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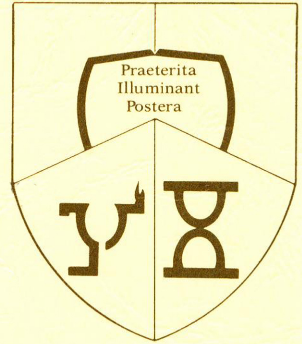

The Accounting Historians Journal

June 1993
Volume 20, Number 1

Research on the Evolution of Accounting Thought and Accounting Practice

The Accounting Historians Journal

June 1993

Volume 20, Number 1

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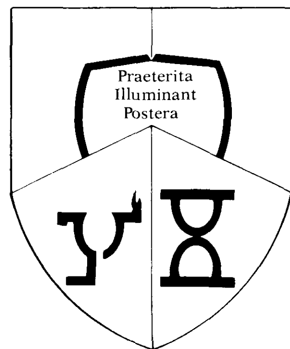

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Volume 20, Number 1 **June 1993**

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THE SAVINGS AND LOAN DEBACLE: THE CULMINATION OF THREE DECADES OF CONFLICTING REGULATION, DEREGULATION, AND RE-REGULATION

Abstract: The role of the public accounting profession in the savings and loan debacle of the 1980s has recently been the subject of Congressional inquiry and extensive litigation by government agencies, and by angry stockholders and bondholders. These efforts suggest a broad misunderstanding by the public of the causes of the disaster. this paper illustrates that the difficulties which precipitated the crisis were a result of the historical development of the regulatory environment of the savings and loan industry. Examining this regulatory environment helps in understanding the current problems and crises of savings and loans as well as the situation in which the accounting profession now finds itself.

The paper illustrates that the manner in which the industry was regulated, including piecemeal and often conflicting legislation, locked the industry into long-term mortgage commitments and then urged diversification from these commitments. The paper illustrates that, over the years, industry responses to this legislation created a net worth crisis. The extent of the crisis was obscured by accounting principles developed by regulators, and which ran contrary to GAAP. Finally, the paper discusses recent legislation designed to correct the regulatory and accounting inconsistencies, and the anticipated effect of this legislation on the future of the savings and loan industry.

The end of the 1980s decade was marred by the financial collapse of many savings and loan institutions. Current estimates of federal expenditures necessary to bail out the savings and loan industry from its financial debacle generally exceed $100 billion and some estimates range as high as $300 billion [Adams, 1990, p. 17; Pilzer, 1989, p. 233]. When interest costs on 30 to 40 year debt used to finance the federal bailout are included, cost estimates rise steeply to between $500 billion and $1 trillion [Carlton, 1992]. The *"true"* cost of the bailout will not be known for years to come, until all of the failing institutions have been shut down, merged, and sold off; until the Resolution

Trust Corporation liquidates its holdings; and until all of the tax breaks and special portfolio performance guarantees granted to acquiring institutions have expired. Meanwhile, the American public is still asking: how the fiasco came about; who should be blamed for it; and how the clean up should be financed.

These are questions of particular concern for accountants for the following reason. While the responsibility for the widespread failure in the industry has not yet been fully determined, the role of the public accounting profession as well as the accounting standards, principles, procedures, and rules for savings and loan financial reporting have been called into question. Auditors of failed savings and loans have been shouldering part of the blame for the fiasco and some of the financial responsibility for the clean up, as a result of various lawsuits by federal agencies.[1] In addition, auditors have been subjected to various class action lawsuits brought by investors in failed savings and loans.[2] These lawsuits, whether justified or not, reflect a myopic perspective of how the debacle occurred. The thrift debacle was not simply the result of audit irregularities, Federal Home Loan Bank Board forbearance in closing troubled institutions, or fraud and mismanagement by thrift industry executives. Although each of these factors contributed substantially to the crisis, the problem was also fundamentally rooted in the historical regulation of the industry.

This paper discusses, from a historical perspective, the regulatory environment of the savings and loan industry. Examining this regulatory history helps in understanding the current

---

[1]By April 1986, 38 investigations had been launched by the Federal Deposit Insurance Corporation (FDIC) and $3,319,000 had been turned over to the FDIC by various auditors [U.S. General Accounting Office, 1986]. The Resolution Trust Corporation (the agency designated to dispose of the assets of failed savings and loans) has recently filed suits against the following CPA firms for their roles in failed savings institutions: KPMG Peat Marwick, $154 million; Deloitte and Touche, $444 million; Pannell Kerr Forster, $41 million [Pickering, 1992]. Ernst and Young agreed to a total comprehensive settlement of $400 million. This agreement was reached with the federal thrift regulations to resolve all "current and potential claims" against the firm for its role in audits of failed depository institutions [Eldridge, 1992].

[2]Recently Ernst and Young agreed to pay a total of $63 million to settle a class action lawsuit related to failed Lincoln Savings and Loan [Stevens, 1992, p. A3]. In addition to this settlement, Ernst and Young agreed to pay the Resolution Trust Corporation $41 million [*Public Accounting Report*, 1992]. Arthur Andersen has also paid a total of $30 million to bondholders of Lincoln Savings and Loan [*Public Accounting Report*, 1992].

problems and crises of savings and loans as well as the situation in which the accounting profession now finds itself. The paper illustrates how changes in regulations and conflicting regulatory intentions laid the framework for the savings and loan debacle. Finally, this paper calls for greater coordination of Congressional goals for savings and loans, and the financial services industry, as the only way to achieve a lasting resolution to thrift industry problems. The remainder of this paper is organized as follows: The Early Years; Post Depression Years Through the 1960s; The 1970s: Disintermediation and Consumerism; The 1980s: Deregulation, Expansion, Crisis, Re-regulation; and What will the 1990s Bring?

THE EARLY YEARS

The first savings and loan institution was organized in 1831. Its primary purpose was to finance home ownership for association members. At this time, commercial banks were not filling this need because they perceived their role as financing the capitalization of industry [Ewalt, 1962, p. 372]. With the growing industrialization of the nation and the need for housing for urban residents, savings and loans spread across the country to serve savers and home mortgage borrowers. The spread of the thrift industry spurred a tremendous growth in residential construction across the nation. This construction boom became a leading factor in the prosperity of the 1920s [Keith, 1973].

Throughout this developmental period from 1831 into the 1920s, the institutions were chartered by states and were regulated by laws which varied greatly between states. Many states had no requirement for the establishment of reserves against losses on loans; consequently, some institutions paid out essentially all profits in dividends to shareholders. In addition, mortgage repayment arrangements frequently failed to provide for methodical reduction of the principal balance of loans. Mortgage financing arrangements too frequently involved first, second, and third mortgages financed over periods of 10 to 15 years. This was not a great problem while real estate prices were stabilized or rising with the economic boom in the stock market. However, in 1929, the stock market crashed and real estate prices plummeted.

Early in the 1930s, institutions found themselves with delinquent loans, foreclosures, and a bulk of repossessed real estate assets. With so much repossessed property for sale, even at re-

duced prices, little property was changing hands because of a lack of public confidence in the real estate market and the banking industry. Furthermore, with assets that were illiquid and having paid out most of the profits in prior years as dividends, the savings and loans were in deep financial difficulty. As part of legislation to restore financial vitality and public confidence in the banking system, Congress enacted several laws aimed at promoting stability in the housing market and the savings and loan industry. Among these laws were the Federal Home Loan Bank Act (1932), the Home Owner's Loan Act (1933), and the National Housing Act (1934). Some of the major provisions of these laws were as follows.

First, the Federal Home Loan Bank Act established the Federal Home Loan Bank (FHLB) System operated by the Federal Home Loan Bank Board (FHLBB). The intent of the Act was to help hard pressed homeowners who could not get mortgage funding from banks to receive financing from a FHLB member. Thus, the purpose of the Board and the system was primarily to advance funds to Federal savings and loans so that they could advance the funds to homeowners. Secondarily, the Board regulated those institutions participating in the funds advancement. This latter purpose was largely implemented in two ways. First, the Board took an active role in evaluating proposed laws to determine their effect on the financial well-being of the industry, and then lobbied Congress on the thrifts' behalf. Second, the Board assured "that regulated institutions adhered to written laws and regulations" [Strunk and Case, 1988, p. 109]. This function was a very legalistic one, which did not necessarily coincide with determining the financial soundness of individual institutions. While these provisions of the Federal Home Loan Bank Act served to stabilize the mortgage market by making funds available on a regular basis, emergency funding was made available by the Home Owners Loan Act.

The Home Owners' Loan Act of 1933 provided emergency mortgage funding to distressed home-owners by offering them long-term mortgage loans (15 year periods), with fixed interest rates capped at 5% initially. This Act further provided that Federal savings and loans could only lend their funds for home mortgages and combinations of home and business property mortgages; and these loans could only be made within 50 miles of the association's home office. Finally, the Act specifically exempted Federal savings and loans from federal taxation and

from taxation by any state. This offered the institutions tax protection for the purpose of rebuilding their reserves.

The third major act, The National Housing Act, established the Federal Savings and Loan Insurance Corporation (FSLIC) to insure depositors at the savings associations. It also established the Federal Housing Administration (FHA) to insure savings associations against losses on mortgages and home improvement loans and to regulate amortization of those loans. Additionally, the Act established the Federal National Mortgage Association (FNMA or Fannie Mae) to create a secondary market for mortgages.[3] Finally, the Act provided that each institution establish a reserve of 5% of deposits. Institutions were given 10 years to meet this goal. These three laws marked the first Federal involvement in the housing industry, and reflect the national recognition of the important role of savings and loans in home ownership. This depression-era legislation set the framework for the system of federally chartered savings and loans.

THE POST-DEPRESSION YEARS THROUGH THE 1960s

Under this regulatory framework, the savings and loan industry returned to prosperity in the late 1930s. From then until the late 1960s, the institutions experienced increasing profit margins. This prosperity was the result of several factors including the following. First, World War II promoted high long-term mortgage rates and low short-term interest payments to depositors, with rates remaining relatively stable throughout the 1940s, 1950s and early 1960s. Second, a tremendous post-war prosperity was experienced across the nation. Third, the middle class enlarged, and society began moving to the suburbs. Fourth, real estate prices escalated; and, fifth, the Federal government established a continuing concern for housing development [Ewalt, 1962, pp. 255-341]. This Federal concern for housing fueled savings and loan prosperity during the Post-Depression years; however, it also established the framework for the difficulties the industry would encounter in the 1970s, and ultimately the 1980s, for the reasons detailed below.

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[3]Provisions of these Acts are summarized in U.S. Congress, *Evolution of [the] Role of the Federal Government in Housing and Community Development*, 1975.

Increasing Role of Federal Government in Setting Mortgage Terms

During the post-depression years, the availability of the secondary mortgage market (through Fannie Mae) enabled institutions with excess cash to participate in the prosperous mortgage lending in booming housing markets. However, in order for institutions to sell mortgages through Fannie Mae, the mortgages had to meet FHA criteria. These criteria related most notably to the length of the loan repayment period, the percentage of appraised value eligible for loan financing (referred to as *loan-to-value* ratios), and interest rate caps on the loans. Initial repayment periods were 15 to 20 years, with loan-to-value ratios of 80%. These values were changed almost annually through the 1940s and 1950s in various Housing Acts. One of these Acts, the Servicemen's Readjustment Act of 1944 (the G.I. Bill of Rights), established a program of government regulated, government insured loans especially for veterans. Provisions of these loans were similar to FHA loan provisions. The loans were administered by the Veterans Administration (VA) and eventually became known as *VA loans.*

The VA and FHA loan terms at times had repayment periods extended to 40 years, and at times loan to value ratios were as high as 97% [Mason, 1982, p. 64]. The government rationale for supporting such generous mortgage terms continued to be that "housing is a segment of the economy demanding special treatment to assure a flow of credit which it would not ordinarily attract" [Ewalt, 1962, p. 262]. This government philosophy was effective in attracting capital to the mortgage market, primarily in the form of a growth in mortgage bankers. The mortgage bankers aggressively marketed FHA and VA insured loans with long maturities and low interest rates. They then sold these loans to Fannie Mae. This fierce competition from the mortgage bankers forced the savings and loans to make FHA and VA qualified loans, or, alternatively, to make conventional loans which closely paralleled the long repayment periods, low interest rates and generous loan to value ratios of the FHA loans. Thus, the FHA loan terms became the industry standard, and savings and loans began to lock themselves into 20, 30, and 40 year loan commitments.

Fuelled by generous FHA and VA loan terms, and FSLIC insurance guarantees, housing starts in the 1950s and 1960s reached record levels; and the savings and loan industry continued to prosper. This prosperity led to the creation of new sav-

ings and loan institutions, and these associations were given up to 20 years to meet the 5% reserve requirement established in the National Housing Act. During this period of increasing prosperity for savings and loans, the institutions found their assets expanding in geometric proportions. At the same time, commercial banks were experiencing only modest growth [Woerheide, 1984, p. 5]. The commercial banking industry attributed the savings and loan prosperity to favorable tax treatment because, during the World War II and Post-War Era, savings and loan associations were not subject to federal income taxation. The tax policy at that time (consistent with the regulatory policy) was that these institutions served a vital role in financing the development of residential housing, an important national goal [Biederman and Tuccillo, 1976, p. 5]. In addition, since savings and loans were traditionally mutually owned, they were viewed as tax conduits for the depositors/owners. This preferential tax treatment, not available to commercial banks, was a continual irritant to the commercial banking industry which voiced complaints about this unfair tax treatment afforded savings and loans.

The Revenue Act of 1951

Commercial banking arguments centered around the fact that savings and loans were in direct competition with commercial banks for savings deposits; and that if savings and loans were to be allowed to compete with banks for deposits, they should be subject to equal taxation [U.S. Congress, 1951, p. 783]. In response to these and other persuasive arguments advanced by commercial banks, the Revenue Act of 1951 amended the *Internal Revenue Code of 1939* to treat savings and loans as regular corporations.[4] This Act set the framework for savings and loan taxation. It was significant because it signalled a shift in tax policy which lost some of its focus on protecting saving and loans because of their commitment to housing finance, and

[4]Several exceptions to this general rule of taxing savings and loans as regular corporations have developed over the years. Major exceptions include: the percentage of taxable income bad debt deduction (discussed at length in the text of this paper), ordinary loss treatment from the sale of corporate and government securities, deduction for interest incurred to carry tax-exempt bonds (pre-Tax Reform Act of 1986) and a longer net operating loss carryback period (pre-Tax Reform Act of 1986). These exceptions, as well as several less significant ones, are explained more fully by Halperin [1971] and by Clark [1975].

moved towards the concept of tax equality among thrifts and banks competing for consumer deposits. This shift marked a divergence in tax policy and FHLBB regulatory policy. Although the tax policy shift at this time was major, the actual tax impact was negligible for the following reason.

The Revenue Act of 1951, in addition to subjecting savings and loans to taxation for the first time, provided them a choice of methods for determining their allowance for bad debts. This allowance then determined the bad debt deduction for tax purposes. Like other corporations, savings and loans could choose to set up their allowance based on actual bad debt experience, averaged over a specified period of years. In lieu of this experience method, they could choose the percentage of taxable income bad debt deduction.[5] This method enabled the institutions to write off as much as 100% of their taxable income to a reserve for bad debts. The balance of this reserve, together with earned surplus and undivided profits, was limited to 12% of total deposits. This limitation was, as a practical matter, seldom a binding constraint [U.S. Congress, 1969, p. 3514]. Thus, while savings and loans were nominally taxable entities, few paid any income tax until the passage of the Revenue Act of 1962.

The Revenue Act of 1962

In 1962, Congress again devoted its attention to the issue of savings and loan taxation. This reconsideration was initiated by President Kennedy's demand for a review of the taxes of "private savings and lending institutions [that] are accorded tax deductible reserve provisions which substantially reduce or eliminate their Federal income tax liability" [U.S. Congress, 1961, p. 2]. As a result of the ensuing Congressional review, the Revenue Act of 1962 reduced the percentage of taxable income bad debt deduction rate to 60% of taxable income. Subsequent to this change, effective tax rates of savings and loans rose (see Exhibit

[5]Savings and loans could also choose a method known as the "3-percent method" which allowed them to set up a reserve at three percent of eligible loans (as defined in the *Internal Revenue Code of 1939*). This method became known in the *Internal Revenue Code of 1954* (IRC) as *the percentage of eligible loans method.* This method underwent few changes from 1954 to 1986 when it was struck from the law in the Tax Reform Act of 1986. For this reason, and since most of the controversy over bad debt deductions for savings and loans focused on the percentage of taxable income bad debt deduction, this method is not discussed further in this paper.

1). The Act also added a restriction that savings and loans using this deduction were required to hold at least 72% of their assets in "qualified assets." *Qualified assets* included residential real property loans; loans secured by members' deposits or by church facilities; cash and U.S. government obligations; and property used in conduct of the institution's business [*Internal Revenue Code* (IRC) section 7701(a)(19)(C)]. This was the first explicit linking in the tax law between the percentage of taxable income bad debt deduction and an institution's investment in mortgages. It also placed the tax law in the position of dictating specific investments allowable for savings and loans. This introduced a conflict in allowable investments for tax and regulatory purposes.

At this time, savings and loans had little choice but to accept their tax increase because the regulatory rules which specified permitted savings and loan investments were even more stringent than the 72% investment in qualified assets required for tax purposes.[6] While the tax law did not specify how the remaining 28% of assets had to be invested, regulatory rules limited investments exclusively to: (1) residential mortgage loans on one to four-family home types, (2) loans secured by members' deposits, (3) cash, (4) government securities, (5) property used in conduct of the institution's business, (6) residential property improvement loans (limited to 15% of total assets), or (7) loans on the security of improved real estate other than one to four-family home types (limited to 20% of total assets) [12 CFR 545.11]. Thus, for all practical purposes, regulatory investments, other than cash, government bonds, business property, and loans secured by members' deposits, were committed to residential mortgages and improvements to residential property. Effectively only 20% of an institution's assets could be invested in anything other than residential property and related loans. Because of these constraints, savings and loans had to maintain approximately 80% of their assets invested in qualified assets to meet regulatory requirements.

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[6]Savings and loans could have expanded their investment in tax free government bonds in order to avoid incurring a greater tax burden. Baer [1983] illustrates the potential benefits of this strategy. Hendershott and Koch [1980], however, present contradictory evidence showing that relative before tax returns on taxable and non-taxable investments would have to be in excess of their historic relationship to make this strategy worthwhile.

EXHIBIT 1

Aggregate Effective Tax Rates of Savings and Loan Associations, 1960-1988

(Dollars in Millions)[a]

Year	Net Income Before Taxes	Taxes	Effective Tax Rate
1960	$ 552	$ 4	0.7%
1961	716	3	0.4
1962	820	3	0.4
1963	764	93	12.2
1964	919	131	14.3
1965	929	134	14.4
1966	727	97	13.3
1967	711	95	13.2
1968	1,011	148	14.7
1969	1,230	194	15.8
1970	1,166	241	20.7
1971	1,748	434	24.8
1972	2,317	630	27.2
1973	2,655	758	28.5
1974	2,144	661	30.8
1975	2,082	634	30.5
1976	3,219	969	30.1
1977	4,610	1,412	30.6
1978	5,717	1,799	31.5
1979	5,198	1,578	30.4
1980	1,193	409	34.3
1981	-6,148	-1,516	N/A
1982	-5,869	-1,598	N/A
1983	2,561	593	23.2
1984	1,871	770	41.2
1985	5,951	2,112	35.5
1986	3,300	3,100	N/A[b]
1987	-4,100	2,700	N/A[b]
1988	-11,565	1,874	N/A[b]

[a] Information obtained from U.S. League of Savings Institutions [1989, p. 50] and U.S. Congress [1983, p. 286].

[b] Industry-wide effective tax rates for these years are meaningless because they reflect a growing disparity in income between profitable and unprofitable institutions.

Such an investment level was not a hardship for the institutions during this time period because, as discussed previously, profit margins were relatively stable, demand was relatively stable, and real estate prices were rising. This was the last time

the industry experienced such stability. In the years following 1961, further conflicts developed between allowable assets for tax and regulatory purposes, thereby sending the industry a mixed message on the role it was expected to play in home financing. Tax burdens on the industry increased; and Regulation Q was imposed by regulators. The regulatory rationale for the implementation of Regulation Q is explained in the following section.

Regulation Q Imposed

Beginning in the mid-1960s, inflation became a serious problem. Fuelled by the Vietnam War, which the government tried to finance without a major tax increase, inflation rates became higher and more variable than in the past [Carron, 1982, p. 5]. The rampant inflation exerted upward pressure on market interest rates, which were also being driven upwards by competition among savings and loans in the western and eastern portions of the country, and between banks and savings and loans.

By 1966, interest rates reached a 100 year high [Bowden and Holbert, 1984, p. 28]. The Federal government became concerned about savings and loans' ability to pay these high interest rates to depositors. Since their portfolios were tied up in long-term, fixed-rate residential mortgages, savings and loans were unable to make rapid adjustments in their revenue base to offset the rising cost of short-term borrowing (deposits). Thus, the industry was trapped by fixed-yield, long-term investments financed by short-term borrowing at volatile interest rates. To protect the savings and loan industry, in 1966 the Federal government imposed Regulation Q deposit rate ceilings on savings and loans. This was viewed as a viable means of keeping down savings and loans' cost of funds and protecting the industry from competitive forces. Subsequent to imposition of Regulation Q, market rates dropped and some observers believed that savings and loans were out of trouble. This belief may have been at least partially responsible for the imposition of additional taxes on savings and loans in the Revenue Act of 1969.

