptual logic in both poolings and purchases, and that guidelines should be reestablished to curb the abuses.
- . Some agree with the research study's conclusion on goodwill.
- . Others say NO; goodwill must be reflected in the balance sheet.

This group is divided though, with some:

- (1) Calling for the steady amortization of the goodwill to the income statement over a period of time.

While Others

- (2) Want income charged only when there are indications that the goodwill has lost part or all of its value.

I would not hazard a guess, at this time, on the final outcome.

The Chairman of this subcommittee is using two others from his firm on an almost full time basis. The subcommittee has scheduled an extremely heavy schedule and an extra two-day meeting of the Board has been scheduled in August. Our target dates are exposure in early Fall and an opinion by year-end.

DIVERSIFIED COMPANIES

Another hot subject is conglomerates, although here the heat is on more than just their accounting methods.

There is a general belief, shared by the SEC, the stock exchanges, Congress and many financial writers:

- . That the growth of conglomerates is almost out of control,
- . That slick accounting, imaginative capital structures, aggressive public relations and stockholder greediness have pumped values into stock issues well beyond their worth,
- . That the threat of take-overs by conglomerates is affecting the thinking and actions of many managements whose positions normally would or should be impregnable,
- . That too great a concentration of financial control could result.

I don't intend to speculate on whether the managers of conglomerates are ingenious financiers or exceptional opportunists. They are going to be under very close scrutiny for some time to come and I feel sure, that those doing the investigating will attempt to apply some brakes through the use of accounting rules.

The Board issued a statement in 1967 which urged diversified companies to review their own circumstances carefully and objectively with a view toward disclosing voluntarily supplemental financial information as to industry segments of their business.

The SEC has recently issued a proposed rule (softening slightly a previous proposal) that would require supplemental reporting in registration statements of certain information by product or service lines.

The Board is considering (1) the question of whether disclosure of financial data by industry segments of a diversified company is necessary for fair presentation of financial position and results of operations in accordance with generally accepted accounting principles, and (2) a determination of what is an industry segment or line of business.

Our present schedule, which is uncertain, calls for exposure in December 1969 and issuance early in 1970.

FUNDAMENTALS

The Board has been criticized over the years for "putting out fires" or taking care of the emergencies and not concentrating on the basic fundamentals of accounting and the basic purposes of financial statements. My only explanation is two-fold: (1) There were a great many fires that had to be dealt with, and (2) a great amount of time has been spent on the basics. The first research study produced under the Board's program covered the basic postulates, the third was on broad principles and the seventh was an inventory of existing principles.

A very able subcommittee of the Board, using these studies and comment engendered by their exposure, has spent more than three years preparing a very lengthy draft of an opinion entitled Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises. This has been reviewed by the full Board and has been studied by a special committee of the American Accounting Association. Comments received are being studied by the committee and a second draft is being produced. This will be submitted to other groups who cooperate in the Board's efforts.

This is only the first step towards a sounder conceptual foundation for accounting principles. Hopefully, it will lay the groundwork for moving into areas previously considered too controversial for handling.

RESEARCH-INVENTORY PRICING AND DEPRECIATION METHODS

Two research studies have been started recently on Inventory Pricing and Depreciation Methods. These had not been started earlier as it was felt that the basic concepts should be established first. The research work, the writing of the studies, their review by Project Advisory Committees, and their approval for publication will take from 18 to 30 months. It is hoped that the conclusions of each study will answer to the greatest degree possible, the frequent objections to the "free choice among alternative practices."

Subcommittees for drafting opinions in these two areas will not be appointed until the studies are close to final draft form. Thus, it will be a considerable time before more comparable reporting can be achieved in these two very major areas.

PRICE LEVEL ACCOUNTING

One of the basic assumptions underlying our accounting today is the stability of the dollar for its use as a measuring unit. With creeping inflation having reached a jog, the shrinkage in the dollar's purchasing power raises a question as to the fairness of conventional financial statements.

Statements restated for general price level changes are under consideration. An opinion draft was completed over one year ago and has since been used as a research tool. It has been tested by 18 clients of Board members and the results of these tests have been evaluated.

A decision has been made to issue this as a statement, not an opinion. Its purpose is to establish recognized procedures for:

(1) measuring and eliminating the distortive effect of inflation on conventionally prepared financial statements, and (2) to reflect the effects of changes in the purchasing power of the dollar that otherwise would not be disclosed in conventional financial statements. As now drawn the statement recommends:

- . that "price level" statements be accepted as the prime statements in countries that have had extreme inflation,
- . the presentation of "Price level" statements in the U. S. A. but only as supplementary to conventional statements.
- . and provides general rules and guidelines for restatement.

This statement will be approved at our June 1969 meeting and issued in July.

EQUITY ACCOUNTING

A portion of a broader research study on Intercorporate Investments has been finished and is being used by a subcommittee to consider:

- . A requirement that investments in unconsolidated subsidiaries be reflected on the equity method in parent company statements when they are the primary statements being issued.
- . And to consider the manner that 50% and less than 50% holdings in affiliates and incorporated joint ventures be reflected in financial statements; possibly on the equity method. Criteria being considered preliminarily includes:
(1) effective control, (2) joint control, and (3) a minimum percentage of ownership.

The target dates for this opinion at present are exposure in September 1969 and issuance in December.