The Revenue Act of 1969

The Revenue Act of 1969 increased savings and loan taxes by reducing the percentage of taxable income limit for the bad

debt deduction. During the hearings which preceded this act, the savings and loan industry requested that the definition of qualified assets be expanded to encompass new regulatory powers.[7] Regulators had expanded savings and loan allowable assets to include certain education loans (up to five percent of total assets), housing for the aging (up to five percent of total assets), loans on improved real estate other than residential property, and loans for the acquisition and development of land (raised from 15% to 20% of total assets) [12 CFR 545.6-545.8]. However, the industry was unable to pursue these investments because of the stringent asset restrictions of Section 7701(a)(19) of the *Internal Revenue Code*. Thus, the tax law and operating regulations were in conflict.

As a partial response to industry pleas, the 1969 Act expanded qualified assets to include: loans secured by commercial property in certain urban renewal areas; loans secured by school, health, or welfare facilities; and student loans. However, the qualified assets percentage was increased to 82%, and a sliding scale implemented for investment levels from 82% to 60%. For every one percent of an institution's portfolio which fell below 82%, the bad debt deduction was reduced by three-fourths of one percent. Once the institution's portfolio fell to less than 60% investment in qualified assets, it could no longer use the percentage of taxable income bad debt deduction.

This marked the widest divergence yet in tax and regulatory policy. While regulators were becoming more lenient in allowing institutions some limited diversification out of residential mortgages (up to 30% of the portfolio), the tax law was imposing a tax penalty for diversification in excess of 18%. In addition to this constraint, the Act reduced the deduction rate from 60% to 40%, phased in over a 10 year period. Thus, even those institutions not diversifying experienced a tax increase.[8] This tax increase contributed to a severe financial crunch which gripped the industry in the 1970s.

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[7]See testimony of William J. Hallahan, Consultant on Monetary Policy and Economic Affairs, National League of Insured Savings Associations [U.S. Congress, 1969, p. 3524].

[8]See Exhibit 1 for a summary of Savings and Loans effective tax rates following the 1969 Act.

THE 1970s: DISINTERMEDIATION, CONSUMERISM AND NET WORTH CRISIS

During the 1970s, a growing rate of inflation was experienced across the country. This was attributed in part to the Federal government trying to finance the Vietnam War without any major tax increase, and to the Organization of Petroleum Exporting Countries (OPEC) 100% increase in oil prices. In an effort to curb the growing inflation problem, the Federal Reserve Bank increased its discount rate and its reserve requirements to record levels. It also implemented a new monetary control policy which focused on regulation of the total reserves of the banking system instead of regulation of short-term interest rates. Subsequent to announcement of this policy, short-term market interest rates rose rapidly. This precipitated financial chaos in the savings and loan industry.

During the 1970s and early 1980s, savings and loans were prevented by Regulation Q from passing these high short-term market interest rates on to their depositors. This situation motivated depositors to withdraw funds from savings and loans in order to invest in alternative, higher yielding investment vehicles (particularly money market mutual funds) offered by unregulated intermediaries. This disintermediation forced savings and loans to enter the market as short-term borrowers, paying very high interest rates on borrowed funds. Meanwhile, their income-generating portfolios were tied up in long-term, low interest bearing, fixed-rate mortgages. This latter problem was largely the result of years of savings and loan responses to the trend in mortgage lending established by the FHA and VA, and the portfolio restrictions established by Congress.

The institutions fought back against these regulations by circumventing them to the extent possible. Since investment opportunities were still largely limited to mortgages by FHLBB regulations, and by tax regulation, the savings and loans began to enhance their services. The industry expanded operations into costly branch networks (Exhibit 2) and other customer amenities, thus causing operating costs to rise. Savings and loans expected that these enhanced services would lure back customer deposits. To further lure depositors, they began offering Negotiable Orders of Withdrawal (NOW accounts) which were in substance interest-bearing checking accounts. This strategy further increased operating costs and resulted in a severe profit squeeze for the industry.

EXHIBIT 2

Number of Savings Institutions and Their Branch Offices, 1960-1987[a]

	Savings Institutions Offices		
Year-end	Main	Branch	Total
1960	6,320	1,611	7,931
1965	6,185	2,994	9,179
1970	5,669	4,318	9,987
1971	5,474	4,961	10,435
1972	5,298	5,851	11,149
1973	5,170	7,036	12,206
1974	5,086	8,775	13,861
1975	4,931	10,518	15,449
1976	4,821	11,908	16,729
1977	4,761	13,087	17,848
1978	4,725	14,250	18,975
1979	4,684	15,508	20,192
1980	4,594	16,733	21,327
1981	4,298	17,495	21,793
1982	3,831	18,712	22,543
1983	3,645	18,635	22,280
1984	3,591	18,812	22,403
1985	3,535	19,186	22,721
1986	3,488	19,540	23,028
1987	3,408	19,664	23,072

[a]Source: U.S. League of Savings Institutions [1989, p. 56].

This profit squeeze was the beginning of the savings and loan debacle of the 1980s. As profits plunged, the net worth, or capital position, of the industry eroded making reserve requirements ever more difficult to maintain. This situation prompted the industry to pressure the Bank Board into extending its deadline to meet the 5% reserve requirements. In 1972, the Board responded by authorizing institutions to compute their reserves as a percentage of savings deposits averaged over a five-year period. As the earnings positions of the institutions continued to weaken, the industry trade organization, the U.S. League of Savings Institutions, petitioned Congress to reduce the reserve requirements. Congress eventually did this in the Depository Institutions Deregulation Act of 1980.

THE 1980s: DEREGULATION, EXPANSION, CRISIS, RE-REGULATION

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 was the first in a series of ill conceived regulation attempting to repair the regulatory induced damage done to the savings and loan industry in the 1970s. The regulation of the 1980s was ill conceived for several reasons. First, deregulation of savings and loan liabilities (freeing interest rates on interest bearing deposits) preceded deregulation of investments, thus exacerbating an already volatile earnings situation. Secondly, regulators authorized the use of several accounting methods which obscured the true financial condition of the industry. Finally, a lack of communication and coordination among various government regulators created a regulatory environment of uncertainty and confusion about the role the institutions were to play as financial intermediaries. Details of how this confusion developed follows in the discussion of the regulatory events that occurred during the 1980s.

DIDMCA and Garn-St. Germain Act

The first of the regulatory changes in the 1980s, DIDMCA, authorized a phase out of Regulation Q deposit rate ceilings, thus allowing savings and loans to increase rates paid on deposits (liabilities). In addition, the law legitimized NOW accounts nationwide. Both of these provisions caused an increase in the institutions' cost of funds. Furthermore, the Act gave the Federal Home Loan Bank Board the authority to vary reserves (or capital) requirements for individual institutions between 3% and 6% of deposits. The Act also granted savings and loans some limited freedom to diversify asset holdings including the ability to invest up to 3% of assets in service corporations (i.e., subsidiary corporations allowed to participate in a wide range of business activities). These asset diversification powers were further expanded in 1982.

The 1982 Act, the Garn-St. Germain Depository Institutions Act, allowed savings and loans to invest up to 30% of their assets in consumer loans and corporate debt, up to 40% in nonresidential real estate, and up to 10% in commercial loans. In addition to these new investment powers, the Garn-St. Germain Act eliminated loan to value ratios on all loans (thus permitting 100% financing of real estate projects); and, for the first time,

permitted adjustable rate mortgages. Regulators believed that, collectively, these 1980 and 1982 changes would enable savings and loans to diversify some of their long-term lending and short-term borrowing financial structure and better weather changing economic conditions in the future.

This expectation may have proved true had the DIDMCA and Garn-St. Germain asset reforms been enacted a decade earlier, before the devastating interest rate spread losses in the 1970s. As it happened, upon entering the 1980s, savings and loan profits were at a historical low (Exhibit 1), and institutions may have lacked the capital to acquire investment expertise in many of the areas newly opened to them. Furthermore, reserves for some institutions were below the 3% minimum mandated by Congress in DIDMCA [Strunk and Case, 1988, p. 31]. Garn-St. Germain provided a *solution* to problem in the form of net worth certificates.

Beginning in September, 1982, the Garn-St. Germain Act allowed a pseudo-capital infusion for under capitalized institutions in the form of net worth certificates which the institutions purchased from the FSLIC. These certificates served to increase an institution's assets and equity for regulatory purposes, and basically provided for a semi-annual cash infusion to the institution by the FSLIC until such time as the institution returned to profitability.[9] These net worth certificates were not treated as capital by generally accepted accounting principles (GAAP).[10] This became the first in a series of GAAP versus RAP (regulatory accounting principles) differences which obfuscated analysis of the financial condition of savings and loans. Other such differences were deferral of loan losses and appraised equity capital, discussed below.

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[9]Net worth certificates were recorded as Notes Receivable-FSLIC and Capital. Under the arrangement the FSLIC paid interest on these notes semiannually to the institution "at rates equal to the yield on FHLBB obligations plus 25 basis points" [Peat Marwick Main & Co., 1988, Section 19.3.3]. The institution would then reimburse the FSLIC at the same rate of interest, "but interest is not due until the institution returns to profitability" [Peat Marwick Main & Co., 1988, Section 19.3.2].

[10]Per GAAP, the net worth certificates were treated as an off balance sheet item which was to be disclosed in footnotes, although interest accruals were made [Peat, Marwick, Main and Co., 1988, Section 19.3.3].

GAAP versus RAP

In order to buy time for institutions to restructure their portfolios in response to the new investment opportunities of DIDMCA and Garn-St. Germain, the FHLBB developed a series of optional accounting rules designed to bolster the appearance of net worth. The most prominent of these became the appraised equity capital provisions, and deferral of losses on the sale of loans.[11] Appraised equity capital arose from institutions recording the increase in the market value of the office buildings which they owned and occupied. During the 1970s, some institutions began to build net worth by selling their buildings, recording the gain, and leasing the facility back from the new owners. From November, 1982, to December, 1986 the FHLBB permitted all institutions to "book" this gain in market value, without actually selling the premises, calling it "appraised equity capital." This non-consummated transaction was not recognized by GAAP.

In contrast to this GAAP violation, a second FHLBB regulation challenged GAAP by deferring recognition of transactions that were consummated. This new provision allowed the deferral of losses on the sale of loans. By contrast, GAAP required recognition of these losses. However, in order to encourage institutions to sell off low interest bearing loans, the Bank Board allowed any such losses to be deferred and amortized over what remained of the original life of the loan. This regulation was in effect from October, 1981 to October, 1984. These two primary regulatory accounting techniques constituted the most blatant departures from GAAP; however, other differences also developed.

Other GAAP versus RAP differences developed because of aggressive interpretation of existing GAAP rules, special institution specific decisions made by the Bank Board, and a delay in the issuance of authoritative accounting literature by the Financial Accounting Standards Board (FASB). Some of these included the following. First, RAP allowed recognition of gains and losses on "wash sales" of securities sold and reacquired within a short period of time, while GAAP did not allow such recognition. Second, RAP allowed recognition of current income from loan origination and commitment fees up to 2% of

[11]Several less significant differences in GAAP and RAP which existed at this time are summarized in McEachern, 1986.

loan value, while GAAP required recognition of these fees as an adjustment to yield over the life of the loan using the interest method of amortization.[12] Third, RAP allowed use of real estate appraisals to satisfy GAAP requirements of net present value computations for valuation of real estate collateral on acquisition, development and construction loans. Fourth, for certain mergers of troubled institutions, the FHLBB allowed goodwill to be amortized over an extended period of time, while GAAP allowed such extensions only when a substantial amount of liabilities acquired were long-term in nature. In addition, for certain mergers including FSLIC cash assistance, RAP treated this as a contribution to capital, while GAAP generally treated this as a deferred revenue or discount on the assets for which the allowance was granted.[13]

Many of these GAAP verses RAP discrepancies were vehemently opposed by the accounting profession because of the potential for creating misleading financial statements. Several comment letters to this effect were written by the AICPA and the FASB to the FHLBB, the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives, the SEC, and various individual Congressmen.[14] Some of the comment letters were written as early as January, 1981 when the RAP rules were only at the proposal stage. Each letter detailed differences between the RAP treatment and the GAAP treatment (or proposed GAAP treatment), indicating the potential for distortion of an institution's capital position. The profession feared such distortions would then mask the true financial condition of the savings and loan industry.

These concerns from the accounting profession went largely unheeded, as evidenced by regulators' decision to allow RAP for reporting purposes. Furthermore, regulators allowed each institution to choose which set of accounting rules, GAAP or RAP, to follow in preparing its financial statements to be filed with the Bank Board. Not surprisingly, those institutions adopting RAP

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[12]This GAAP treatment was not promulgated until issuance of *Statement of Financial Accounting Standards No. 19, Accounting for Nonrefundable Fees and Costs associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, in December, 1986.

[13]Details of these four GAAP verses RAP differences are described in McEachern [1986, p. S-48, S-49] and Peat Marwick Main and Co. [1988, Chapter 30.2 and 21].

[14]An extensive list of these communications is presented in Chenok, 1989, pp. 150 and 154.

were generally found to be the ones with lower capital ratios [Hill and Ingram, 1989]. Since institutions with low capital ratios were in danger of violating minimum net worth requirements, they could have been forced to merge or liquidate. For such institutions, the adoption of RAP served to postpone intervention by the FHLBB. This forbearance by the FHLBB has been cited as one of the factors contributing to the savings and loan debacle of the 1980s.[15]

Forbearance by the FHLBB should not, however, have been surprising, since the Board had behaved similarly in the crisis of the 1970s (as discussed previously) by manipulating capital standards. In doing this, the Board was conforming to its original legislative purpose established in the 1930s: to assure the uninterrupted flow of funds to the savings and loan industry. This original legislative intention assumed the primary purpose of savings and loans to be the supply of funds for residential mortgages. A broadening of the scope of the industry was, however, introduced in the new investment vehicles provided by DIDMCA and Garn-St. Germain legislation. The role of the FHLBB following these changes was not updated. This was only one of several conflicts in Congressional intent. Another conflict was manifest in the tax law.

Tax Reforms in the 1980s

The specific tax law provisions related to savings and loans remained virtually unchanged following DIDMCA and Garn-St. Germain. Despite the investment flexibility permitted under DIDMCA and Garn-St. Germain, the tax law still required savings and loans to maintain between 82% and 60% of their assets in qualified form (primarily residential mortgages). While still demanding this large commitment to residential mortgages, and even as industry profits sagged, tax changes made in 1982 and 1984 served to increase the tax burden placed upon the institutions. The tax changes increased the tax burden on savings and loans by reducing the percentage of taxable income bad debt deduction from 40% to 32% of taxable income.[16] This deduction was further reduced to 8% in the Tax Reform Act of 1986.

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[15]Pilzer, P., 1989; Pizzo, S., Fricker, M. and Muolo, P., 1989; and Adams, J., 1990 each discuss this problem at length.

[16]The Tax Equity and Fiscal Responsibility Act of 1982 added section 291, which provided that the deduction for certain preference items, including the bad debt reserves of savings and loans (to the extent they exceeded reserves

The Tax Reform Act of 1986 made two major changes to the percentage of taxable income bad debt deduction. First, the Act eliminated the sliding scale between 82% and 60% investment in qualified assets. This effectively reduced the minimum required investment to 60%. This change brought tax qualified assets into closer alignment with regulatory allowed assets for the first time since 1969. The second change reduced the deduction percentage from 32% to 8% of taxable income. Prior to the passage of this provision, Congress had contemplated the complete elimination of this deduction [U.S. Congress, 1983]. Thus, the savings and loan institutions became aware that they were losing their tax protection for performing their service to the mortgage market. At the same time, they were allowed more flexibility in structuring their portfolios. The message from Congress was consistent at this point: diversify and become fully taxable financial intermediaries. Some institutions acted quickly to diversify.

Expansion and Crisis

Some savings and loans began using new investment powers granted to diversify out of residential mortgages.[17] However, by the time these powers were granted in the 1980s, the industry had a severe net worth problem. The Bank Board, anxious to encourage an influx of new capital into the industry, dropped a long standing requirement that institutions have a minimum of 400 shareholders, with no one shareholder owning more than 25% of the savings and loan. After this policy change, institutions were eligible for 100% ownership by a single individual [Strunk and Case, 1988, p. 94]. This attracted a new type of owner/manager to the savings and loan business: mortgage bro-

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computed under the experience method), be reduced by 15% of the otherwise allowable deduction. At the same time, the amount considered a preference for the minimum tax computation was reduced to 71.6% of excess reserves [IRC section 57(b)(1) and (2)]. Assuming that the entire percentage of taxable income bad debt deduction addition to the reserve was in excess of the experience method, the applicable rate for the deduction was reduced to 34%. Next, the Deficit Reduction Act of 1984 reduced this deduction rate to 32% by increasing the IRC section 291 rate to 20% and also reducing the amount included in the minimum tax base to 59.833% of the excess. This reduced the bad debt deduction to 32% of taxable income.

[17]For a summary of empirical research documenting this diversification and its effects on profits, see Margavio, 1990.

kers and land developers who saw the opportunity to capture a source of financing for their investments and projects. "In both cases, an association charter now provided them [the new owners] with a lower cost and more certain source of funds than commercial bank borrowings" [Strunk and Case, 1988, p. 95]. In addition, the borrowings were federally insured by the FSLIC.

Federal insurance of depositor accounts by the FSLIC was the root of a risky investment strategy undertaken by many institutions that were desperate to build their net worth. If the big risks paid off, then the institution and its shareholders would benefit, but if risky investments did not pay off, the FSLIC would share in the loss of a collapse of the association. Some institutions invested extensively in junk bonds, and others increased interest rate hedging transactions to a level of gambling on the direction of future interest rates.[18] Institutions began investing heavily in ADC (acquisition, development, and construction) loans to fund the commercial and residential real estate development activity of the new owner.[19]

In order to attract funds to finance this activity, some institutions began offering interest rate premiums to depositors. This attracted a substantial amount of deposits from brokers outside of the institution's geographic area. Savings and loans were limited to obtaining 5% of deposits from this source. However, in March 1982, the restriction was removed by the Bank Board and billions of dollars flowed out of money market funds and into thrifts [Strunk and Case, p. 91, 92]. Institutions using brokered deposits began to grow at a phenomenal pace, further fuelling real estate development activity.[20]

Some thrifts became so extensively involved in funding real estate development activities of certain developers that the institutions became, in substance, equity partners. This was particularly true in the case of ADC loans. Accounting rules during this time allowed such loans to be classified as loans rather than direct investments, obscuring the true relationship between the

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[18]Pilzer [1989] describes this strategy in Chapter 5, "The Gamblers," pp. 123-135; and in chapter 6, "The Man With the Lucky Coin," pp. 136-149.

[19]Pilzer [1989] describes this strategy in Chapter 4, "The Cowboys," pp. 80-122.

[20]Many institutions were growing at rates faster than 25% per year [Pilzer, 1989, p. 174].

institution and the developer.[21] In addition, many fraudulent appraisals were obtained to value the collateral land. In the early 1980, this problem was not discovered because real estate prices continued to rise. This spurred another problem. Some institutions became careless in granting credit to applicants under the assumption that if the loan went bad, increasing property values would cover the losses. Problems with these strategies surfaced in the Southwest beginning in late 1985 and early 1986 when a drop in oil prices caused a major economic recession. This was followed by a substantial decline in real estate prices; a problem which spread nationwide with the spread of the recession. In addition, by 1985 many markets began to show signs of overbuilding as office vacancies rose.[22] This condition was aggravated by 1986 tax changes which eliminated many tax benefits for real estate ownership.[23] Consequently, the number of failing institutions began to rise (Exhibit 3).

Both the FHLBB and the FSLIC were aware of the problem. They were, however, prevented from acting quickly to close the institutions because of a severely outdated regulatory structure and purpose. The historical purpose of the FHLBB examiners was to check for compliance with government regulations. This required little training since substantial regulatory changes were not often made. Consequently, examiner positions were filled by low level civil service employees. Examiners merely reported their findings to the Washington Office of the FHLBB; the examiners could not require establishment of reserves for loan losses, and had no other enforcement powers. Enforcement powers rested with the supervisory branch of the Federal Home

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[21]Subsequent to the publicizing of some of the thrift industry problems, the Accounting Standards Executive Committee of the AICPA issued (in February, 1986) a "Notice to Practitioners - ADC arrangements." This notice clarified stringent rules which must be met for classification of ADC loans as loans. Those arrangements not meeting the rules were required to be shown as equity investments. [Peat Marwick Main and Co., 1988, Chapter 6].

[22]The overbuilding was largely a result of the Economic Recovery Tax Act of 1981 which gave special tax breaks for investing in real estate. Investors seeking tax deductions formed highly leveraged tax shelter partnerships which overbuilt the real estate market. The leverage used in these real estate partnerships came in part from the savings and loan industry.

[23]These tax changes include passive investment loss limitations for investments in real estate; change in depreciation computations; at risk rules applied to real estate investment; investment interest limitations; and capital gains changes.

EXHIBIT 3

Failures of FSLIC-Insured Institutions[a]

Year	Number	Assets (In Millions of Dollars)
1980	11	$ 1,457.6
1981	28	11,553.4
1982	74	20,202.9
1983	55	19,741.8
1984	27	6,000.4
1985	49	18,441.3
1986	85	31,620.5
1987	71	20,918.1

[a]Source: Strunk and Case, 1988, pp. 8, 9.

Loan Bank which consisted of the president and a small staff at the regional FHLB level. This structure created delays in communications of problems and further delay in corrective action.

Once communication difficulties were overcome and a problem institution identified, the first step in taking action was for the regional FHLB to obtain a "consent decree." In this agreement, the thrift management would voluntarily discontinue specified transactions. If this failed, "cease and desist" orders and management removal requests were sought. These could only be issued by the Washington Office. They were difficult to obtain because they could be challenged in court, and required additional evidence of wrongdoing. Despite these shortcomings, the system worked until the deregulation of the 1980s added complexities to the business.

With the proliferation of new investments allowed in the 1980s, rapid market changes in the late 1970s, and the expansion of branch networks, the FHLBB examination staff was overextended and undertrained as to potential problems. Examinations of the institutions took more time and were conducted less frequently as problems mounted. Then the stories of the famous failures surfaced.[24] The FHLBB petitioned Congress

[24]The Empire Savings and Loan of Mesquite, Texas scandal become public information in 1983 when the owners became the subjects of an extensive FBI investigation for fraud, conspiracy and racketeering in various land flip deals [Pilzer, 1989, p. 115]. American Savings of Stockton, California received public

to tighten the regulatory reins to give the FHLBB power to act more quickly in "cease and desist" cases, and to provide funds to the FSLIC so that it could absorb projected losses from closing problem institutions.

Re-regulation

Congress responded with the Competitive Equality Banking Act (CEBA) of 1987, the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) of 1989, and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. These Acts provided a much needed infusion of funds (approximately $177 billion) to the FSLIC; and established the Resolution Trust Corporation, a temporary entity, to dispose of the assets of failed institutions. The Acts also changed the savings and loan regulatory structure by abolishing the FHLBB system. The FHLBB supervisory and examination functions were turned over to the Office of Thrift Supervision (OTS) [*Savings Institutions*, 1989, p. 32]. Responsibilities of the OTS were designed with greater emphasis on assessing the financial viability and asset quality of institutions. Thus, responsibilities more closely paralleled those of the Office of Controller of the Currency, the banking industry supervisory agency. The OTS was also given greater autonomy in requiring operating changes for, and ultimately, shutting down institutions judged to have too many risky investments.

In order for the OTS to perform this function effectively, objective measures of riskiness had to be established. A system of risk determination was structured for both individual assets, and for an institution's entire portfolio of assets. This system recognizes a strong connection between the quality of an institution's assets, individually and collectively, and how that quality improves or deteriorates the institution's capital posi-

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attention in 1984 when regulators forced out the CEO for betting wrong on interest rate swings and masking bad real estate loans [Pilzer, 1989, p. 216-219]. Vernon Savings and Loan of Dallas, Texas entered receivership in 1987 when 96% of its real estate loans were deemed worthless [Adams, 1990, p. 47]. Lincoln Savings and Loan of Irvine, California became a much publicized scandal in 1987 when news of its fraudulent real estate deals and ties to the "Keating Five" were revealed [Adams, 1990, p. 252]. Columbia Savings and Loan of Beverly Hills, California, and Franklin Savings Association of Ottawa, Kansas were exposed in 1988 for their huge portfolios of junk bonds and their relationship with Michael Milken [Pilzer, 1989, p. 136-149].

tion. Definitions of risk are, therefore, cast in terms of minimum capital standards required to sustain the institution's investment in certain types of assets. The definitions and capital requirements were borrowed largely from the three tier capital standards system used by the Office of Controller of the Currency. A brief overview of the composition of these tiers is presented below.

Tier one, core capital (or leverage capital), is defined as the sum of common stockholders' equity and noncumulative preferred stockholders' equity; plus identifiable intangibles (excluding goodwill and limited to 25% of total core capital); plus purchased mortgage servicing rights. Savings and loans must maintain this core capital at a level of 3% of total assets. In addition, a second tier, defined as tangible capital, must be maintained at a level of 1.5% of total assets. Tangible capital is defined as core capital (tier one) minus all intangible assets. Finally, tier three, known as risk-based capital standards, requires institutions to maintain reserves of 6% of risk-weighted assets and to increase this percentage for interest rate fluctuations that adversely affect earnings [*Savings Institutions*, 1989, p. 32; 12CFR Ch.V Part 567]. Each major category of assets is given a risk weighting factor which is multiplied by the dollar amount of assets in that category.[25] These risk factors are changed as market conditions dictate. There is a gradual phase in period until January 1, 1993 for the risk-based standards. As the standards are designed, savings and loans must meet the minimum capital criteria in each of the three tiers.

These standards are monitored by the OTS as savings and loans file the required quarterly financial statements. Effective January 1, 1994, these statements must be stated on a GAAP basis [Bush and Morrall, 1989, p. 30]. In addition to this return to GAAP accounting, the independent auditor now has a greater role in assessing institutional safety and soundness in the following ways.[26] First, institutions with over $150 million in assets are required to obtain annual audits. Second, in addition to traditional GAAP and GAAS (generally accepted auditing stan-

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[25]For example, Goodwill is generally given a 200% risk weight, thereby requiring a 12% reserve. Mortgage backed securities are given a 20% risk weight, thereby requiring a 3% reserve. Cash and federal government backed securities have a 0% weight, thus requiring no reserves.

[26]These provisions are summarized in *Journal of Accountancy*, March, 1992, p. 17.

dards) responsibilities, the audit report must comply with any additional disclosures that regulations require. For example, a separate report must be prepared attesting to management assertions that the institution is in compliance with regulations related to safety and soundness. Third, outside auditors must agree to provide workpapers to regulators upon request, and must notify the Federal Deposit Insurance Corporation (FDIC) if the auditor's services terminate. Finally, the FDIC may require that an institution's quarterly financial statements be subject to CPA review procedures. This authority of the FDIC stems from its new responsibility as the insuring agency for savings and loans.

In a massive reorganization of the insurance system, FSLIC merged into the FDIC, the insuring agency for commercial banks. This facilitated coordination of insurance goals, rates, and supervision philosophy between the thrift and banking industries. By shifting the insuring of savings and loans and by the creation of the Office of Thrift Supervision, Congress implemented a policy of regulatory equality for savings and loans and commercial banks.

As the recent restructuring of savings and loans suggests, the banking industry has been successful in its long time urging of parity between the banking and thrift industries. Since 1951, the Commercial banking industry lobbied for tax equality between banks and savings institutions.[27] These arguments were reiterated in hearings related to changes implemented in the percentage of taxable income bad debt deduction in the Tax Reform Act of 1986. Bankers perceived these 1986 changes to be a move towards tax equality. In addition, arguments in the tax hearings acknowledged that the deregulation Acts of 1980 and 1982 (DIDMCA and Garn-St. Germain) were perceived by both industries to be regulatory moves towards establishing investment equalities. Thus, a trend had developed towards increasing equality between banks and savings and loans. The regulatory equalities implemented in CEBA, FIRREA, and FDICIA could be viewed as the culmination of this equality movement, with one

[27]Banks perceived the percentage of taxable income bad debt deduction to be the single greatest advantage afforded by the tax law to savings and loans over commercial banks. In virtually every major tax hearing that opened discussion of this deduction (see U.S. Congress, House, Committee on Ways and Means, 1951, 1961, 1969, and 1986 and U.S. Congress, Senate, 1983), the banking industry lobbied for its elimination in order to allow more equitable competition between the two industries.

major exception which now subjects savings and loans to investment restrictions not required of banks.

The recent legislation implemented a new qualified thrift lender (QTL) test which restricts savings and loans to investing 70% of their portfolio assets in qualified assets. The definition of qualified assets is limited to mortgages and home equity loans, mortgage backed securities, and construction loans. Up to 15% of these qualified assets can include: investments in service corporations; loans to churches, schools, nursing homes and hospitals; and consumer and education loans (limited to 5% of portfolio assets) [*Savings Institutions*, 1989, p. 33]. Portfolio assets are defined as total tangible assets reduced by fixed assets and liquid assets. These definitions impose limitations on the investment freedom of savings and loans which are even more severe than the pre-1980 limitations. These restrictions have been criticized by the industry as being almost vindictive [Wilson, 1990, p. 22].

This QTL test constituted a very significant change in the three most recent laws which is contrary to the trend towards equality among competing financial institutions. It serves to force savings and loans to specialize in mortgages by restricting other investment activity. At the same time, FHLB membership was opened up to banks and credit unions; and commercial banks obtained the authority to acquire savings institutions. These latter regulatory changes further expanded the operating capabilities of banks and credit unions by giving them greater access to housing funds. These financial intermediaries can now compete with savings and loans for mortgages, and obtain optimally diversified portfolios. However, savings and loans are now statutorily prohibited from diversifying extensively. This situation may lead to a devaluation in the savings and loan charter in the future.

WHAT WILL THE 1990s BRING?

This devaluation has been predicted by some experts [McLean, 1991; Jacobe, 1990; *Savings Institutions*, 1990]. They argue that as a result of the 1980s debacle, savings and loans have a bad image problem to overcome. A viable way of overcoming this problem may be simply to change over from a savings and loan charter to a savings bank or commercial bank charter. Such a trend has already been observed in California savings and loans [*Savings Institutions*, 1990, p. 31] and institu-

tions formed after 1988 [*Savings Institutions*, 1990, p. 5]. This leads some commentators to predict the demise of the traditional savings and loan institution.

The function of the traditional savings and loan, making mortgage loans and holding them to maturity, is perhaps outdated. This conclusion rests primarily on the burgeoning secondary mortgage market which was developed and promoted by government sponsored enterprises such as Fannie Mae. This agency (and others like it) buys mortgages and repackages them into mortgage backed securities which are sold on the open market with varying maturities. Such securities are popular with investors because of a perceived federal guarantee. This has created an adequate supply of capital to the housing market despite the savings and loan crisis (see comments by Alfred A. Dellibova, Deputy Secretary of the Treasury in *Mortgage Banking*, 1991, p. 31). It has also served to integrate housing financing into the nation's overall capital market.

This development of the real estate loan marketplace may eventually usurp the traditional function of the savings and loan industry. However, some industry observers still see the need for a strong consumer-oriented banking industry which would include mortgage financing and some other types of consumer financing. In addition, as the economy improves and investors seek investment opportunities with higher returns, they may retreat from the mortgage backed security market. The savings and loan industry then may acquire a new function in the capital market, that of buying and holding to maturity mortgage backed securities.

A type of specialization strategy similar to this has been observed by some empiricists [Kaplan, 1988; Rudolph, 1988]. However, its effect on profitability has not been demonstrated consistently. Ultimately, carving out a market niche of some kind may be the key to continued viability of savings and loans, as well as other financial intermediaries. Thus, all financial intermediaries could focus on their managerial strengths in structuring a strategy anywhere from specializing in housing finance, to consumer lending, to becoming a completely "diversified financial supermarket" [McLean, 1991]. Such specialization decisions would then rest with management instead of Congress, and the industry as a whole could be more responsive to market changes. This flexibility could be effected by regulatory changes allowing a universal charter for financial intermediaries. This

development, with corresponding adjustments in the tax law, would be an appropriate culmination to the 1980s piecemeal trend toward equality. It would also assist Congress in synchronizing its goals for the financial services industry.

CONCLUSION

In conclusion, Congress has made major progress in the 1980s in equalizing the regulatory structure of the financial services industry. The savings and loan industry benefited from these changes by becoming better able to respond to changing market conditions. Many of these changes were, however, overdue corrections of poor legislation in the 1950s, 1960s and 1970s. Those regulations (specifically the imposition of Regulation Q, tax and regulatory portfolio restrictions, and overly generous loan-to-value ratios and mortgage terms) set the stage for the crisis the industry encountered in the late 1970s. The disintermediation crisis of the 1970s led to a severe net worth problem from which the industry was not given the opportunity to recover until DIDMCA, Garn-St. Germain and the Tax Reform Act of 1986. This net worth problem was a driving force in many of the irregularities that developed in the industry during the 1980s. Better timing and coordination of the diversification opportunities afforded by DIDMCA, Garn-St. Germain and the Tax Reform Act of 1986, combined with the FIRREA structural changes have reduced these irregularities. Attention to these past policy changes, however, is only useful in understanding the problems of today and for examining needed future policy changes.

In planning for the future, Congress must recognize that market conditions have integrated the housing finance function into the overall capital market structure. Therefore, designing a future for the savings and loan industry must involve a process of setting policy goals for the entire financial services industry. Legislation in the 1980s moved in the direction of equalizing opportunities for the thrift and banking sectors of the financial services industry. However, it stopped short of full equalization and a definitive policy statement. Once an integrated policy goal is established, legislators can then structure tax considerations, supervisory functions and other regulations to achieve these goals, while at the same time allowing the institutions the flexibility to respond to ever changing market conditions.

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THE "REVOLUTION" IN FINANCIAL REPORTING THEORY: A KUHNIAN INTERPRETATION

Abstract: A Kuhnian perspective is used to explain the transition in financial reporting theory from an "economic income perspective" to an "informational perspective" (a transition that Beaver refers to as a "revolution"), and to examine the subsequent development of the latter. The demise of the economic income perspective (represented by the normative *a priorists*) is attributed to the lack of a paradigm which could serve to identify research problems and provide methodological guidance. The success of the informational paradigm, on the other hand, is attributed to the fact that it was, in essence, a subparadigm of the broader and well-established market economics paradigm. The study concludes, however, with a discussion of two types of persistent anomalous findings (the first with respect to the EMH and the second with respect to the CAPM) that have the potential to generate a crisis for the informational paradigm.

The 1960s was a decade of turmoil in financial accounting theory and research. Post-1960s financial accounting research is radically different in method, theoretical content, and philosophical thrust than pre-1960s research. Wells [1976] has suggested that the turmoil signified the beginning of a Kuhnian revolution. Beaver [1989] characterizes the outcome as "an accounting revolution"; a revolution whereby an "economic income" approach was replaced by an "informational perspective" [Beaver, p. 18]. Although there is no indication that Beaver is using the term *revolution* in a Kuhnian sense, the implication is that the changes were internally generated, an overthrow that was initiated by developments in accounting theory. This paper offers a significantly different interpretation. A Kuhnian perspective is employed to argue that the new view of financial reporting theory described by Beaver can be seen as a "normal science" expansion of the economics paradigm.

This approach holds the potential of a new explanation for the failure of the normative *a priori* research movement and the success of the new informational research movement. The Kuhnian perspective also provides a unique vehicle for analyz-

ing the potential significance of challenges to the validity of the efficient markets hypothesis (EMH) and the capital asset pricing model (CAPM) which have long served as cornerstones for the informational perspective. First, however, it will be useful to locate the present study within the context of existing Kuhnian analyses in the accounting literature.

KUHNIAN ANALYSIS OF ACCOUNTING THOUGHT

Cushing [1989] has provided an excellent review of Kuhnian references in the accounting literature and there is no need to repeat that process. This section, accordingly, shall be limited to locating the present study with respect to the more prominent and comprehensive applications of Kuhnian ideas that can, in turn, be related to the accounting debates of the 1960s and 1970s

In the mid-1970s, there were suggestions that accounting was in the midst of a Kuhnian crisis characterized by paradigm debate [Wells, 1976; The AAA's *Statement on Accounting Theory and Theory Acceptance*, 1977]. Peasnell [1981] and Laughlin [1981] challenged the applicability of Kuhn's ideas to accounting. Kuhn's theory, according to Peasnell, applies only to sciences, and since accounting is not a science, Kuhnian analysis of accounting thought is inappropriate. Cushing, on the other hand, presents a case for the applicability of Kuhn's ideas to intellectual disciplines other than the sciences. His analysis is more elaborate than previous studies and provides useful background for the present study.

With respect to accounting, Cushing argues that since the traditional concerns of accounting (making sense of the economic performance of business enterprises) share significant common ground with the concerns of science (making sense of reality), "Kuhn's theories may be pertinent to an understanding of the historical evolution of the accounting discipline" [Cushing, p. 11]. He maintains that "the double-entry bookkeeping model has the features of an accounting paradigm, as that term is used by Kuhn, and that the historical evolution of accounting from approximately the Sixteenth century until about 1960 resembles the normal science of Kuhn's theory" [p. 20].

The advent of governmental regulation of accounting practice and reporting in the Twentieth century led to a search for uniform accounting principles and resulted, according to

Cushing, in the first stage of crisis for the double-entry paradigm. "The combination of government regulation and the commitment to uniformity has led to a buildup of unresolved accounting issues that perhaps more closely resemble the anomalies of Kuhn's theory" [Cushing, p. 23].

A second stage of accounting's crisis was triggered, Cushing suggests, when the search for a scientific foundation for financial accounting theory — a search which reached its most fervent pitch in the 1960s — produced instead a widespread conviction that "accounting was inherently arbitrary" [Cushing, p. 27]. The sense of crisis was further deepened by the growing conviction that even if a scientific theory of financial accounting could be found, it could never be implemented because of the extent to which the rule-making process had been politicized. "In essence, the further development of accounting thought along traditional lines was now irreconcilable with the ideals of science that accounting scholars had fervently embraced" [Cushing, p. 27]. Many academic accountants responded to this situation, Cushing argues, not by abandoning science, but by abandoning accounting. "Accounting scholars have committed themselves to science, but having come to realize that accounting has no scientifically valid paradigm to provide a basis for scientific research, have chosen to practice other sciences that do have such paradigms" [Cushing, p. 29].

This author agrees with Cushing that the 1960s ushered in a wholesale concern with scientific accounting research, but attributes this concern more to outside social, political, and technological factors than to crisis in a Kuhnian-type paradigm. Similarly, this author tends to share Peasnell's skepticism about the applicability of Kuhn's ideas to traditional (pre-1960s) accounting thought, but views the alternative proposals for scientific accounting practice which were put forth by the so-called normative *a priori* theorists of the 1960s as manifestations of pre-paradigm struggle. There is also agreement with Cushing's view that, since the 1960s, there has been a wholesale abandonment (by academic accountants) of the traditional concerns of accounting and a corresponding wholesale acceptance of other disciplines (especially economics) which are considered to be scientific.

In short, the 1960s marked the beginning of the applicability of Kuhn's ideas to accounting thought in correspondence with the development of widespread concern about being scien-

tific. In the context of Kuhn's ideas, the 1960s academic accounting literature was dominated by the search for a paradigm.

THE "SCIENTIFIC TURN" AND THE SEARCH FOR A PARADIGM

On all fronts, the 1960s were, in the words of Dyckman and Zeff, "a pivotal decade" for accounting research: "In the literature of accounting research, the 1960s was the Decade of Awakening" [Dyckman and Zeff, p. 233]. A unique congruence of social, political and technological developments had produced a shared commitment to the pursuit of scientific research in accounting. By the mid-1970s, however, it was obvious that the "decade of awakening" had produced nothing remotely resembling a consensus view of financial accounting and reporting theory. In fact, a study commissioned by the American Accounting Association concluded that, "a multiplicity of theories has been — and continues to be — proposed" [AAA, 1977, p. 1]. The AAA committee further characterized the current theoretical debate as "virtually endless argumentation and inability to resolve issues that are raised" [AAA, 1977, p. 1]. In Kuhnian terms, the committee suggested that accounting theorists were involved in paradigm competition [p. 43].

The AAA's study, published under the title *Statement on Accounting Theory and Theory Acceptance (SATTA)*, classified the diverse perspectives on accounting theory into three categories: "classical approaches to theory development" [p. 5]; "the decision usefulness approach" [p. 10]; and "information economics" [p. 21]. *SATTA*'s classification scheme, however, is deficient on two counts. In the first place, it does not differentiate the pre-1960s theorists from the science-oriented theorists of the 1960s. Secondly, it lumps empirical capital markets researchers such as Gonedes, Beaver, Ball and Brown together with normative, *apriorists* such as Chambers and Sterling in the "decision usefulness" category. As Peasnell points out, this categorization is at odds with other classifications in the accounting literature. He (Peasnell) charges that "the committee's classification seems to border at times on the artificial" [p. 70]. This charge is further borne out by the fact that Beaver, in 1981, presented very cogently the interrelationship of information economics theory and empirical capital markets research: schools of thought which the AAA committee had treated as separate "paradigms".

This brings up another problem with the AAA's *SATTA*; a problem with respect to the committee's use of Kuhnian terminology. *SATTA* included an argument that, "[t]here are a number of people offering different paradigms" [p. 45], thus suggesting that Kuhn's description of paradigm competition was applicable to the (then) current state of accounting theory. As Peasnell has pointed out, however, this is indicative of a misunderstanding of Kuhn's theory. A given way of looking at the world, including theoretical orientation, becomes paradigmatic *after it has found a certain level of acceptance*. Theories may be offered by individual theorists, but paradigms are not put forth by individuals. The perspective suggested by an individual may eventually become paradigmatic, but it is not paradigmatic at the time it is put forth. Such considerations led Peasnell to pose the following question: "Do the variety of accounting theory approaches identified by the committee really constitute competing paradigms (or pre-paradigm 'schools of thought', for that matter)?" [p. 69]. The present study argues that, with respect to the various normative *apriorists*, the 1960s and early 1970s cannot be appropriately characterized by Kuhn's notion of paradigm competition.

Kuhn [1970b] points out that the discourse of philosophy, as well as many of the social sciences, is characterized by "claims, counter-claims, and debates over fundamentals" [p. 6]. According to Kuhn, debate over fundamentals was also characteristic of many fields that subsequently developed into sciences:

> . . . there are many fields — I shall call them proto-sciences — in which practice does generate testable conclusions but which nonetheless resemble philosophy and the arts rather than the established sciences in their developmental patterns. I think, for example, of fields like chemistry and electricity before the mid-eighteenth century, of the study of heredity and phylogeny before the mid-nineteenth, or of many of the social sciences today. In these fields . . . incessant criticism and continual striving for a fresh start are primary forces . . . [Kuhn, 1970c, p. 244]

It is the contention here that the debates among the normative *apriorists* of the 1960s and early 1970s can be much more aptly characterized as pre-paradigm debate [Kuhn, 1970a, p. 160], or alternatively as proto-science debate, than as paradigm competition.

With respect to the situation faced by the information economics and the capital market researchers, however, the AAA committee erred in a different direction. After noting that, in the absence of an accepted body of thought, each theorist must "provide his own foundation for the field" [AAA, 1977, p. 43], the committee asserts that, "Theorizing from efficient markets research has proceeded in a similar vein" [p. 43]. With respect to the informational perspective (information economics and capital markets research), the contrary was actually the case. Instead, accounting theorists in the informational perspective were, in fact, "jumping onto the bandwagon" of a very solidly established paradigm — the economics paradigm.