LEASES

Another subcommittee has been given the job of reconciling the criteria for capitalizing leases as now required in Opinion No. 5 and Opinion No. 7.

This subcommittee has taken on additional informal research and is considering breaking new ground. An opinion was originally scheduled for early Fall 1969, but this date has now been pushed back several months.

EXTRACTIVE INDUSTRIES

A final draft of a research study on accounting in the extractive industries has been completed and is being used by a subcommittee which is tackling many of that industries unusual problems.

This subcommittee has met with and taken a field trip out of Houston with representatives of the American Petroleum Institute. The committee is just beginning its work and a meaningful target date has not been set.

PUBLIC UTILITIES

The implication of the rate making process in accounting for public utilities is a constant problem in most opinions and a matter of some controversy. Generally, if a regulatory commission determines how a matter must be accounted for and establishes rates accordingly, then that accounting treatment is considered proper on the grounds that costs have been properly matched with revenues. That treatment, however, might be otherwise contrary to generally accepted accounting principles.

A subcommittee is beginning to develop an opinion on this subject, and is compiling a list of all differences between public utility accounting methods and generally accepted accounting principles. There are so many different regulatory commissions, Federal and State, that this will not be an easy task.

Eventually it is hoped that improved generally accepted accounting principles will prove so clearly sound that they will be fully acceptable for rate making purposes. This may be wishful thinking, but is certainly a worthy goal. Again, a meaningful target date has not been set.

AUDIT GUIDES

There are other industries where regulatory agencies have created accounting and reporting techniques that vary from generally accepted accounting principles; for example: savings and loan associations, insurance companies (casualty and life), railroads, etc.

Attempts to solve problems in these areas are being made by the issuance of audit guides. These are prepared by other committees of the American Institute of CPAs, not by the Board. Subcommittees of the Board or its chairman review the accounting principles presented in the guides to determine that they are not contrary to any current or contemplated pronouncement of the Board or its predecessor.

Our attempts to work with the industries and their regulatory agencies have been only partially successful to date. Much more must be done on our part to gain the needed cooperation.

INTERIM FINANCIAL STATEMENTS

There has been criticism recently of the fairness of some quarterly reports issued to stockholders. One of our subcommittees is working on the problem of establishing ground rules for making interim financial statements more meaningful.

COMPONENTS

A project called "Components;" started several years ago by the Committee on Auditing Procedure, was passed on to the APB and then was deferred because some of its problems were similar to those of conglomerates. This has been put back on the agenda with targets of exposure this Fall and issuance at the end of 1969 or early 1970.

This effort involves the determination of generally accepted accounting principles for a component or piece of a whole enterprise.

The main problem is:

- . Should we express an opinion on facts as they exist, no matter how arbitrarily they may have been contrived, with full disclosure?
- . Or should we try to reconstruct the facts as they might have been under arms length bargaining?

Nether answer is very palatable!

ACCOUNTING POLICIES

Another subcommittee is working on a statement, not an opinion, urging companies to prepare summaries of their accounting policies for inclusion in their annual reports. It is hoped that this will be issued in late Fall 1969.

MATERIALITY

A research study on Materiality was started late last year. This should be of interest to all of us and I wish it were further along than it is.

OTHER RESEARCH STUDIES

Other research studies in varying degrees of completion, are being conducted on (1) accounting for research and development costs, (2) foreign operations, (3) stockholders equity, and (4) asset and liability valuation and income determination.

PERSONAL INVOLVEMENT OF ALL

Now that I have reviewed the current activities of the Accounting Principles Board, I have a "commercial." Each of you become involved personally in the evolution of reporting standards. Give us:

- . Your constructive suggestions for Board operational improvements.
- . Your constructive comment on exposure drafts. Make them as objective as you can. Don't just parrot the unhappiness of a valued client.
- . Become completely familiar with issued opinions and give them your real support.
- . You have just as great a stake in the APB's effectiveness as do we on the Board.

We don't need blasts, public or private calling for haste or damning us for making changes that hurt. We are well aware of the urgent need on the one hand and the practical problems created by change on the other. A recent article in the Wall Street Journal cast doubt on the reasons for action taken or not taken by the Board, by quoting some of our critics to the effect that: (1) we had bowed to pressure, (2) we could not bite the hand that fed us, and (3) the outlook for revolutionary ardor in the accounting profession is dim.

We always will be vulnerable to this type of criticism and there always will be those, regardless of our progress, who honestly believe we should be doing more. I would point out though to those who doubt our backbone, that we have clients on all sides of every controversial

matter, we knew this when we joined the Board, and we can all stand the heat. Our opinions, no matter how carefully prepared, must prove effective and must be able to stand the test of time. If they do not, changes in them must be and will be made.

While it may seem slow in coming, real progress in reporting standards is being made and will continue to be made, particularly with the responsible assistance of all. When I say all, I mean:

- . You - our profession.
- . Management - The FEI, NAA and all other responsible representatives.
- . Government - The SEC, regulatory bodies, etc.
- . Those representing the investors - The financial analysts and investment bankers.
- . The credit grantors - The RMA and the ABA.
- . The educators - AAA, etc.
- . And any other interested group.

While it may seem to be coming slowly, I predict great improvement in the next 10 years. I also predict, though, that we will never reach complete perfection.