Thus, with respect to Kuhnian thought, accounting in the 1960s and early 1970s was the site of two distinct, yet interacting, Kuhnian processes. From the perspective of the traditional concerns of accounting, i.e., concern with the measurement of economic performance of business enterprises, the efforts of theorists such as Chambers, Edwards and Bell, Mattessich, and Sterling (so-called normative *apriorists* are viewed as pre—paradigm debate. The normative *apriorists* were attempting to establish a solid scientific foundation for the pursuit of the traditional concerns of accounting.

At the same time, another Kuhnian process was in operation. From the perspective of economics (a discipline which can be considered to be appropriately characterized as a full-fledged scientific paradigm), the "normal science" process appropriately includes attempts to expand the explanatory power of the paradigm. During the 1960s theoretical developments such as the EMH and the CAPM held the promise of extending the explanatory power of the basic economics paradigm to encompass first business finance, and subsequently, financial accounting, while developments in information economics served to locate the emerging new perspective on financial reporting theory within the broader theoretical framework of economic thought.

In sum, accounting in the 1960s and early 1970s is viewed as the site of competition between the normative *apriorists* (who were engaged in pre-paradigm debate with each other) and the proponents of the newly formed financial economics paradigm (an economics sub-paradigm which was engaged in normal science expansionary efforts). The remainder of this paper presents: a Kuhnian interpretation of competition between the normative *apriorists* and proponents of the financial economics

paradigm; an overview of the subsequent normal science-type development of the "informational perspective" of financial reporting theory; and an exploration (in terms of Kuhnian crisis theory) of the significance of challenges to the EMH and the CAPM.

THE FAILURE OF THE NORMATIVE *A PRIORI* RESEARCH MOVEMENT

It has been noted that the decade of the 1960s witnessed tremendous pressures for "scientific" accounting research. But the 1960s also saw a major increase in the pressure for *more* research. The American Assembly of Collegiate Schools of Business (the primary accrediting organization for academic schools of business in the U.S.) instituted the doctorate as the terminal degree for academic accountants in 1967 and began placing greater and greater emphasis on research productivity in the accreditation process. This emphasis, together with the social and political pressures noted earlier, resulted in a major push for more accounting research that was also scientific.

However, research never happens in isolation from a network of beliefs, attitudes and theories. This was one of the most salient features of Kuhn's exposition of normal scientific practice: ". . . in the absence of at least some implicit body of intertwined theoretical and methodological belief that permits selection, evaluation, and criticism . . . it must be supplied, perhaps by a current metaphysic, by another science, or by personal and historical accident" [Kuhn, 1970a, pp. 16-17]. From a Kuhnian perspective the body of intertwined theoretical and methodological belief provided by a paradigm is what gives researchers the confidence that their work will find acceptance. With respect to the situation faced by new PhDs in accounting in the 1960s, a research paradigm was needed to provide confidence that their research would "pay off", that it would lead to success and recognition in the form of tenure.

This sort of consideration is a major reason that "normal science . . . [is] firmly based upon one or more past scientific achievements, achievements that some particular scientific community acknowledges for a time as supplying the foundation for its further practice" [Kuhn, 1970a, p. 10]. More precisely, "When the individual scientist can take a paradigm for granted, he need no longer, in his major works, attempts to

build his field anew, starting from first principles and justifying the use of each concept introduced" [Kuhn, 1970a, pp. 19-20]. An accepted paradigm ends "the constant reiteration of fundamentals" [Kuhn, 1970a, p. 18]; it provides "confidence that they [are] on the right track . . . [and encourages] scientists to undertake more precise, esoteric, and consuming sorts of work" [Kuhn, 1970a, p. 18].

According to the AAA's *SATTA*, the normative *apriorists* of the 1960s were not operating from any generally accepted paradigm. Various theoretical perspectives were put forth by individual researchers, but no single perspective found widespread acceptance. The most notable proposals tended to disagree on one or more fundamental issues. The situation is stated quite succinctly by Mattessich in his personal account of the "golden age" of *a priori* research: "It is characteristic of my approach that in contrast to others (e.g. to Alexander who used present values, Edwards and Bell who stressed replacement values, Chambers who championed exit market values, Ijiri who defended acquisition cost values), I introduced a general valuation assumption, thus tolerating all specific valuation hypotheses . . ." [Mattessich, 1984, p. 34].

Mutual criticism among the leading *apriorists* was also highly visible. Perhaps the most notable example was the exchange between Chambers and Mattessich. Chambers published a critical review of Mattessich's *Accounting and Analytical Methods* (AAM) in the *Journal of Accounting Research* [1966b] suggesting, according to Gaffikin, that "the work suffers from being 'forced' to fit methodological requirements at the expense of more fundamental, substantive analysis" [Gaffikin, 1988, p. 21]. Mattessich has subsequently referred to Chambers' review as a "wholesale rejection" of his work [Mattessich, 1984, p. 32]. With respect to Chambers' *Accounting, Evaluation and Economic Behavior*, Mattessich has asserted that, "Chambers started from a preconceived, and to my mind, dogmatic objective" [Mattessich, 1984, p. 33].

Mattessich was also involved in another notable exchange, this one with Sterling. Mattessich had published a critical review of Sterling's *The Theory of the Measurement of Enterprise Income* in *Abacus* in 1971. Sterling's reply, the following year, concluded that Mattessich had criticized his (Sterling's) book for:

1. not taking an approach (teleological) that it in fact took;
2. not considering three users (creditors and stockholders, taxing authorities, and managers) that it in fact considered;
3. not drawing a conclusion (different-incomes-for-different-purposes) that was identical to its statement of the problem;
4. placing boundaries (to serve only stockholders) on the theory of accounting that it did not place;
5. drawing a conclusion (exclusive market values) that it did not draw; and
6. not being a general theory of accounting when it was explicitly stated to be (and entitled) a theory of income measurement. [Sterling, 1972, p. 101]

Sterling closed his reply with the assertion that Mattessich's critique was "amorphous" and "without foundation" [p. 101].

In such an environment, in which even the theoretical leaders cannot seem to gain any substantial degree of acceptance, and at times display open contempt for each other's work, is it any wonder that young new PhDs under pressure to publish would tend to look for a safer, more promising research perspective? Mattessich attributes the "reorientation of many young scholars, away from the *a priori* approach, towards empirical research" [1984, p. 36] to a "reaction of the dialectical process of academic fashion . . ." [1984, p. 35]. From a Kuhnian perspective, however, a different explanation is compelling. That explanation is that many young accounting academics tended to gravitate toward a budding new research paradigm which provided clear-cut research problems and examples of acceptable research methods. Many young new PhDs tended to gravitate toward a new accounting research paradigm which can be considered to be a sub-paradigm of economics.

THE ECONOMICS PARADIGM AND THE RISE OF MARKET-BASED ACCOUNTING RESEARCH

In contrast to the debates which dominate pre-science, the practice of normal science is characterized by the lack of debate over fundamentals. In fact, normal science is what Kuhn terms paradigm-based research, where the term *paradigm*, in the broad sense "stands for the entire constellation of beliefs, values, techniques, and so on shared by the members of a given

community" [Kuhn, 1970a, p. 175]. According to Kuhn, the accepted framework provided by a paradigm serves as a foundation for the articulation of problems that must be solved if the range of explanatory power is to be extended: ". . . normal-scientific research is directed to the articulation of those phenomena and theories that the paradigm already supplies" [1970a, p. 24]. As indicated earlier, ". . . in the absence of at least some implicit body of intertwined theoretical and methodological belief that permits selection, evaluation, and criticism . . . it must be supplied, perhaps by a current metaphysic, by another science, or by personal and historical accident" [Kuhn, 1970a, pp. 16-17]. This provides a major clue to the success of the informational perspective in financial reporting theory.

Three related theoretical developments in the 1950s and 1960s — the efficient markets hypothesis (EMH), the capital assets pricing model (CAPM), and modern portfolio theory (MPT) — had served to transform business finance into financial economics [Whitley, 1986]; they all three extended the "rationality assumption" and the "basic maximizing model" of economics to securities price research. These developments, in conjunction with the theoretical framework of information economics, created the opportunity for accounting researchers who were trained in economics to import the constructs and methods of economics into financial accounting research.

The spectacular "scientific" developments in finance in the 1960s were followed closely by academic accountants (especially at the University of Chicago) who were anxious to find a theoretical foundation for the development of "scientific" research in accounting. The University of Chicago began its annual Conference on Empirical Accounting Research in 1966 with the leadership and participation of academics trained in the theory and methodology of financial economics.

In 1967, Ball and Brown presented their paper ("An Empirical Evaluation of Accounting Income Numbers") at the conference; a paper that would later be recognized as having a formative influence on the emerging new research paradigm. Brown, in his recently published reflections on the paper, attributes their (Ball and Brown's) success to their Chicago-style training in economics and finance. Brown notes that he had already studied the accounting classics at the University of New South Wales before going to Chicago for graduate study in 1963. "So on my arrival at Chicago I was exempted from all accounting

courses other than the doctoral seminar . . . I was, however, programmed into a full complement of courses in Chicago-style economics and finance" [p. 203]. The strong empirical impetus in finance research at Chicago was supported by the data base made available by the University's Center of Research into Security Prices, and scholars such as Merton Miller and Eugene Fama provided the intellectual leadership. "It did not take long", Brown notes, "for me to be completely seduced by the sheer vitality of the Chicago finance group which, at that time, was rapidly developing lines of research fundamentally at odds with much of the accounting literature to which I had been exposed" [Brown, p. 203]. Developments in finance, however, were closely related to the spirit of Chicago economics which, as Brown implies, provided the theoretical underpinning of the entire financial economics paradigm.

> The second part to this 'formative' story is the role of Chicago's Economics Department. I and many of my doctoral program classmates chose Economics as our basic discipline . . . We then trotted off to the Economics Department where we inevitably were schooled in applied microeconomics and given a heavy dose of so-called positive economics, often taught by Milton Friedman himself. The empirical mindset was so dominant in the 1960s that it influenced almost all of the doctoral students' choices of research topics for a generation or more. [Brown, p. 203]

In any case, the publication of Ball and Brown's article in 1968 provided the real breakthrough for the aspiring new accounting research movement. Watts and Zimmerman [1986, p. 5] cite this article as the one having the biggest impact on the evolution of securities price research in accounting. This was borne out by an earlier report by Dyckman and Zeff of an informal survey of their research-oriented colleagues regarding the most important contributions to accounting literature between 1960 and 1980. Their survey resulted in 56 votes for articles published in *The Journal of Accounting Research (JAR)* versus 44 for articles published in the *Accounting Review*, but fully one-half of the votes for *JAR* were votes for the 1968 Ball and Brown article [Dyckman and Zeff, p. 254]. It was an article that "stirred widespread interest in efficient markets research in accounting" [Dyckman and Zeff, p. 242].

The Ball and Brown study was essentially an extension of the financial economics paradigm. Using the CAPM as a tool for relating accounting numbers to securities prices, they investigated the relationship between unexpected earnings and abnormal rates of return for 261 New York Stock Exchange firms during the nine years from 1957 to 1965. The results, interpreted in light of the efficient markets hypothesis, indicated that stock price changes do reflect earnings changes, but that most of the change in stock prices occurs prior to the report of annual earnings.

The Ball and Brown article was so different from traditional accounting literature that "it was rejected [by the *Accounting Review*] on the reviewer's contention that 'it was not an Accounting manuscript' " [Dyckman and Zeff, p. 242]. From a Kuhnian perspective, it is not surprising that a study that was so radically different from the traditional approach to accounting research should become the exemplary study for future research. The "scientific achievements" that become the exemplars for a new paradigm must be "sufficiently unprecedented to attract an enduring group of adherents away from competing modes of scientific activity" [Kuhn, 1970a, p. 10]. From a Kuhnian perspective, the Ball and Brown study can be seen as a demonstration of how accounting researchers could harness the productive potential of the financial economics paradigm. For the growing number of young accounting academics who were under pressure to publish "scientific" research, the prospect of having an intellectual foundation (a paradigm) with established respectability must have been quite compelling; especially when compared with the tumultuous pre-paradigm debate among the normative *apriorists*.

This consideration (the pressure to publish) leads to Kuhn's second characteristic of exemplary "scientific achievements" — they must be "sufficiently open-ended to leave all sorts of problems for the redefined group of practitioners to resolve" [Kuhn, 1970a, p. 10]. If there was nothing left to be done, no unsolved problems or nagging questions, researchers would have to look for different areas in which to practice their skills of inquiry. The "success of a paradigm", Kuhn points out, ". . . is at the start largely a promise of success discoverable in selected and still incomplete examples" [1970a, pp. 23-24]. When paradigms cease to be problematic (as very few have), they cease "to yield

research problems at all and . . . become tools for engineering" [Kuhn, 1970a, p. 79].

The Ball and Brown [1968] article was a success in the sense suggested by Kuhn. It held the promise of successfully extending the financial economics paradigm to accounting. Ball and Brown established that, within the financial economics paradigm, accounting earnings are empirically related to stock prices, but they studied only a limited set of accounting earnings (annual) and established only a gross relationship between earnings and stock prices. Left unanswered were such questions as the following. Could their results be duplicated for other sets of accounting earnings (such as quarterly earnings)? To what extent does the market anticipate changes in earnings? To what extent do accounting earnings announcements convey information to market participants? Are investors misled by earnings changes that result solely from changes in accounting procedures? The Ball and Brown article stimulated a number of studies aimed at answering such questions. As Watts and Zimmerman pointed out, "A reasonable characterization of the objective of the economics-based empirical literature that evolved in the 10 years following Ball and Brown (1968) . . . is that it sought to investigate the implications of the EMH and the CAPM for the role of accounting numbers in supplying information to the capital markets for valuation purposes" [pp. 15-16].

MARKET-BASED ACCOUNTING RESEARCH AS NORMAL SCIENCE

Most of the empirical work stimulated by Ball and Brown fits Kuhn's characterization of normal science; it was work aimed at articulating and fleshing out the financial economics paradigm with respect to accounting numbers. It consisted mainly of "mopping-up operations" which could be classified into Kuhn's three categories of normal scientific problems — "determination of significant fact, matching of facts with theory, and articulation of theory . . ." [Kuhn, 1970a, p. 34].

By demonstrating that a certain class of facts is "particularly revealing of the nature of things . . . the paradigm has made them worth determining both with more precision and in a larger variety of situations" [Kuhn, 1970a, p. 25]. Much normal scientific research, accordingly, aims at more clearly delin-

eating the boundaries of this "class of facts". Such work can be demonstrated quite clearly with respect to the extension of the financial economics paradigm to financial reporting theory. Whereas Ball and Brown had demonstrated the relationship between annual earnings and stock prices for NYSE firms, an obvious approach for further research was to determine whether the same relationship existed for other securities. As Watts and Zimmerman note, "The Ball and Brown study has been replicated for annual earnings announcements by firms traded in U.S. markets other than the NYSE . . . It also has been replicated for annual earnings announcements for firms traded in other countries" [p. 47]. Other "mopping-up" work by researchers in the new accounting paradigm established that the class of significant facts included the relationship between interim earnings and securities prices.

A second category of normal scientific problems arises as a result of difficulties involved in matching theory with factual observations. "Improving that agreement or finding new areas in which agreement can be demonstrated at all presents a constant challenge to the skill and imagination of the experimentalist and observer" [Kuhn, 1970a, p. 26]. In the natural sciences, for instance, special equipment must be developed to measure results that are not observable to the naked eye, and the use of such special equipment usually requires theoretical justification and adaptation. This type of problem was very pointed for researchers in the new accounting paradigm. The underlying theory of financial economics specified a certain relationship between *expected* future cash flows and securities prices. Accounting researchers, on the other hand, were primarily concerned with the relationship between *earnings* and securities prices; and in any case, expectations about the future are not directly observable. The development of the new accounting paradigm, therefore, left much scope for work regarding the fit between fact and theory.

Ball and Brown assumed that accounting earnings could be used as a surrogate for cash flows, thus allowing them to use the CAPM to make predictions about the response of securities prices to earnings announcements. Due to the fact that expectations are not directly observable, Ball and Brown chose to proceed as follows: ". . . we construct two alternative models of what the market expects income to be and then investigate the market's reactions when its expectations prove false" [p. 161].

They further used market models to differentiate the market response in terms of normal versus abnormal rates of return. In short, the actually observed data was compared with theoretical models which were, in turn, (theoretically) linked with the underlying theories of financial economics. Such investigative procedures obviously left considerable scope for further mopping-up work aimed at improving the fit between fact and theory. And indeed, many of the studies stimulated by Ball and Brown experimented with alternative models for measuring market expectations and abnormal returns.

Finally, the third type of normal scientific problem noted by Kuhn can be illustrated with respect to the new accounting paradigm; that is, "work undertaken to articulate the paradigm theory, resolving some of its residual ambiguities and permitting the solution of problems to which it had previously only drawn attention" [Kuhn, 1970a, p. 27]. As noted earlier, the Ball and Brown study established that securities price changes are related to accounting earnings changes, but it also found that much of the price changes occur prior to the annual earnings announcements. This gave rise to what was perhaps the most interesting question for subsequent researchers seeking further articulation of the basic theory — how much information content do accounting earnings actually convey? Ball and Brown concluded that annual earnings announcements do contain useful information, but that only 10-15 percent of the potential information is conveyed in the month of announcement. The limitations of their study raised a number of questions about the validity of their conclusions with respect to information content of earnings announcements, and especially with respect to the role played by interim announcements. Many subsequent studies which addressed these issues can be viewed as attempts to refine and further articulate the paradigm theory.

Using Kuhn's terminology, then, much of the accounting research stimulated by Ball and Brown can be aptly characterized as Kuhnian "puzzle-solving". The paradigm both generates (acceptable) research problems and supplies criteria for acceptable solutions, in much the same way that game-type puzzles specify problems and stipulate the rules for solving them. Thus,

> when engaged with a normal research problem, the scientist must *premise* current theory as the rules of his game. His object is to solve a puzzle . . . and current theory is required to define that puzzle and to guaran-

> tee that, given sufficient brilliance, it can be solved. [Kuhn, 1970b, pp. 4-5]

Kuhn employs the puzzle metaphor to emphasize that normal science research is not carried out as a test of the paradigm theory. Quite the contrary, it is the skill of the researcher that is at risk: "I use the term 'puzzle' in order to emphasize that the difficulties which *ordinarily* confront even the very best scientists are, like crossword puzzles or chess puzzles, challenges only to his ingenuity. *He* is in difficulty, not current theory" [Kuhn, 1970b, p. 5, n. 1].

The upshot of this is that the puzzle-solving activity of the normal science researcher is frequently aimed at establishing predictable or unsurprising results. Consider, for instance, the studies which applied Ball and Brown's methods to stock markets other than the NYSE. It surely was no surprise to find, as Watts and Zimmerman note, that "The replications suggest that the results are not unique to the NYSE" [p. 47]. Or consider the research on interim earnings, when Ball and Brown provided evidence that most of the price adjustments related to earnings changes took place prior to the month of annual earnings announcements, the obvious explanation was that most of the information reported was not new. It had previously been reported in interim announcements. So, it was no surprise when Foster [1977] reported a study using quarterly earnings which found evidence "consistent with the hypothesis that quarterly earnings convey information to the capital markets" [Watts and Zimmerman, p. 51]. Such examples are consistent with Kuhn's contention that normal science does not "aim to produce major novelties" [1970a, p. 35].

This raises questions about why so much accounting research effort and so much journal space has been devoted to issues that are merely "mopping-up" or "puzzle-solving" issues. The answers Kuhn suggests are as follows. In a general sense, such studies increase the paradigm's claim to legitimacy by increasing the scope and precision of its application [Kuhn, 1970a, p. 36]. As for the motivation of the individual researcher, personal satisfaction and professional recognition are associated with demonstrations of ingenuity in "puzzle-solving."

> Bringing a normal research problem to a conclusion is achieving the anticipated in a new way, and it requires the solution of all sorts of complex instrumental, conceptual and mathematical puzzles. The man who suc-

ceeds proves himself an expert puzzle-solver, and the challenge of the puzzle is an important part of what drives him on. [Kuhn, 1970a, p. 36]

ANOMALY AND THE DEVELOPMENT OF POSITIVE ACCOUNTING THEORY

The foregoing discussion is not intended to imply that normal science proceeds in a perfectly straight line with no unexpected turns or new directions. "Normal science does not aim at novelties of fact or theory . . . New and unsuspected phenomena are . . . repeatedly uncovered by scientific research, and radical new theories have again and again been invented by scientists" [Kuhn, 1970a, p. 52]. Indeed, anomalies — findings that seem contradictory to the paradigm theory — are ever present. They provide many of the puzzles that drive the normal scientific researcher. If solutions prove to be too elusive the paradigm theory may be adjusted to incorporate the anomaly. One of the most visible extensions of the dominant financial reporting paradigm can be attributed to the process of dealing with anomalous observations, such as the development of positive accounting theory.

Watts and Zimmerman note that "by the mid-1970s accounting researchers had observed . . . whole industries changing from one method of accounting to another at one point in time (e.g., the switch by the steel industry from accelerated depreciation to straight line in 1968)" [p. 6]. Such observations seemed consistent with the view that the stock market can be misled by earnings changes that result solely from changes in accounting procedures; a view that was widely held in the 1960s. However, as Watts and Zimmerman point out, this view contradicts the EMH which implies that the stock market will not be misled by such changes [p. 108]. From the perspective of financial economics, these observations represented anomalies.

These anomalous observations were dealt with by positive accounting theorists by adjusting the paradigm theory. Early research within the paradigm had applied the EMH with the assumption of no information or transaction costs. The anomalous observations of entire industries making costly changes in accounting procedures "led some researchers to drop the zero information and transaction assumptions . . ." [Watts and Zimmerman, pp. 109-110]. This created an opening for intro-

ducing the contracting theory that had developed from the "property rights" version of economic theory. With the addition of sophisticated contracting models the paradigm theory was modified to provide answers to the following question: "If an accounting change that does not affect taxes is costly and has no other effect on firm value, why do managers make those changes?" [Watts and Zimmerman, p. 173]. A very simplified version of the answer proposed by positive accounting theorists can be gleaned from the following examples.

For firm's with restrictive debt contracts that tie dividend payments to the level of reported earnings, a change in accounting procedures that causes an increase in earnings can cause a change in the cash flows to various contracting parties. This led to the formulation of the "debt/equity hypothesis" which Watts and Zimmerman state as follows: "*Ceteris paribus*, the larger a firm's debt/equity ratio, the more likely the firm's manager is to select accounting procedures that shift reported earnings from future periods to the current period" [p. 216]. Similarly, for firm's with contracts that tie management compensation to the level of reported earnings, management may have some incentive to change accounting procedures. Consideration of various compensation contracts thus led to the formulation of the "bonus plan hypothesis" which Watts and Zimmerman formulate as follows: "*Ceteris paribus*, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period" [p. 208]. Finally, for firms concerned about attracting regulatory attention with the reporting of large earnings, there may be an incentive to change accounting methods to reduce reported earnings. This consideration led to the formulation of another testable hypothesis that has been dubbed the "size hypothesis" — "*Ceteris paribus*, the larger the firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods" [Watts and Zimmerman, p. 235].

In summary, the anomalies encountered by the economics-based empirical research paradigm were dealt with by adopting various changes in the theoretical framework. What emerged was a dramatic new extension of the informational view of financial reporting theory; an extension that explains previously anomalous changes in accounting procedures by attributing them to the existence of contracting, information, and political costs.

ANOMALY AND CRISIS: IS THE INFORMATIONAL PARADIGM IN DANGER?

Anomaly, on the other hand, can generate a crisis. If solutions prove to be elusive and the theory cannot be adjusted — because the contradiction is too destructive of the paradigm theory — then the paradigm may be thrown into a "crisis" which, in the extreme case, may make it susceptible to a scientific "revolution" and replacement by an alternative paradigm. To generate a crisis, an anomaly must be seen as "more than just another puzzle of normal science . . ." [Kuhn, 1970a, p. 82]. This could be the case for an anomaly that "clearly call[s] into question explicit and fundamental generalizations of the paradigm . . ." [Kuhn, 1970a, p. 82]. The informational paradigm has encountered two types of anomalous findings that clearly hold the potential for generating a crisis — findings that call into question the validity of the EMH and the CAPM. The crisis potential of such anomalies can be gleaned from a brief overview of the paradigm.

The informational paradigm can be described as a coherent program for financial accounting research which seeks to describe the role of accounting information in the operation of capital markets. Capital markets are presumed to provide for the efficient allocation of resources. Modern portfolio theory is presumed to describe the way rational investors make decisions which optimize lifetime consumption possibilities. The CAPM is presumed to describe the efficient allocation of risk in capital asset pricing. The EMH presumes that securities markets function to eliminate economic profits with respect to information. Within this theoretical context, the linkage between accounting information and capital market theories has been succinctly described by Lev and Ohlson [1982] as follows:

> The link provided by capital market theories connects the accounting information system to its function in capital markets. Information has a dual role in these markets. First, it aids in establishing a set of equilibrium security prices that affects the allocation of 'real' resources and the productive decisions implemented by firms. Second, it enables individuals to exchange claims to present and future consumption across different states, thereby attaining both preferred patterns of lifetime consumption and the sharing of societal risks. This explicit conceptualization of the role of informa-

> tion in capital markets appears to provide the elusive operational framework for the systematic analysis of alternative accounting information systems. The outcome of the economic system, as a function of the information system, can now be analyzed. [p. 252]

In short, the EMH and the CAPM provide linkages between information, securities prices, and expected utility in a way that allows for a coherent financial reporting theory that is an integral part of a broader theory of market economics. "Such integration pointed to a well-specified and operational agenda for financial accounting research" [Lev and Ohlson, p. 252]. If the validity of the EMH and/or the CAPM is rejected, then the integral relationship between financial reporting theory and the theory of market economics is called into question. From this perspective, there is good reason to suspect that the informational perspective may be entering a state of crisis.

With respect to the EMH, researchers have long been aware of anomalous findings. In 1978, the *Journal of Financial Economics* published a special issue dealing with findings anomalous to the EMH. In an editorial introduction to that issue, Jensen states succinctly the need for special consideration of the anomalous findings.

> I believe there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis . . . Yet, in a manner remarkably similar to that described by Thomas Kuhn in his book, *The Structure of Scientific Revolutions*, we seem to be entering a stage where widely scattered and as yet incohesive evidence is arising which seems to be inconsistent with the theory. As better data become available (e.g., daily stock price data) and as our econometric sophistication increases, we are beginning to find inconsistencies that our cruder data and techniques missed in the past. It is evidence which we will not be able to ignore. [Jensen, p. 95]

Jensen expressed optimism that future research would explain the anomalies without sacrificing the underlying theory of market efficiency [p. 100]. Over a decade later, however, Brown commented with respect to market efficiency that, "There are so many 'anomalies' around nowadays that I sometimes wonder if there are more anomalies than instances of efficiency" [p. 215]. Nevertheless, Brown asserts his allegiance to market efficiency in no uncertain terms: ". . . I am afraid my Chicago training has

left me too skeptical to believe that competitive capital markets could remain so obviously inefficient for so long" [p. 216].

The increasingly widespread awareness of findings anomalous to the EMH, however, are not being ignored or pushed aside with mere reiterations of belief in market efficiency. A recent issue of *The Accounting Review*, for example, published a series of articles dealing with the functional fixation hypothesis (FFH) which is directly contradictory to the EMH. Whereas the EMH assumes that investors are sophisticated enough to sort out the effects of reported accounting numbers and rationally assess future cash flow potentials, the FFH assumes that investors are fixated on accounting numbers "and, therefore, fail to unscramble the true cash flow implications of accounting data" [Hand, p. 740]. The article by Hand (which was one of two articles awarded the AAA's Competitive Manuscript Award for 1989), reported evidence which was inconsistent with the EMH, but consistent with a modified version of the FFH. In another study, Harris and Ohlson reported results (based on the application of trading rules to oil and gas firms) which supported neither the EMH nor the FFH. In a discussion of these papers, Tinic concluded that, "The studies by Hand and Harris and Ohlson are useful first steps in developing alternative testable hypotheses to the EMH. They offer thought-provoking illustrations of the type of problems that should be included in the agenda for future research" [p. 795].

Functional fixation clearly represents an anomaly with respect to the informational paradigm; an anomaly that calls into question one of the cornerstones of the informational perspective (the EMH). If enough researchers become convinced that investors are functionally fixated, it could generate a crisis for the paradigm.

> When . . . an anomaly comes to seem more than just another puzzle of normal science, the transition to crisis and to extraordinary science has begun. The anomaly itself now comes to be more generally recognized as such by the profession. More and more attention is devoted to it by more and more of the field's most eminent men. [Kuhn, 1970a p. 82]

While there is no indication that the FFH is widely accepted at this time, the prominent display of a series of FFH articles in one of the leading academic accounting journals indicates how seriously functional fixation is taken by some highly respected

academics. If the concern increases, it will trigger more and more research that is characteristic of extraordinary science rather than normal science.

As indicated above, anomalous findings with respect to the CAPM also have the potential to generate crisis for the informational paradigm. In 1982, Lev and Ohlson noted that, "Disenchantment with the CAPM is widespread on both conceptual and empirical grounds" [p. 287]. The grounds for disenchantment continued to grow during the 1980s. In a new study of the CAPM, Fama and French [1992] discuss several studies published in the 1980s which reported evidence that average returns on stocks may be related to market size, leverage, book-to-market equity, and/or earnings-price ratios. Since the CAPM purports to explain the variability of returns solely on the basis of market beta's, the evidence reported by these various studies is clearly anomalous with respect to the CAPM.

The new study by Fama and French, however, appears to be much more damaging to the validity of the CAPM than the previous studies. They (Fama and French) sought to evaluate the joint roles of the above mentioned variables (including beta) with respect to average returns. Their study included non-financial stocks traded on the NYSE, AMEX, and NASDAQ and covered the years 1963-1990. Their abstract conveys the results succinctly:

> Two easily measured variables, size and book-to-market equity, combine to capture the cross-sectional variation in average stock returns associated with market [beta], size, leverage, book-to-market equity and earnings-price ratios. Moreover, when the tests allow for variation in [beta] that is unrelated to size, the relation between market [beta] and average return is flat, even when [beta] is the only explanatory variable. [Fama and French, 1992, p. 427]

In short, market beta's, according Fama and French, are not related to average returns; market beta's have no explanatory power with respect to systematic risk.

So, what are the implications of these findings for the informational paradigm of financial reporting theory? First, as noted above, the CAPM has served the role of connecting accounting information to the efficient functioning of a market economy. A quote from Markowitz will highlight the importance of the CAPM in this regard: "My work on portfolio theory considers

how an optimizing investor would behave, whereas the work by Sharpe and Lintner on the Capital Asset Pricing Model . . . is concerned with economic equilibrium assuming all investors optimize in the particular manner I proposed" [1991, p. 469]. In short, if the CAPM is not valid, then the rationality of capital asset pricing may be in doubt. At the very least, if the CAPM is rejected, then another theory of rational asset pricing is called for, and a new theory of asset pricing opens space for paradigm debate.

Second, if the findings of Fama and French gain widespread acceptance, then the validity of many of the classic articles in the informational paradigm are placed in doubt because of the widespread reliance, directly or indirectly, on the CAPM in estimating abnormal returns or in controlling for systematic risk. In any case, the Fama and French study holds the potential for a very substantial blurring of the paradigm, and in Kuhn's words, "All crises begin with the blurring of a paradigm and the consequent loosening of the rules for normal research" [1970a, p. 84].

CONCLUSIONS

The decade of the 1960s has been widely recognized as a watershed decade in accounting thought. Most notably, it was the decade which initiated the transition from the "economic income perspective" to the "informational perspective" in financial reporting theory. Kuhnian analysis yields some unique insights into both the transition itself and the subsequent development of the informational perspective.

One of the major conclusions of the present study is that the informational perspective predominated precisely because it provided the support of a widely accepted paradigm, while the proponents of the "economic income perspective" could not offer paradigm support. The informational perspective, as an extension of the financial economics paradigm, provided researchers with well-defined normal science problems together with exemplars that served as guides regarding acceptable research methods, while the economic income theorists (the so-called normative *apriorists*) could offer neither a generally accepted theoretical perspective, nor exemplars for the pursuit of research problems.

As with the development of any scientific paradigm, the informational paradigm has encountered anomalous evidence,

most of which could be ignored, explained away, or incorporated into the paradigm by theoretical adjustments. The informational paradigm has also encountered more troublesome anomalies that hold the potential of throwing the paradigm into a Kuhnian-type crisis. Perhaps the most notable anomalous findings are those reported in a dramatic new study by Fama and French; a study which flatly contradicts the validity of the CAPM and the explanatory power of market beta's. Because the EMH and the CAPM have served as cornerstones for so many of the classic studies in the informational paradigm, the spreading awareness of challenges to their validity are prompting more and more attention. There is reason to believe that increasingly widespread attention to the persistence of such fundamental anomalies is beginning to blur the paradigm and loosen the rules for normal science research, thus creating intellectual space for the consideration of alternative paradigms.

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EVOLUTION OF CONCEPTS OF MINORITY INTEREST

Abstract: The FASB is currently addressing issues related to accounting for minority interest as a part of the "entity project". Decisions regarding the measurement and financial statement presentation depend upon the determination of the fundamental nature of minority interest. Alternative views describing the nature of minority interest rely upon alternative equity theories of consolidation. This paper traces the evolution of concepts of minority interest from the early 1900s to the present. The evolution is placed in perspective vis-a-vís the development of relevant corporate theories of equity.

The Financial Accounting Standards Board (FASB) is currently evaluating consolidation accounting methods under the agenda project — Consolidations and Related Matters [FASB, Highlights, 1991]. The first phase is completed and resulted in the issuance of *SFAS No. 94, Consolidation of All Majority-owned Subsidiaries*. The second phase is under way; and on September 10, 1991, the FASB issued a discussion memorandum (DM), *An Analysis of Issues Related to Consolidation Policy and Procedures*, which "is intended to cover all aspects of accounting for affiliations between entities . . ." [FASB, 1991, par. 4].

The DM addresses a number of procedural and theoretical issues wherein a parent company has a controlling interest in a subsidiary entity. In those cases where there is less than 100 percent ownership, the appropriateness of a particular accounting approach (e.g., the measurement of goodwill or the treatment of unrealized profit arising from intercompany transactions) hinges upon the nature of noncontrolling "minority" interest, which in turn relies upon the nature of the reporting entity.[1] Thus, a concept of minority interest is important to the

[1]The DM and authors in the literature refer to the two prominent theories of equity — parent company theory and entity theory (discussed later in the paper) — to support positions taken on the nature of minority interest and to relate those positions to various accounting procedures and policies. The following example illustrates the importance of a concept of minority interest to consolidation principles and procedures. When published financial statements are pre-

development and implementation of consolidation policies and procedures.

Minority interest has not received a great deal of attention in the accounting literature. The question of the fundamental nature of minority interest has been linked to the question of whether the appropriate basis of accounting should rely upon the entity concept or the parent company concept. That is, the two prominent equity theories of consolidation — entity theory[2] and parent company theory — typically appear as a basis of support for discussions pertaining to minority interest. Under the entity theory, corporate assets are independent of capital structure, and majority and minority stockholders provide alternative sources of corporate resources. Parent company theorists perceive parent company investors as the primary benefactors of the consolidated group, and minority stockholdings as outside interests.

There is little official guidance on how to account for minority interest or how to handle matters which rely upon a concept of minority interest. "*ARB No. 51, Consolidated Financial Statements* and *FASB Statement No. 94* . . . are the prevailing authoritative literature on accounting and reporting standards for consolidated financial statements" [FASB, 1991, par. 14]. Neither pronouncement offers a definition of minority interest nor prescribes how to treat or measure minority interest in published financial statements.[3] Minority interest has appeared as a liability, between liabilities and stockholders' equity, and in stockholders' equity. Before accountants can determine how to measure and present minority interest, a consensus on the nature of minority interest is needed. Is it debt or equity, or perhaps neither?

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pared from the perspective of the parent company, minority interest is considered an outside interest. Under this view, when an interest in a subsidiary is purchased, goodwill is equal to cost minus the fair value of the proportion of identifiable net assets acquired. Conversely, when the business entity is considered to be independent of its capital providers (entity theory), minority stockholders are viewed as having an equity interest. In this case, goodwill would be recorded at its total fair value, imputed from the cost of the acquisition to the parent.

[2]In the DM, the FASB referred to entity theory as the "economic unit" theory.

[3]ARB No. 51 does not expressly define a concept of reporting entity, a concept of consolidated financial statements, or a concept of minority interest [See for example FASB, 1991, par 20]. According to the DM, *ARB No. 51* expressed some preferences, but set forth few hard and fast rules.

This paper traces the evolution of concepts of minority interest from the early 1900s to the present. The developments are placed in perspective relative to the evolution of the entity and parent company theories. The nature of minority interest, but not its measurement, is discussed. No attempt is made to critically evaluate the theoretical merits of minority interest concepts or related consolidation theories.

EARLY VIEWS OF MINORITY INTEREST

Minority interest has been referred to as a liability, equity, or neither. References describing the placement of minority interest in corporate balance sheets began appearing in text books and journal articles in the early 1900s.[4] Differences of opinion were evident from the start. Newlowe [1948] examined 150 journal articles and books from 1908 through 1945. He determined that 84 references proposed that minority interest be listed, but either preferred no classification or did not mention where minority interest should be placed. Four authors preferred that minority interest be placed among liabilities, and 28 preferred to classify minority interest as an element of stockholders' equity. The other 34 sources cited did not address the nature of minority interest.

Early references proffered their views of what minority interest is but did not offer theoretical defenses for particular positions taken. Moreover, proponents of one view did not typically refer to alternative accounting treatments. For example, when referring to matters ". . . appertaining to minority shareholders . . . ," Dickinson [1918] stated

> The proper practice is to take up as a liability the par value of the outstanding stock, together with its relative share of surplus, but when the amount involved is

[4]The earliest reference is a presentation made by William M. Lybrand at the annual meeting of the American Association of Public Accountants in October 1908 which was published in two parts in *The Journal of Accountancy* in November 1908 and December 1908. Lybrand depicted "Common Stock of Subsidiary Companies Not Owned by the Holding Corp." under a general heading of "Liabilities," following "Common Stock of the Holding Corp." [November 1908, p. 40]. In Part II, Lybrand stated that "Under capital stocks will be included the stock issues of the holding company and separately stated, such part of the stocks of the subsidiary companies as are not owned by the holding company" [December 1908, p. 120].

> small, the proportion of surplus is not always set aside [1918, p. 183].

Finney described minority interest as a "capital liability to outsiders", stating

> If there is a minority interest, it would be wrong to eliminate the capital stock and surplus or deficit accounts of the subsidiary entirely, because they represent two things: (1) The capital liability to the holding company, which is an inter-company relation and is therefore eliminated; and (2) the capital liability to the minority stockholders, which is an outside relation and must therefore be shown in the consolidated balance sheet [1922, p. 20].

Newlowe referred to minority interest as "proprietors," noting

> From the point of view of the majority interests, the algebraic sum of the capital stock, surplus, deficit, and proprietorship reserves belonging to minority interests is a liability. However, the minority stockholders rank as proprietors rather than creditors. The minority interest, therefore should be shown on the consolidated balance sheet as a special net worth account [1926, p. 6].

And, Rorem wrote

> In cases where the parent company owns most, but not all, of the stock of the subsidiary, the interest of minority stockholders should be shown separately as a special proprietary item on the consolidated balance sheet [1928, p. 440].

In all four cases, no more was said about the nature of minority interest.

During the 1940s, authors began to offer theoretical arguments to support a favored position. For example, Sunley and Carter argued

> This interest of the minority is thus somewhat similar to the interest of a creditor. The creditor hopes for the prosperity of his customer so that he may receive some share in that property; but, on the other hand, the creditor does not wish his customer's prosperity to be made at the expense of the creditor's own profits [1944, p. 361].

In addition, the pros and cons of alternative accounting treatments for minority interest began to be compared and contrasted. Childs wrote

> It would seem that a minority interest should not be looked upon as a liability unless it represents recalcitrant stockholders whom the majority is trying to buy out or a capital consumed by losses which, nevertheless, has a "nuisance" value. It does not have a lien on any assets; it does have a proprietary equity in certain assets and is a part of the capital of the enterprise. To deny a minority interest co-ordinate status with the majority because it does not represent an equity in the assets of more than one legal entity is no more logical than to deny a liability a co-ordinate position with other consolidated liabilities for the same reason [1949, p. 55].

Minority Interest As a Liability — AAA

The initial position of the American Accounting Association (AAA) was that minority stockholdings are outside interests. Kohler presented a paper at the 1929 annual meeting of the AAA which was later published in *The Accounting Review*. The paper represented "the main opinion" of the Executive Committee regarding the topic of consolidated reports [Kohler, 1938, p. 63]. The Committee determined that "outside stockholders" possess attributes of creditors because "their interests do not parallel those of the controlling entity" [Kohler, 1938, p. 67]. Consistent with others writing on the topic of minority interest during this period, no theoretical support was given for this statement.

In 1955, the AAA Committee on Concepts and Standards issued *Supplementary Statement No. 7, "Consolidated Financial Statements."* Consistent with the 1929 Executive Committee's position, minority interest was referred to as an "outside financial interest" along with preferred stock and debt instruments [AAA, 1955, p. 194]. However, the 1955 Committee did not mention where minority interest should be shown in published financial statements, nor did the Committee offer a definition of what minority interest is.

The thrust of the 1955 Statement was to set forth basic principles of consolidated financial statements. One of those principles was that: "In so far as practicable, the consolidated data should reflect the underlying assumption that they repre-

sent the operations, resources, and equities of a single entity" [AAA, 1955, p. 194]. A subsequent Statement, *"Accounting and Reporting Standards for Corporate Financial Statements: 1957 Revision,"* expanded and clarified the principle of the consolidated entity, but again was silent on the subject of the nature of minority interest [AAA, 1957].

Proponents of the entity concept argue that classifying minority interest as a liability is inconsistent with the view that consolidated financial statements are prepared for a single entity. Thus, the 1957 AAA Committee's silence on this point may be interpreted as indicating a shift from the 1929 Executive Committee's position as described by Kohler.

Minority Interest As Equity

The view which holds that minority interest is an equity interest is rooted in the development of the entity theory. Paton described the essence of the entity theory. Paton [1922] proposed that the accounting equation is properly depicted as "Assets = Equities". Equities were described as ". . . a marvelous diffusion of all aspects of ownership — control, income, risk, etc. — among a host of investors" [Paton, 1922, p. 73]. Accordingly, all types of corporate securities represent equity in corporate assets. Paton argued that a mere change in the source of corporate capital does not affect the cost of factors of production. It follows that the corporate entity is independent of its capital structure. Assets are corporate assets, and income is corporate income until distributed as returns to the various capital providers.[5] Under this scenario, consolidated financial statements would be prepared for the entity, rather than being extensions of the separate financial statements of the parent company.

Moonitz [1942] pointed out that because there was no generally accepted theory of consolidation, a number of confusing alternative and sometimes contradictory practices coexisted. He extended the discussion of the entity theory to consolidated financial statements and argued that the entity concept provides an appropriate theoretical base. Moonitz viewed the consolidated balance sheet as a depiction of assets and liabilities asso-

[5]In his theory book Paton did not describe minority interest nor did he address any consolidation issues vis-a-vís the entity theory. His ideas were extended to consolidation policies by Moonitz [1942].

ciated with an affiliated group as though they belonged to a single operating unit. Following Paton's argument, Moonitz stated

> In accordance with our fundamental premise, a consolidated balance sheet contains a list of the assets and liabilities assignable to an affiliated group treated as a single operating unit. The net worth or capital is therefore the net worth or capital of the whole group [1942, pp. 241-2].

That is, the minority interest, like the controlling interest, provides net worth which is utilized to carry on the operating activities of the consolidated group. According to Moonitz, "minority interest serves as a reminder that complete community of interest in the affiliated companies does not exist, and the divergence of interest must be recognized" [1942, p. 241]. Thus, net worth should be divided between controlling and minority interest in order not to exaggerate the extent of the equity of the controlling interest.

Position of the Committee on Accounting Procedure

Although the AICPA has not taken an official stand on the nature of minority interest, *ARB 43* [1953] does provide support for the entity concept. In Chapter 7, the following statement is made: "The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income" [Section B, par. 6]. This statement is consistent with the entity theory position taken by Paton and Littleton in 1940. Specifically, the corporation can be viewed as "an institution separate and distinct from the parties who furnish funds" [Paton and Littleton, 1940, p. 8].

On the other hand, *ARB 51* states

> The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions" [par. 1].

No mention is made of where to place outside interests on the balance sheet, but the above statement could provide support for the "parent company" theory of equity which has been utilized to justify placement of minority interest outside of owners' equity. If consolidated financial statements are prepared to ben-

efit parent company capital providers, then the consolidation process merely sets forth the details of parent company investments. From the parent company perspective, consolidations transform parent company financial statements and do not provide information which is relevant for minority interest decision-making.

The Origin of Parent Company Theory

The parent company theory has evolved from the proprietary theory of equity, which in the corporate context has been referred to as an association, or representative viewpoint. Husband described the corporation as ". . . a group of individuals associated for the purpose of business enterprise, so organized that its affairs are conducted through representatives" [1938, p. 242]. He argued that although stockholders do not have legal title to corporate assets, they are proprietors because their equity changes in response to the incurrence of corporate income. Consequently, stockholders are proprietors. They possess title in equity. In a later paper, Husband expanded his arguments and referred to the corporation as an agency organization which operates for the benefit of the common stockholder entrepreneur [Husband, 1954]. Although Husband referred to his theory as an association, or representative viewpoint, it is consistent with the proprietary theory of equity in which the corporation is seen as an association of entrepreneurs [Li, 1960, p. 258].

Husband did not address the issue of the nature of minority interest. Although he referred to consolidated statements, no attempt was made to link the development of the proprietary theory to the early propositions that minority interest is not appropriately considered a part of owners' equity. As a result, the early concepts of "outside interests" and the proprietary theory were developed independently of each other. Conversely, early concepts of minority interest as owners' equity were linked to the entity concept and arguments of proponents have relied upon the development of and implications inherent in the entity concept.

POSITIONS TAKEN IN THE 1960s

Those Based on the Entity Theory

During the 1960s, the entity concept was expanded upon, but little new was said about implications for minority interest.

Moonitz continued to defend the entity concept and argued that minority interest clearly reflects proprietary ownership because there is no obligation to pay anything to minority shareholders [1960, p. 46]. Sapienza [1960] agreed and proposed that minority interest be presented in the balance sheet as a special class of stockholders.

In 1964, an AAA Committee was charged to explore the depth and significance of the entity concept. The ensuing AAA report concluded that the role of the entity concept should be to serve as a guide for determining what information should be reported to users [AAA, 1965, p. 358]. The report stated that consolidated financial statements are prepared primarily for parent company stockholders (a position which is consistent with that taken by the AICPA in *ARB 51*). Those stockholders are interested in information about investments in subsidiary companies. However, because the essence of the reporting entity is that its existence is separable from any view on how to report, "the concept does not dictate solutions to the valuation and disclosure problems arising from business combinations" [AAA, 1965, p. 367].

On the surface, the 1965 AAA report appeared to support the entity concept, but narrowed it from that envisioned by Moonitz and Paton and Littleton. Instead of the economic unit being regarded as the corporation itself, the emphasis that consolidated statements are prepared primarily for the parent company's stockholders appeared to redefine the entity concept in terms of the primary user of published financial statements. In essence, this new definition could be seen as a relabeling of Husband's proprietary theory, and as such could be interpreted as providing support for the 1938 AAA "outside interests" position. However, like its predecessor committees, the 1965 AAA committee report did not specifically address minority interest.

Minority Interest, As a Separate and Distinct Equity

Writing prior to the 1965 AAA report, Smolinski [1963] described minority interest as a "unique" interest. He said that it is neither a liability nor an item of owners' equity. Rather, minority interest "is an interest in only one unit of the consolidated entity, and any rights which it has, are rights to the net assets of this unit" [Smolinski, 1963, p. 167]. In other words, majority stockholders, not minority stockholders have a claim to the total consolidated net assets. This view has apparently been shared

by a large number of consolidated entities, because historically, a majority of companies have reported minority interest between debt and stockholders' equity [See for example, Campbell, 1962, p. 99 and FASB, 1991, p. 21].

POSITIONS TAKEN IN THE 1970s

Expansion of the Entity Concept

Hendriksen [1970] favored a return of the entity concept to encompass like consideration of all equity providers as envisioned by Paton and Littleton and Moonitz. He pointed out that the stated objective of *ARB 51* was to view the reporting enterprise as a single economic unit, but at the same time emphasized the interests of the parent company's shareholders. Hendriksen stated

> If the entire enterprise is really one economic unit, all interested parties should be given equal consideration, as in the enterprise theory; or the entity theory should be expanded to include the entire economic entity rather than merely the legal entity of the parent corporation [1970, p. 515].

Stated differently, Hendriksen felt that the entity concept as described in official pronouncements was too narrowly defined to encompass the true nature of economic entity. Limiting the reporting entity to the parent company has resulted in treating minority shareholders as outsiders, in the same manner as liabilities. Nevertheless, both majority and minority stockholders provide equity capital to the entire enterprise. Hence, minority interest should be accorded treatment similar to that of the parent company's stockholders.

International Accounting Standards

In 1972, the Accountants International Study Group, which was associated with the AICPA and similar bodies in other countries, reported on the results of a study regarding the nature of consolidated financial statements. The report favored the "parent company" concept which it described as one which views consolidated financial statements as an extension of the parent company statements. As such, the consolidation process simply replaces the parent company's investment account with the individual assets and liabilities underlying that investment.

When this occurs, minority shareholders are considered an outside group.

The study group report stated that the predominant practice in the United States, Canada and the United Kingdom is to show the minority interest as a separate item outside stockholders' equity. The report concluded that this practice is appropriate. It did not state whether minority interest should be reported as a liability or be placed in a separate category between liabilities and stockholders' equity. However, to state that it should be reported as a separate item could be interpreted as supporting the latter position. The subsequent pronouncement (*International Accounting Standard No. 3*) officially affirmed the position taken by the study group. That is, minority interest is not an element of stockholders' equity and should be shown as a separate item.

Minority Interest As a Standing Source of Capital

Scott [1979] was critical of placing minority interest in a separate category. He described placement of items such as minority interest between liabilities and stockholders' equity as "items, seemingly adrift in a 'no man's land'" [Scott, 1979, p. 758].

Instead, Scott proposed that the classification of equities should depend on whether or not they provide permanent sources of capital. He argued that the going concern assumption negates the relevance of dividing equities between liabilities and owners' equity. Accordingly, such a division is based upon legal claims which are not resorted to under normal circumstances [Scott, 1979, p. 759]. Scott stated that sources of capital should be divided between transitory sources and standing sources. Because contributions of majority and minority stockholders are relatively permanent, both should be classified as standing sources of capital.

RECENT VIEWS

No Reporting of Minority Interest

A recent argument holds that because there is no consensus on the nature of minority interest, parent company stockholders would be better served if no minority interest was reported at all. Rosenfield and Rubin [1985] commented that minority interest does not fit neatly into any balance sheet category. Pro-

portional consolidation, in which the parent company reports only its proportionate share of the items reported by a subsidiary, was described as having appealing characteristics [Rosenfield and Rubin, 1985, p. 95]. Although both authors appear to believe that minority interest should not be reported in consolidated financial statements, their 1986 article presented opposing views on how not to do so.

According to Rosenfield, a new view of equity is needed. He argued that consolidated financial statements should continue to reflect the total assets and liabilities of the parent and subsidiary. But, the residual represents the combined interest of majority and minority stockholders in the consolidated reporting entity itself and is therefore, the entity's equity in its own assets. The implication is that consolidated entities should report only one amount — the residual [Rosenfield and Rubin, 1986, p. 84]. This view is consistent with Husband's description of the entity concept as providing a rationale for disclosing stockholder claims as equity [1954, p. 556]. Another name given to the Rosenfield view is contemporary theory (see Beams below).

Rubin countered, stating that Rosenfield's approach would still include minority interest in stockholders' equity. Hence it would still be disclosed, but camouflaged. He proposed that "the only sound way to exclude amounts that relate to minority stockholdings from the numbers column is to exclude all such amounts, and the only way to do that is through proportional consolidation" [Rosenfield and Rubin, 1986, p. 88]. The contention is that when a subsidiary's voting stock is acquired, the parent obtains the right to receive a pro-rata share of dividends, when declared. This pro-rata claim implies that only the parent's pro-rata share of the subsidiary's assets and liabilities is relevant information to parent company stockholders. Hence, proportional consolidation provides relevant information to the primary users of consolidated statements, present and prospective parent company investors.

The FASB's View

Like its predecessors, the Committee on Accounting Procedure and the Accounting Principles Board, the FASB has yet to take an official stand on the nature of minority interest. Nevertheless, the Board has described minority interest as an example of a financial statement item which fits the definition of equi-

ties, rather than liabilities. Reflecting the view of Moonitz, *SFAC No. 6* [1985] states

> Minority interests in net assets of consolidated subsidiaries do not represent present obligations of the enterprise to pay cash or distribute other assets to minority stockholders. Rather, these stockholders have ownership or residual interests in a consolidated enterprise [par. 254].

In the recent Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*, the FASB reiterated the position that minority interest does not meet current definitions of liabilities and thus must be an equity interest [FASB, 1990, par. 16]. The Board acknowledged that "Advocates of the parent company concept, however, generally take the position that a minority interest is a liability or perhaps that it is neither a liability nor equity" [FASB, 1990, par. 16]. The Discussion Memorandum went on to say that the issue of the nature of minority interest is being addressed as a part of the entity project.

SFAS No. 94 determined that, unless control was clearly lacking, all majority owned subsidiaries should be consolidated. The standard amends *ARB 51*, but does not change the stated objective of consolidated financial statements. When discussing the basis for its conclusions, the Board stated that "Those who invest in the parent company of an affiliated group of corporations invest in the whole group, which constitutes the enterprise that is a potential source of cash flows to them as a result of their investment" [*SFAS No. 94*, Appendix B, 1987, par. 34]. This means that consolidated financial statements provide relevant information to parent company investors in accordance with the objectives of financial reporting as outlined in *SFAC No. 1* [*SFAS No. 94*, Appendix B, 1987, par. 35]. At the same time, the reference to investing in "the whole group" could be interpreted as implying that parent company stockholders provide capital for the economic entity, an entity concept perspective.

The FASB's 1991 consolidation procedures DM presented and discussed the pros and cons of alternative views of consolidation theory and the nature of minority interest. Based on paragraph 1 of *ARB 51*, the Board defined consolidated financial statements as

> A set of financial statements that presents, primarily for the benefit of the shareholders and creditors of the parent company, the combined assets, liabilities, revenues, expenses, gains, losses, and cash flows of a parent and those of its subsidiaries that satisfy the criteria established for consolidation [1991, par. 61].

The wording of the definition retains the parent company focus of *ARB 51* while allowing the flexibility to include alternative consolidation criteria. The Board acknowledged that issues being addressed and those to be addressed in subsequent FASB releases may result in redefinitions or even new categories of the elements of financial statements. Hence, it is unclear just what position, if any, will emerge.

Legal Claims

According to *SFAC No. 6*, "liabilities and equities are mutually exclusive claims to or interests in the enterprise's assets by entities other than the enterprise, and liabilities take precedence over ownership interests" [1985, par. 54]. This statement implies that the classification of minority interest should be unambiguous. Minority interest is either an equity or a liability interest. Classification between liabilities and stockholders' equity does not qualify as an element of financial statements.

The FASB determined that equity is an "ownership interest" which is "enhanced or burdened by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners" [*SFAC No. 6*, 1985, par 62]. Assets and liabilities can be independently defined and measured [Hendriksen, 1970, p. 495]. But, the value of equity is affected by operations and the income of the enterprise. Unlike liabilities, "no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied" [*SFAC No. 6*, 1985, par. 62].

There is no question that majority stockholdings fit the definition of equity. A strong case can be made that minority stockholdings do also. Minority interest is affected by investments, dividends and earnings of the subsidiary entity. Their only claim to corporate assets is residual in nature. Like the majority, minority interest does not represent a present obligation to distribute corporate resources. Future receipt of corpo-

rate assets is contingent upon the declaration of dividends or liquidation.

Nevertheless, while majority stockholders control and have an ownership interest in the combined entity, the minority interest's residual claim is limited to the net assets of the subsidiary's segment of the combined entity. Moreover, their segment of the consolidated group is controlled by the parent company. They may participate in policy decisions of the subsidiary, but cannot control them. Hence, from the minority stockholders' perspective, a noncontrolling interest in the consolidated entity is unlike that of the majority.

Positions Taken in Recent Text Books

The inability of official bodies to decide what to do with minority interest is reflected in current advanced accounting text books. Like their early counterparts, some textbooks classify minority interest as a liability, some as a part of stockholders' equity, and some as neither. Others present alternative views but express no preference.[6]

Fischer, Taylor and Leer [1990] stress entity theory. They define and measure minority interest as an equity interest and include it in stockholders' equity. Heufner and Largay concur, stating

> We believe that the minority interest problem is one of disclosure of the fact that not all of S's shares are held internally. Since the resources controlled by the consolidated entity relate to both the majority and minority stockholders, in consolidation both sets of interests must be treated consistently. In our view, minority shareholders may be viewed as shareholders in the consolidated entity even though their interest is limited to part of the consolidated entity. Therefore it is our view that the amount assigned to the minority interest should be included as a separate item within consolidated stockholders' equity [1992, p. 181].

Larsen [1991] takes the opposite view. He argues that minority shareholders are a special class of creditors. This position

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[6]For example, Hoyle [1991] and Griffin, Williams, Boatsman, and Vickrey, [1991] do not express a preference for a particular consolidation approach, nor do they appear to prefer any one method of presenting minority interest in consolidated financial statements.

is buttressed by the argument that minority shareholders typically do not exercise ownership control whatsoever.

Pahler and Mori [1991] assert that the consolidation process has no impact upon the reporting entity. Therefore, ". . . consolidated financial statements are usually of no benefit whatsoever to the minority shareholders" [Pahler and Mori, 1991, p. 212], and minority interest should not be a part of stockholders' equity. At the same time, reporting minority interest as a liability has little or no theoretical support. Rather, minority interest ". . . is an equity interest, but not of the parent company, which is the reporting entity" [Pahler and Mori, 1991, p. 211]. Pahler and Mori conclude that reporting minority interest between liabilities and stockholders' equity reflects its unique nature.

Beams [1991] states that neither entity theory nor parent company theory are consistently followed in practice. He describes a third theory which he calls contemporary theory [pp. 437-439]. Contemporary theory is described as a merging of the two equity theories. Like parent company theory, contemporary theory identifies the primary user as common stockholders of the parent company. At the same time, the financial statements present the financial position and results of operations of a single business entity. Minority interest is reported as a part of stockholders' equity but is not reported as a separate amount. Contemporary theory is consistent with the position taken by Rosenfield [Rosenfield and Rubin, 1986]; with the 1965 AAA Committee's definition of the entity concept; and with the purpose of consolidated financial statements set forth in *ARB 51* (which was reaffirmed in the appendix to *SFAS No. 94*).

Current Accounting Practice

Lack of agreement on a theory of consolidation and a consistent treatment of the nature of minority interest is reflected in current accounting practice. A sample of 100 industrial companies which reported minority interest in their balance sheets in 1990 was drawn from Compustat. Company balance sheets on Compustat Corporate Text were scanned for the placement of minority interest. Of the 100 companies, only 11 reported minority interest as an element of stockholders' equity. Twenty-one companies added minority interest to liabilities. Twenty-five companies placed minority interest between stockholders' equity and a subtotal for liabilities. The remaining 43 companies

listed minority interest above stockholders' equity, but did not subtotal the preceding liabilities. In this context, minority interest appears to be indistinguishable from liabilities. It appears that the preparer is content to allow the user to decide whether to include minority interest with liabilities when conducting financial statement analyses. It is clear that practice has not conformed to the FASB's definition of minority interest in *SFAC No. 6*. However, it is not clear whether practitioners view minority interest as a liability or a separate unclassified item.

SUMMARY

This paper traced the development and discussion of concepts regarding the nature of minority interest from the views which appeared in the literature during the early 1900s through 1991. Current views which have appeared in recent journal articles and text books and in current accounting practice were also examined.

Concepts of minority interest are tied directly to the evolution of theories of corporate equity. The review has shown that entity theorists originally perceived corporate reporting as reflecting the legal entity of the corporate enterprise. It follows that all claims to corporate assets should receive the same treatment. Under this concept, minority interests would be treated in a manner similar to majority stockholdings.

As the entity theory evolved, its definition was narrowed to take a user oriented approach which is consistent with the contemporary theory as described by Beams. Accordingly, consolidated financial statements are prepared primarily for the parent company's stockholders, but because they report the consolidated companies as a single economic entity, the residual equity includes both minority and majority interest in the consolidated net assets.

The parent company concept evolved from the representative viewpoint proposed by Husband. The parent company concept is consistent with the proprietary theory of equity which holds that a corporation's primary responsibility is to provide a return to its common stockholders — the corporate entrepreneurs. For the consolidated entity, corporate entrepreneurs are the parent company's common stockholders, not minority stockholders. Hence, minority interest is an outside interest and should not be reported as an element of stockholders' equity. Proponents have used this theory to argue that minority interest

is a liability, and that it should be presented in its own special category, even for proportional reporting wherein no minority interest is reported at all.

The evolution has led to no conclusion on the issue of the nature of minority interest. The FASB has taken no stand. Nor is there any consensus in the literature on the appropriateness of any one position.

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INTERNAL CONTROL: HOW IT EVOLVED IN FOUR ENGLISH-SPEAKING COUNTRIES

Abstract: The concept of internal control, as embodied in auditing standards and other statements by professional accounting bodies, has varied over time and geographically. There are, however, a number of similarities in the events that shaped professional statements concerned with internal control in the United States, United Kingdom, Australia and New Zealand.

The evolution of internal control has been influenced by increasing public expectations of auditing standards. Another influence was a trend in the evolution of management control concepts towards recognizing a broader range of influences on the control of organizations: These trends have been opposed by auditors, who wished to avoid increasing their responsibilities.

Recent discussions of internal control in accounting and management literature have concerned aspects of control that go beyond simple checking procedures. For example, Thompson [1967], Ouchi and Maguire [1975], Ouchi [1977, 1979, 1980, 1981], Boland and Pondy [1983], Mintzberg [1983], and Macintosh [1985] discuss complex models of control that consider human factors. The history of the changes in models of control was described by Parker [1986a, 1986b, 1986c]. A similar trend towards recognizing a wider view of control has also developed in auditing. This trend is reflected in professional auditing standards, for example, in the development of terms such as "control environment".

This paper presents the results of a study that examines and compares the evolution of internal control in statements by professional accountancy bodies in the United States, United Kingdom, Australia and New Zealand. Internal control, as embodied in auditing standards and other statements by professional ac-

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counting bodies, has varied from country to country, and has been modified at different times, but has resulted in professional statements that are all quite similar. This study looks at why changes in the professional promulgations concerning internal control occurred. The origin of these professional statements, and the causes of changes to them are examined by referring to professional journals and other materials published at the time these changes took place.

The statements about internal control by professional bodies are of particular relevance now, since further changes are being considered, particularly in the United States. Following a recommendation by the Treadway Commission, the Committee of Sponsoring Organizations of the Commission is examining the issue of internal control and developing new definitions [COSO, 1991]. It is likely that these new standards will influence those adopted in other English-speaking countries, as U.S. auditing pronouncements have previously influenced the developments in other countries. That influence is discussed later in the paper.

The professional statements of the American Institute of Accountants and its successor, the American Institute of Certified Public Accountants, are examined in this study, because the accounting profession in the United States was influential in the evolution of internal control. The United Kingdom, Australia and New Zealand are also included in this study because the auditing profession is well-established there. These countries adopted auditing statements concerning internal control later than in the U.S. In addition, influence of statements by the International Auditing Practices Committee of the International Federation of Accountants, and the status of internal control in other select countries are examined briefly in this study.

Internal control was first included in professional statements in the 1920s and 1930s, but most of the developments have taken place in the 1950s and later. As a result, the paper examines the period from 1949 (when the American Institute of Accountants issued its definition of internal control) to 1988, when the 1949 definition was superseded. However, earlier sources are considered where appropriate.

The research question, "how did internal control evolve?" is applied to auditing promulgations in each country by analyzing it into the following sub-points:

How was internal control defined in professional statements?

How did it change during the period [1949-1988]?

What influences on the professional statements about internal control were reported?

Information about each sub-point is examined with respect to the major changes in professional statements concerning internal control for each country. Used in this study are the professional accounting journals of each country along with other sources, such as auditing textbooks, which have been used by previous studies of auditing history [e.g. Brown, 1962; Hackett and Mobley, 1976; Myers, 1985].

PREVIOUS RESEARCH

Previous studies of the history of internal control include Hackett and Mobley [1976] and Bintinger [1986]. These studies were concerned with developments within the United States. They concentrated on developments following the promulgation of the definition set out in 1949 [AIA, 1949], and the subsequent "clarification of the previous definition" which divided internal control into accounting controls and administrative controls.

Trends identified by previous studies of auditing history in general are also relevant. Dirsmith and McAllister [1982, p. 218] noted that changes in published auditing doctrines were frequently related to action external to the profession, which in turn reflected changes in society's expectations concerning the profession. The history of auditing was depicted by Lee [1988, p. xxiii] as taking place against a background of constant resistance by audit practitioners to expanding the auditor's duty of care and skill. A long-standing trend for auditors to reduce emphasis on fraud detection, established since the 1890s, was also identified by Lee [1988, p. xxvi], and Moyer [1951, p. 7]. Myers [1985] perceived that audit procedures developed in a pattern which he called "spiralling upwards". He suggested that there is a general trend whereby auditing procedures apparently repeat earlier stages of their development. This pattern does not, however, represent a simple reversal of earlier changes, since at each stage of the cycle a more sophisticated approach is taken.

Changes in management theories of control have also indirectly influenced the evolution of internal control. The broad

definition of internal control discussed below [AIA, 1949] was consistent with the classical model of management control that was then current. In 1949, the authoritative literature on management principles was largely based on "scientific management" and the work of Fayol [1916] and Taylor [1916] (according to Parker [1986a, p. 77]). Parker [1986a] noted that the control models of Taylor and Fayol "have little regard to the human dimension of control". As a reaction to scientific management and the classical model, the "behavioral model" developed [Parker, 1986a]. The recent definition of "internal control structure" appears to reflect the view that other factors (such as management philosophy) influence the control of an organization, in addition to management's system of authority. This is in accordance with the behavioral model of management control [e.g. Ouchi, 1980; Mintzberg, 1983; Macintosh, 1985].

THE UNITED STATES

The United States was the first country to introduce professional guidance on internal control. Internal control started to become significant to auditors in the United States early in the twentieth century [Staub, 1904, p. 98; Vincent, 1952, p. 3; Brown, 1962, p. 699; Myers, 1985, p. 69]. Its importance was associated with American audit procedures, which were beginning to develop independently from those used by the British profession. In particular, procedures became oriented to financial reporting rather than to fraud detection [Moyer, 1951, p. 7; Brown, 1962].

In 1936, the American Institute of Accountants defined "internal check and control" as:

> Those measures and methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical aspects of the book-keeping [AIA, 1951].

The statement which included this definition was a formulation of what was generally accepted in 1936, and was not an attempt to change existing procedures, according to the expert witnesses in the SEC's hearings into the *McKesson and Robbins* case [Edwards, 1960, p. 165].

The Institute subsequently published more authoritative auditing standards, partly as a result of the Securities and Exchange Commission's report into the *McKesson and Robbins*

case [AIA, 1951, p. 4; Berryman, 1960, p. 76; Hackett and Mobley, 1976, p. 4]. These were published as a tentative statement in 1947 and "lost their tentative status" after a vote of Institute members in 1948. The standards included a requirement for a "proper study and evaluation of internal control" [AIA, 1947, p. 16].

This requirement in the standards was then supplemented by a definition from the AIA's Committee on Auditing Procedure. The Committee's definition of internal control, (which stood for another 39 years) was:

> Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies [AIA, 1949, p. 6].

The 1949 definition extended internal control to include the objectives concerned with operational efficiency and with prescribed managerial policies. It represented a concept of control which was considerably broader than the previous professional statement.

The 1949 statement coincided with an upsurge in accountants' interest in internal control which resulted from both economic developments and changes in audit techniques. Previous studies of the history of auditing reported that internal control had become important as a result of failures and flaws in auditing procedures which were revealed by the *McKesson and Robbins* case [Berryman, 1960; Hackett and Mobley, 1976]. A much wider range of other causes was indicated by a review of contemporary sources. Internal control was described as a means of assisting auditors [AIA, 1949, p. 6; Jennings, 1953, p. 38; Bevis, 1955, p. 46]. It was recognized that the "detailed audit" — a test of all transactions — was no longer cost-effective [Cranstoun, 1948, p. 274; Sprague, 1956, p. 55]. Reliance on internal control was now possible because systems of internal control were now generally more effective [Jennings, 1953, p. 38] because business organizations had recently become larger [Jennings, 1950, p. 192] and more complex [Cobb, 1952, p. 341]. Bevis [1955, p. 46] attributed the increased concern with internal control to the change in the objective of auditing from detection of fraud and error to reporting on the overall reliability of the financial statements. World War II was also an influence,

since it led to a shortage of audit personnel to do detailed testing [AIA, 1942, p. 119].

The internal control definition published in 1949 was criticized later by Byrne [1957] and Levy [1957] who suggested that it caused misunderstanding about the extent of auditor responsibility and that it could increase the legal liability of auditors. Grady [1957], (chairman of the Committee on Auditing Procedure when the statement Internal Control was published in 1949), responded in support of the definition. In 1958, the definition was narrowed; another statement divided internal control into two parts: accounting controls and administrative controls. The Committee on Auditing Procedure went on to state that an auditor is primarily concerned with accounting controls, "because they bear directly on the reliability of the financial data," [AICPA, 1958, p. 67]. The objectives that had been added in 1949 to the early definition ("to promote operational efficiency" and "to encourage adherence to prescribed managerial policies") were reclassified as administrative controls, which were not seen as part of an auditor's primary responsibility.

The "clarification" was a reaction to the new, broad definition published in 1949. When AIA members had adopted auditing standards in 1948, and included a requirement for a "proper study and evaluation of internal control," internal control was narrowly defined. When the later broad definition was added in 1949, the standard resulted in an expansion of auditors' duties. The 1958 clarification restored the *status quo.* It also appears that evaluation of internal control in accordance with the broad definition had not been applied in practice (according to a survey of auditing firms [Vincent, 1952]).

The definition was modified again in 1973. The AICPA revised the distinction between accounting control and administrative control (singular, not "controls" as in the earlier version). One objective of internal control, the "safeguarding of assets," was narrowed to "the procedures and records that are concerned with safeguarding assets". Mautz and Winjum [1981, pp. 9-11] suggested that the AICPA's main intention was to reduce further the scope of internal control. Other authorities emphasized the new definition's broadening effects. Loebbecke [1975, p. 83] suggested that all controls need to be examined to determine whether they have an impact on the financial statements.

In 1977, a requirement for corporations to comply with the AICPA's [1973] definition of internal accounting control was

passed into law. There had been a public outcry over findings (first identified by the Watergate special prosecutor's office) that more than 400 companies had made questionable or illegal payments totalling more than $300 million. *The Foreign Corrupt Practices Act* was intended to use accepted accounting terminology in a requirement that would prevent "off-the-books slush funds and bribes" [SEC, 1979, p. 610].

This development was followed by a report, from an advisory committee of the AICPA, which revived the broader concept of internal control. The report of the Special Advisory Committee on Internal Accounting Control used the term "internal accounting control environment" [AICPA, 1979, p. 2]. This included factors such as organizational structure and leadership from top management, both believed to lead to appropriate "control consciousness" [AICPA, 1979, p. 2, Cook and Kelley 1979, p. 62].

The 1980s led to further changes in the AICPA's requirements for internal control evaluation, including explicit broadening of the definition of internal control. The changes were, again, partly due to public concern about auditing standards. The National Commission on Fraudulent Financial Reporting (Treadway Commission) was set up in 1985 by the AICPA and other accounting organizations. The Commission commented that some instances of fraudulent financial reporting involved transactions "under management's direct control and not part of the system of internal accounting controls" [National Commission on Fraudulent Financial Reporting, 1987, pp. 29-30].

In 1988, the AICPA replaced the definition of internal control with a new, broader description of "internal control structure." This was defined (in *Statement on Auditing Standards 55*) as "the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved." [AICPA, 1988, p. 4].

The statement also changed the generally accepted auditing standard concerning internal control. The previous requirement for "a proper study and evaluation" of internal control was replaced with "a sufficient understanding of the internal control structure" [AICPA, 1988, p. 3].

The change from using the expression "a proper study and evaluation" to "a sufficient understanding" was not intended to imply that a reduced scope was now required. The rationale for the changes was explained by AICPA office-holders as "to

broaden the auditor's responsibility to consider internal control when planning" [Guy and Sullivan, 1988, p. 38], and as "expanding the auditor's responsibility for determining how internal control works" [Temkin and Winters, 1988, p. 86].

Developments are still taking place. The accounting institutions which sponsored the Treadway report recently issued a draft report that provides "integrated guidance" on internal control [Committee of Sponsoring Organizations, 1991; *Journal of Accountancy* 1991].

To summarize, the United States was the first country in which the audit profession developed a definition of internal control and a standard regarding auditors' examination of it. Developments in the United States were distinctive because more statements concerned with internal control were issued, and there were more changes of approach. Initially, in 1936, a narrow definition of internal control, consistent with existing practice, was adopted. It was replaced by a broad definition, in 1949, that was more consistent with a management definition of "control". After resistance by the profession, the scope of internal control as it concerned auditors was narrowed again in 1958. A revision in 1973 is regarded somewhat equivocally. More recent pronouncements, including the changes to the auditing standards in 1988 and the continuing work of the Committee of Sponsoring Organizations, are seen by AICPA officials as broadening the definition of internal control once more.

THE UNITED KINGDOM

Auditing procedures evolved differently in the United Kingdom from the developments in the United States. Under the companies legislation in the United Kingdom, auditors did not report on the profit and loss account until 1948 [Chastney, 1975, p. 12; Briston and Perks, 1977, p. 59]. As a result, there appears to have been less concern with internal control [Lee, 1988, p. xix].

References to internal control in British professional journals were relatively infrequent before the 1960s, and were not based on binding professional standards. Lawson [1951] and Taylor [1954], however, indicated that some British auditors did rely on internal control. In 1953, the Institute of Chartered Accountants in England and Wales (ICAEW) published a statement discussing internal audit, which included references to internal control and internal check [ICAEW, 1953]. It included a

broad definition of internal control, which was later developed further by the British profession:

> Internal control is best regarded as including the whole system of controls, financial and otherwise, established by the management in the conduct of the business, including internal audit, internal check and other forms of control.

Although the terminology used was different from the AIA [1949] definition, it was a broad definition with a similar meaning. There was still no binding audit standard requiring audit examination of internal control.

In 1961, the ICAEW issued a more general *Statement on Auditing* [ICAEW, 1961]. This statement was issued "for guidance" and did not claim to be an authoritative auditing standard. The statement recommended that auditors "make a critical review of the system of book-keeping, accounting and internal control." The definition of internal control appeared to be a combination of the previous ICAEW definition and the American Institute's [1949] definition:

> By "internal control" is meant not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records [ICAEW, 1961, p. 242].

Internal control was an innovation for some British auditors. Waldron [1961, p. 718] suggested that some practitioners "may be regretfully shaking their heads" because the statement's advice on audit procedures was not appropriate for them.

In 1964, the ICAEW issued a further *Statement on Auditing* [ICAEW, 1965] which dealt specifically with internal control. It repeated the earlier [ICAEW, 1961] definition of internal control. The statement was described as primarily concerned with financial and accounting control:

> That is, those matters which relate to the custody and control of the company's assets and the recording of its transactions [ICAEW, 1965, p. 234].

This concept of control approximated that covered by "accounting controls" in the AICPA's [1958] clarification of the definition.

The subsequent adoption of auditing standards in the UK was preceded by public concern about auditing procedures. In 1976 and 1977, there was severe criticism of auditors and audit procedures in news reports and Parliamentary proceedings, following company failures such as the collapse of London and County Securities Limited in 1976 [Hay Davison, 1977, p. 84; Briston and Perks, 1977, p. 59]. As Hay Davison put it, the UK was "the last among the great accounting countries of the world to introduce auditing standards." [Hay Davison, 1977, p. 91]. (A partner in a major audit firm advised Stamp and Moonitz [1978, p. 67] that the international accounting firms already sought to follow the auditing standards of the AICPA.)

Subsequently, the Consultative Committee of Accountancy Bodies (CCAB) published a set of auditing standards, after extensive consultation [*The Accountant*, 1980, p. 592]. The CCAB included the three Institutes of Chartered Accountants in England and Wales, Scotland and Ireland, together with other bodies such as the Association of Certified Accountants.

The draft of the standard included a requirement for the auditor to "ascertain, evaluate and test the operation of any internal control on which he wishes to place reliance". According to Woolf [1980, p. 63], this paragraph caused problems for practicing auditors. He suggested that its tone and position in the standards indicated to auditors that internal control was being given more emphasis than audit evidence, and that "systems-based auditing" was to be a requirement. After submissions by audit practitioners, the standards were modified slightly to imply a less demanding requirement:

> If the auditor wishes to place any reliance on internal controls, he should ascertain and evaluate those controls and perform compliance tests on their operation [CCAB, 1980, p. 3.101].

Detailed auditing guidelines were published at the same time as the auditing standards. The guidelines included a definition of an internal control system and internal controls:

> An internal control system is defined as being the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the

completeness and accuracy of the records [CCAB, 1980, p. 3.204].

This definition was similar to the ICAEW's 1961 definition. It was no longer considered necessary to include a reference to "internal check and internal audit" being included as part of internal control. The remaining objective, efficiency, was added after being used in the American standard [AIA, 1949].

Although the United Kingdom developed its own definition of internal control, this became increasingly close to the AICPA's 1949 definition. Auditing standards were not adopted until later than in the other three countries. When standards were adopted, the standard concerned with internal control was modified after the original proposal was criticized. The new requirement implied that less emphasis on evaluation of internal control was required. This change appears to have allowed the British profession to avoid the pressure to narrow the definition of internal control that was present in the United States.

AUSTRALIA

Australia was the second of the four countries to issue a professional promulgation requiring evaluation of internal control. However, the recommendation was, according to its author, based on practice in the United Kingdom, not on the American auditing promulgations; yet, it did not follow any British professional statement, and was to some extent at least an indigenous development. Australia subsequently turned to following the United States as its model.

The Australian Institute's first recommendation on auditing practice was issued in 1951, and revised in 1954 and 1969 [Robertson, 1974, p. 4]. Gibson and Arnold [1981, pp. 53-60] reported that professional auditing statements in Australia were initially influenced by one person, Mr. F. E. Trigg (a partner in Price Waterhouse). In 1942, the Institute of Chartered Accountants in Australia asked him to prepare a paper including recommendations on auditing standards and practices. The recommendations in Trigg's paper eventually were adopted as standards by the Institute [ICAA, 1951]. The recommendation was based on Trigg's understanding of English auditing procedures (which had not yet been documented by the British professional accountancy bodies). Trigg advised Gibson and Arnold [1981] that the recommendation was "in no way" influenced by American auditing.

The recommendation, published in 1951, required that "appraisal of the soundness of the accounting methods employed and the effectiveness of the system of internal control" was an essential duty, "which the auditor cannot escape" [ICAA, 1951, p. 10]. No definition of internal control was provided; a narrow approach was implied by references to internal control as the "internal checking system." In addition, the purpose of internal control was described as detecting fraud.

In 1954, a revised "Statement on General Professional Auditing Practice" was published [ICAA, 1954]. The requirements concerned with internal control contained minor changes. The statement now required that appraisal of internal control was "essential to enable the auditor effectively to plan his work" [ICAA, 1954, p. 10]. The reference to "the internal checking system" was replaced by "the system of internal control" [ICAA, 1954, p. 10], and there was still no definition of internal control.

At that time, the broader concept of internal control was not shared by managers and practicing accountants. A study conducted in 1953 [Savage, 1955, p. 363-4] found that Australian managers and accountants held a narrow view of internal control. They associated it with checking of records, not with the AIA's broad definition. The narrow view was consistent with the ICAA's statements.

In 1969, a statement with only minor changes, again prepared by Trigg, was published [ICAA, 1969]. It was soon replaced, in 1974, by a completely new set of standards, this time based on the AICPA's statements. Gibson and Arnold [1981] explained that this change from following a British to an American model was due to changes in trade and investment. The United States had become a more important influence on the Australian economy. In addition, existing standards of audit practice had been criticized by the judge in the *Pacific Acceptance* case in 1969 [*Chartered Accountant in Australia*, 1974; Robertson, 1974, p. 4]. Kenley [1975], however, described the Australian statement as promulgating standards that already existed but which had not been codified.

The standards included a requirement for auditors to evaluate internal control:

> An auditor must systematically evaluate the nature of the client's business and system of internal control to determine the nature, scope and timing of audit procedures to be used [ICAA, 1974, p. 5].

The statement also made a distinction between accounting controls and administrative controls, quoting the AICPA's [1973] *SAP 54.*

The Australian Auditing Standards Committee, a joint body supported by the Australian Society of Accountants as well as the Institute of Chartered Accountants in Australia, reviewed auditing standards again. This was done to satisfy the judge's comments in the *Pacific Acceptance* case [Gibson and Arnold, 1981, p. 60], and because the public had higher, and increasing, expectations of auditors [Kenley, 1977, p. 35]. The new standards [ICAA/ASA, 1977] again included a standard requiring evaluation of internal control.

Subsequently, new standards were adopted based on international guidelines. Australian Auditing Standards now require that:

> Auditors shall gain an understanding of the accounting system and related internal controls and shall study and evaluate the operation of those internal controls upon which they wish to rely in determining the nature, timing and extent of other audit procedures [Auditing Standards Board/Australian Accounting Research Foundation, 1983, p. 2012].

This standard resembles previous Australian statements in its requirement that auditors must examine internal control; its restriction to "the accounting system and related internal controls" provided a limitation to this requirement.

NEW ZEALAND

New Zealand, like Australia, based its internal control promulgations on oversea models. Again, the British profession was initially the source of the professional pronouncements; subsequently, United States promulgations were drawn on. The influence from the United Kingdom was more direct than it had been in Australia. Instead of describing English practice, ICAEW statements were adapted. Later, AICPA auditing standards served as the model in New Zealand.

Evaluation of internal control and reliance on it, together with a number of other modern developments in auditing practice, were recommended to New Zealand auditors at the New Zealand Society of Accountants convention by Chapman [1950]. Comments from New Zealand auditors recorded with his published paper indicated that, at that time, some auditors did not

accept that reliance on internal control would be feasible in the smaller businesses found in New Zealand. Subsequent references to evaluation of internal control as a recommendation for auditors became increasingly frequent in the 1950s [e.g. Perkins, 1950; Dixon, 1950; Parry, 1952; NZSA, 1953; Stewart, 1954; Perkins, 1956; McCaw, 1958; Gilkison, 1959].

New Zealand auditing in the 1950s and 1960s followed the approach that had been taken in the United Kingdom, both in the statutory requirements for auditing, and professional recommendations. A requirement to audit the profit and loss account was not introduced until the *Companies Act 1955* (modelled on the 1948 British Act) [Gilkison, 1962]. In 1962, the ICAEW [1961] *Statement on Auditing* was reprinted in the *Accountants' Journal*, and this was followed by the publication of a New Zealand Society of Accountants "Tentative Statement on Auditing Practice" [NZSA, 1964]. The statement, "General Principles of Auditing", was based on the previous English statement, and included an identical definition of internal control.

In the 1960s, internal control seemed to be accepted by some New Zealand auditors [e.g. Gilkison, 1962]. However, Martin [1963, p. 218] noted that internal control questionnaires, and other methods of documenting controls, were not yet widely used in New Zealand. Titter [1967a, p. 311] identified a need for auditing standards to be codified because there was an inconsistent pattern of auditing procedures. He also asked "How many auditors today do not make an annual systematic review and evaluation of internal control?" [Titter, 1967b, p. 350]. Titter implied that there were still many auditors who did not conduct these procedures.

Subsequently, New Zealand auditing was influenced by its American counterpart. Auditing Standards were adopted in 1973 [New Zealand Society of Accountants, 1973]; upon issuing the standards, the Society expressed appreciation to the American Institute of Certified Public Accountants for assistance that had been provided by *SAP 33* (a codification of AICPA Statements on Auditing Procedure). New Zealand Auditing Standards required that:

> There must be a proper study and evaluation of the existing internal control procedures as a basis for determining the extent of tests to which auditing procedures are to be restricted [NZSA, 1973, p. 354].

This standard was a shortened version of the AIA [1947] standard used in the United States. The standard [NZSA, 1973, p. 356] also included a definition which was identical with the American definition adopted in 1949 [AIA, 1949]. The distinction between "accounting controls" and "administrative controls" that had been added to the U.S. definition in 1958 [AICPA, 1958] was not included in the New Zealand standard.

In 1974, the Society issued a *Tentative Recommendation on Auditing Practice* dealing specifically with internal control. The recommendation [NZSA, 1974] acknowledged American, Canadian and British statements, but it included terms not included in the professional promulgations of the other countries discussed previously. For example, it distinguished between two levels of internal control. "First level" controls included authorization and personnel quality; "second level" controls included the plan of organization and managerial supervision. These innovations never made it into the final pronouncement by the Society. Statement RAP-7, *Internal Control and the Nature and Extent of Audit Tests* was issued in December 1977 [NZSA, 1977]. The new recommendation was, again, based closely on an overseas auditing statement: it repeated the American [AIA, 1949] definition of internal control.

Another set of New Zealand auditing standards was introduced as an exposure draft in 1984, and adopted in 1986. The requirement concerning internal control [NZSA, 1986a, p. 22] was drawn from *International Auditing Guideline No. 3* [IAPC, 1980]. No definition of internal control was included in the Standard, and concurrently the Society withdrew the previous statement [NZSA, 1977], which had contained a definition. A commentary [NZSA, 1986b] advised that a new guideline to replace the material on the nature of internal control in general would be issued. This guideline has not yet been issued, and the definition included in *International Auditing Guideline No. 6* has not yet been adopted by the NZSA either.

The New Zealand profession appears to have developed its auditing standards (including its requirement regarding internal control) out of a desire to ensure consistency with auditors elsewhere in the world. Chapman [1950] suggested that New Zealand auditors should follow generally accepted auditing standards based on overseas standards. Martin [1963] commented that speedier communications and the spread of inter-

national groups of companies had caused an awareness among New Zealand auditors that the New Zealand standards for auditing must be equal those of the United States, Great Britain and Australia.

OTHER COUNTRIES

Although the four countries selected have had variations in their auditing histories, they have a common language and somewhat similar accounting professions. What of other countries? Information from other countries does not indicate that the evolution of internal control has been substantially different. In non English-speaking countries, the AICPA (and later the IAPC) has been the predominant influence on the development of auditing standards and other professional pronouncements [Stamp and Moonitz, 1978; Creamer, 1987]. In Canada, the remaining country with a large and influential auditing profession, the professional body's auditing statements are similar to those in the countries examined above [CICA, 1979, p. 5200.05; Etherington and Gordon, 1985].

According to Stamp and Moonitz [1978], the international accounting firms were also influential in encouraging the use of AICPA standards in other countries. They noted that the AICPA's statements (or a literal translation of them) were in use in Brazil as well as most other Latin American countries, and in Israel and the Philippines; in addition, the international accounting firms in Japan practiced in accordance with U.S. standards [Stamp and Moonitz, 1978, p. 110].

International Auditing Guidelines were introduced in 1979, after Stamp and Moonitz [1978, p. 145] had previously recommended the adoption of a set of international auditing standards under the auspices of the International Federation of Accountants (IFAC). IFAC announced that the guidelines were to be promulgated by the International Auditing Practices Committee. The statement concerned with internal control, International Auditing Guideline No. 3, *Basic Principles Governing an Audit* [IAPC, 1980], included similar material to the AICPA's auditing standards. As discussed above, it has directly influenced auditing statements in Australia and New Zealand. Creamer [1987, p. 92] reported that International Auditing Guidelines had now been adopted by most other countries.

DISCUSSION AND CONCLUSION

This analysis showed that, during the period 1947 to 1980, auditing standards were established in each of the four countries selected; and, in each case, a standard concerning internal control was included. Definitions of internal control were published before and after the relevant standards. The evolution of internal control followed a distinctive pattern in each country; but there were also extensive similarities.

Similarities among the four countries included developments in the evolution of internal control that were preceded by public criticism of existing auditing procedures, resistance by the members of the profession to expansion of their duties concerned with internal control, and the increasing similarity of the definitions. These similarities are discussed in the following paragraphs.

The first similarity was the association between public criticism and change. The adoption of a standard concerning the examination of internal control, or a change in its definition, was frequently preceded by public criticism of auditing procedures. Developments in standards and definitions concerned with internal control often took place after there had been public criticism of audit procedures and concern about corporate management. This was the case in the United States in 1949 and 1988, the United Kingdom in 1980 and Australia in 1974. The pattern was consistent with other studies of auditing history, including Dirsmith and McAllister [1982] and Lee [1988].

Second, in three of the countries, the breadth of the definition was important. The profession appears to have resisted expanding its duties. Whether internal control should be defined narrowly or broadly was an important issue when changes to the American definition took place in 1949, 1957 and 1988. A broad definition was promulgated in 1949; this was narrowed in 1957 as a result of concern about increased liability for practitioners. Subsequently, a broad definition was introduced in 1988 as one of a number of measures to make auditing more effective. The issue of broad or narrow internal control has been dealt with in different ways outside the United States. Practitioners in the United Kingdom ensured that they adopted auditing standards which avoided implying a requirement for auditors to examine internal control [Woolf, 1980, p. 62]. Thus, a broad

definition of internal control was not a problem for them. Australian auditing statements since 1951 suggested that evaluation was necessary, yet the statements did not have the status of auditing standards, and internal control was not defined. Later, when an auditing standard requiring internal control evaluation was introduced, this requirement was moderated by adding the AICPA's narrow definition. This issue does not appear to have been important in New Zealand.

This recurring issue indicates that a strict requirement to evaluate internal control, together with a broad definition of internal control, is associated with resistance by auditors. This can be addressed either by narrowing the definition (as was done in the United States and later in Australia) or by reducing the emphasis of the auditing standard concerned with evaluation (as in the United Kingdom, and in Australia during the early period of professional guidance on auditing).

The third similarity is in the terminology used. Standards and definitions in each of the countries resemble each other. The similarities have increased over the period examined. This is partly because professional bodies used statements that apply in other countries as precedents. Because the AICPA was the first organization to establish auditing standards, the U.S. profession has been the most influential. While the accounting professions in each of the three other countries all developed at least one statement that was indigenous, the AICPA's pronouncements have become increasingly dominant. American influence on the economies of other countries and the spread of the international audit firms have also been cited as reasons for this trend.

The frequent changes to the definition of internal control, and to auditing standards concerned with it, reflect the presence of conflicting pressures. On the one hand, the definition of "control" in other literature is a broad one, and becoming increasingly so. In addition, when auditing procedures are criticized due to apparent faults, then changes that broaden the definition of internal control frequently take place. On the other hand, auditors are concerned to minimize the extent of their duties, and of their liability. As a result, they favor a narrow definition.

The changes in internal control also reflect the changing emphasis of auditing, away from the objective of detecting fraud. The AIA's 1936 definition described "internal check and

control" as concerned first with safeguarding cash and other assets. Since then, the changes in the definitions of internal control, (including the recent AICPA statement [1988]) have continually reduced the emphasis given to safeguarding assets, and indicated that the auditor's prime concern is the reliability of the data used to prepare the financial statements.

The evolution of internal control was consistent with the models of auditing history presented by Dirsmith and McAllister [1982] and Lee [1988]. External events (such as economic developments and the *McKesson and Robbins* case in the U.S., and other cases involving auditors in the UK and Australia) preceded the adoption of auditing standards requiring examination of internal control. Internal pressures (partly in response to an external influence, the increasing legal liability of auditors) were responded to by a narrowing of the definition in the U.S., and by a rephrasing of the proposed standard for evaluation of internal control in the UK. Subsequently, further external events in the U.S. (such as scandals about corrupt practices by corporations) led to a broader definition of internal control.

Earlier in this paper, the research question was identified as "how did internal control evolve?" This question was then analyzed into three sub-questions, each of which has been discussed above. In brief, the definition of internal control has become broader and closer to a definition of management control in all the countries examined. This change has been in response to external pressures, sometimes with resistance from auditors.

In general, the evolution of internal control demonstrates the influence of a number of trends in auditing history. These include the internationalization of auditing, and the extent to which developments in the United States have become important; the pressure from external sources for the area of auditors' responsibility to be increased; and the resistance by auditors to such an increase in their duties. The general trend in each of the four countries has been towards a "broader" view of internal control, a trend consistent with other control literature.

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1992 ACCOUNTING HALL OF FAME INDUCTION: DAVID SOLOMONS

INTRODUCTION

by
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David Solomons has brought a kind of sanity to the accounting literature and to policy deliberations.

While always faithful to his principles, which he expounds with admirable clarity and persuasiveness, he has consistently had regard for their operational feasibility.

The historical evolution of ideas, policies and practices has always occupied an important place in David's writings. Moreover, few authors can match the ease with which he draws out the essence of ideas and experiences from different national cultures.

He is a master craftsman of the English language, with a penchant for argument by metaphor. "Accounting is financial map-making" has been his metaphor of choice.

David provides the reader with a broad perspective for whatever he is discussing, and the reader is invited to follow his inexorable logic in full knowledge of all that he considers relevant to the debate. In his writings, he is, above all, a scholar and a teacher. Even if one does not accept his conclusions and recommendations, he/she nonetheless acquires a precious insight into the issues, the arguments, and the forces driving the controversy. There is always wisdom in what David writes.

David's academic career has been at three universities: the London School of Economics (LSE), from 1946 to 1955; the University of Bristol, from 1955 to 1959; and the Wharton School of the University of Pennsylvania from 1959 to his retirement in 1983.

His earliest work dealt with management accounting, accounting theory, and accounting education. He was much influ-

enced by Ronald S. Edwards, a LSE industrial economist who had a large interest in accounting. In the late 1930s, Edwards had written a series of memorable articles in *The Accountant*, in which he dealt with costing history and, in a 13-part article written in 1938, produced perhaps the first treatise on asset valuation and income determination in the British literature, in which he defended the increased-net-worth concept of income, taking into account Bonbright's notion of "value to the owner." David has called Edwards "one of my principal mentors during my LSE period."

David's first major article, in 1953, was a pioneering essay on costing history, and during the 1950s he revised Sidney Alexander's famous tract, "Income Measurement in a Dynamic Economy," which, like Edwards's work, was an argument for the increased-net-worth concept of income. However, David's pivotal works, in my view, came after his move to the U.S. in 1959.

In 1961, David concluded, ruefully, that it was not operationally feasible to isolate changes in expectations from Alexander's "economic income," thus rendering it of little use as a satisfactory measure of enterprise performance. He thereupon issued his famous prediction that "so far as the history of accounting is concerned, the next twenty-five years may subsequently be seen to have been the twilight of income measurement." Twenty-five years later, he acknowledged that his prediction had not been fulfilled, and that perhaps his forte was not as a seer, In 1966, he published a major paper on Bonbright's "value to the owner" formulation for valuing property, and gave it impetus in the debates over current value accounting by restating it in an inequality notation. David's paper, which was published in the second edition of Morton Backer's *Modern Accounting Theory*, directly or indirectly influenced the Sandilands Committee, the FASB, and the standard-setting bodies in Australia and New Zealand, all of which, in one form or another, embraced "value to the owner" (also known as "value to the business" or "deprival value") in their dicta on current cost accounting issued during the 1970s.

In 1965, at the request of the Financial Executives Research Foundation, David wrote his first book, *Divisional Performance: Measurement and Control*, in which he reported on a survey of 25 major companies and presented his own recommendations on how best to evaluate and control decentralized operations. It

was a path-breaking study, and it earned him the AICPA's Notable Contribution to Accounting Literature Award.

On accounting education, David argued in his inaugural address at the University of Bristol, in 1955, that all entrants into the accounting profession should be required to take three years of university study in accounting, economics and law—a radical view in an era when most entrants came straight into the profession from high school, and took evening courses in correspondence schools! He has always championed a large role for universities in the preparation of entrants into the profession. When, in 1961, the Parker Committee on Education and Training reported to the English Institute that the *status quo*, with only minor changes, should be preserved in preparing prospective Chartered Accountants, he wrote a scathing criticism of the report in the Institute's journal, which the late Eddie Stamp has called "one of the most critical [articles] ever to appear in the literature of the British profession".

However, in the 1970s, David emerged from the academic literature to become an architect of change. In the waning days of the Accounting Principles Board, during the fractious debate over business combinations and intangibles, AAA President Don Edwards invited David to chair a blue-ribbon committee to recommend whether a change in the standard-setting system was needed, and if so, how to go about it. The very existence of such a committee caused consternation within the AICPA, which saw itself as the sole guardian of accounting principles, and once David's committee had reported, Don was asked to nominate an AAA representative on the newly formed Wheat Study, which had been charged by the Institute to conduct a full-scale enquiry into standard setting. Don nominated David, and David eventually became an influential member of the Wheat Study and, in fact, was given the task of writing the first draft of its report. As we know, that report led to the establishment of the FASB. Then, in 1978, he was a consultant to the special Institute committee looking into a restructuring of the Auditing Standards Executive Committee, which led to the formation of the Auditing Standards Board.

As is well known, David was the principal draftsman of the FASB's *Concepts Statement No. 2* on qualitative characteristics, which was adopted or adapted by standard setters in Canada (both the CICA and the CGA), the UK, Australia and New Zealand in the formulation of their own conceptual frameworks.

In 1986, David wrote his valedictory on standard setting and the conceptual framework, a 261-page book entitled *Making Accounting Policy: The Quest for Credibility in Financial Reporting*, which is a model of thoroughness, careful scholarship, and persuasive writing in a field that has been marked by intemperate advocacy and bombast. He argued in favor of Current Cost Constant Purchasing Power Accounting with financial capital maintenance. Finally, in 1989, at the request of the Research Board of the English Institute, he drafted a concise conceptual framework for consideration by the UK's Accounting Standards Committee.

In accounting education, David was invited by the six accountancy bodies in the British Isles to do a major long-range study of accounting education and training, which he completed in 1974. That some of its far-reaching recommendations are only now seeming to find favor in the UK has given "long-range" a new meaning. In the 1970s and 1980s, he also advised the Canadians on their Uniform Final Examination for accounting entrants.

In sum, David has left a large and salutary mark on the literature, but he has been equally active as a highly sought-after consultant to policy makers. Few academics can be said to have played both roles so well.

INDUCTION CITATION

by
Thomas J. Burns
Professor and Chairman,
Committee on Accounting Hall of Fame,
College of Business, The Ohio State University

An exemplary model of a global professor, he has published and taught in numerous countries, and has former students everywhere. His research and writing have had a major impact on the profession in several countries. Truly one of a kind, he is an international professor of accounting.

His career can be dichotomized into two stages, one English and the other American. Born to a man who ran a London pub, he was one of four children in a family that never was poor, perhaps because his father was something of an entrepreneur—later running a bus company and still later a dirt track (for motorcycle races). The son attended a boy's school, Hackney Downs, for eight years, and at age 16 he received advanced placement at the London School of Economics. Taking an optional extra year, he received a University degree, the only one of his family to do so. Following graduation, he was articled to a Dickensian firm (to which his father paid a fee of three hundred guineas) in order to become a Chartered Accountant, a three year ordeal which he barely survived.

He became a CA (1936) and practiced in a firm until the War started (1939). He immediately enlisted in the Royal Army Service Corps as a private, and was commissioned the following year. He served in the North Africa campaign. At the fall of Tobruk (in June 1942), he was taken prisoner together with 30,000 other Allied soldiers, and was interned first in Italy and then in Germany. To relieve the monotony of camp, he began to teach accounting and economics to his fellow prisoners. Finally liberated (1945), he left the Army as a Captain and returned to his London firm, and the following year he became a part-time lecturer at his alma mater, the London School of Economics (where he subsequently earned his doctorate). Thanks to his experience during almost three years as a POW, he had become an academic. At the London School, he was assigned to assist the only full-time accounting faculty member, who suddenly

took ill and died at the beginning of the fall term,[1] leaving his assistant as the only accounting teacher at the school for the rest of his first year (1946-47). (In 1946, there were no full-time professors in accounting in all of the British Isles). In 1949, he was promoted to reader, two years after W. T. Baxter was appointed professor of accounting at the LSE. In 1955, he left to become the inaugural professor of accounting at the University of Bristol, becoming the third full-time accounting professor in all of Britain.[2]

Love conquered him at the first dance he attended. In six weeks he was engaged, and he was married six weeks later. Now, nearly fifty years later, he and his wife, Miriam, still like to dance. They have a son and daughter and three grandchildren. Fond of Mozart, opera, theatre and films, he once rowed for the Thames Rowing Club, but never at Henley. His favorite quotation is from a comedian, Sam Levenson, a one-time high school teacher. "It was on my fifth birthday," Levenson said, "that my father put his hand on my shoulder and said, 'Remember, my son, if you ever need a helping hand, you'll find one at the end of your arm.' "

He is the only professor ever to have headed the two leading academic accounting organizations on both sides of the Atlantic, the one in the U.K. and the one in the U.S. He served as chairman of the Association of University Teachers of Accounting between 1955 and 1958, the forerunner of the British Accounting Association. He crossed the Atlantic in 1959 to accept a professorship at the Wharton School, and he was designated as the Arthur Young Professor in 1974. He became an American citizen in 1976, and the next year he served as president of The American Accounting Association.[3]

A frequent author of professional books and articles, he is widely known for his classic *Divisional Performance: Measurement and Control*.[4] He also was the principal draftsman of the Wheat Report which proposed the establishment of the Finan-

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[1]Stanley Rowlands was a partner and F.C.A. with Sellars, Dicksee & Co. who died in 1946. For many years, a lecturer in accounting at the London School, he was the author or editor of ten textbooks.

[2]Donald Cousins at Birmingham was the second.

[3]He had been Director of Research for the AAA in 1968-70. He was president in 1977-78. He was also the AUTA's secretary from its inception in 1947 until 1950.

[4]He received the AICPA's Notable Contribution to the Accounting Literature Award for this book in 1969.

cial Accounting Standards Board (FASB), and of the FASB's *Concepts Statement No. 2* on the qualitative characteristics of accounting information.

He has been a consultant to the FASB, the SEC, the IASC, the CICA, the AICPA, numerous companies and the accountancy bodies in the U.K.[5] His visiting university appointments have been extensive (fourteen in ten countries).[6] He holds two honorary doctorates, the AAA chose him as an Outstanding Accounting Educator (1980), and the Institute of Chartered Accountants in England and Wales gave him its International Award (1989).

A world leader of accounting research and education, he is the 52nd Accounting Hall of Fame inductee, **DAVID SOLOMONS.**

[5]In the UK, he directed the "Long Range Enquiry into Education and Training for the Accountancy Profession" in 1972-74.

[6]Including service as the Lee Kuan Yew Distinguished Visitor in Singapore in 1986.

RESPONSE

by
David Solomons
Ernst & Young Professor Emeritus
The Wharton School, University of Pennsylvania
1992 Accounting Hall of Fame Inductee

As those who have preceded me into the Accounting Hall of Fame in recent years will know, one's first intimation of the conferment of this high honor comes in the form of a telephone call from Tom Burns. As I have told him, I rank that call with only two others in my professional career. The first was a telephone call from Bob Anthony early in 1963, inviting me to spend the year 1963-64 in Switzerland with my family, teaching at IMEDE. It turned out to be a fabulous year. The other was a call from Charlie Zlatkovich in 1976, saying that I had been nominated as president-elect of the American Accounting Association. Other nice things have happened over the years by mail, or by cable (as in the case of the invitation in 1959 to join the Wharton faculty). But by telephone, these are the three occasions I shall remember.

First, let me acknowledge some debts. It is true, as Chuck Horngren recognized two years ago on a similar occasion, that in naming specific individuals one runs the risk of omitting some deserving names. But I am going to accept that risk.

My greatest debt, of course, is to my wife, Miriam. She has been by my side now for almost 50 years, and no other influence can compare with hers.

However, there have been other influences. One was a certain teacher of English in my London secondary school, so many years ago, who almost brutally instilled some rules that have helped me to write better English than I might otherwise have done. He had a number of "forbidden words," the use of which automatically earned you a zero for an essay. His forbidden words included "very," "extremely," "former" and "latter"; and there were others. During the intervening 65 years, I have often broken his rules, but always to the detriment of my writing.

Another debt of the same kind that I acknowledge is to Reed Storey, whose editing of my drafts when we were working together on the FASB's *Concepts Statement No. 2 on Qualitative Characteristics* greatly improved that document and my writing

generally. I am much more sensitive to dangling participles, the common misuse of "this" when one means "that," the misuse of "which" instead of "that," and other linguistic blunders than I was previously.

My main debt, of an academic nature, is undoubtedly to the faculty of the London School of Economics, both in the classroom when I was a student, and later as colleagues when I went back to teach there for almost a decade after World War II. To have rubbed shoulders with men like Arnold Plant and Ronnie Edwards (both later knighted), Lionel Robbins (later Lord Robbins), my immediate colleagues William Baxter and Harold Edey, Basil Yamey (that fine accounting historian for whom I accepted the Hourglass award here on Sunday evening), and no fewer than four Nobel prize winners in economics (John Hicks, James Meade, Friedrick Hayek, and Ronald Coase), was a rare privilege. This must sound like name-dropping; but these men really have exerted a lasting influence on me. Life at LSE during my years there was life in an intellectual powerhouse.

Most American academics start their careers by writing a dissertation for their Ph.D., mining one or two papers out of it, and then going on from there. My start was different, and I was reminded of it recently when my wife and I were in London, riding down Oxford Street in a bus, past D. H. Evans, a department store. D. H. Evans, in 1947 or thereabouts, gave me the idea for my first serious paper. I was having lunch there one day and I noticed that the dining room was divided into two sections by moveable screens. On one side of the screens, the space was devoted to a self-service cafeteria, while the other side was devoted to waitress service. This led me to think how I would position the screens if I were the restaurant manager. Cost allocation was clearly not the answer. Cost allocation would have to follow the space allocation decision, not precede it. The result was a paper entitled "Cost Accounting and the Use of Space and Equipment," which gave me my start. Of course, I had not heard of linear programming in those days.

Perhaps it was the heady atmosphere of LSE that gave me a somewhat lofty view of the nature of accounting, but also kept my estimate of its importance within reasonable bounds. During my year as president of the American Accounting Association, a committee of the Association produced a report that was published, entitled *Accounting Education and the Third World*. I was asked to write a forward to that report, and I should like to

quote from it here, because it expresses my assessment of accounting as well as I know how, and it is as relevant now as it was in 1978.

> In any ranking of the needs of the developing countries of the world to help them improve the quality of life of their peoples, there are undoubtedly some that would rank ahead of improved accounting and accounting education. The eradication of disease, the elimination of hunger . . ., improved standards of literacy, the spread of political freedom and the rule of law—these are the foremost advances that must be made before the distinction between "developing" and "developed" nations can be discarded.
>
> The report that I am introducing does not deal with these great themes. Accounting itself cannot feed the hungry or cure the sick or bring enlightenment to the illiterate. Yet, it has a part to play in all these advances. Wherever scarce resources need to be economized, there is work for the accountant to do; and the scarcer the resources are, the more important it is that they should not be misdirected or misappropriated.

Accountants can take a good deal of satisfaction in the role that they play in making our free enterprise system work. But we have no reason to be complacent. As I look back over more than 50 years in the profession and compare the progress we have made with the progress made in fields like medicine, electronics, physics and chemistry, transportation, and even economics, our showing is not impressive. Bob Elliott, of KPMG Peat Marwick, had something of interest to say on this subject in a paper recently. He first quotes the complaint of a CEO of a successful software company, who told him that:

> trying to run my organization with the output of our accounting department is like trying to fly an airplane that has only one dial—a dial that shows the sum of airspeed and altitude. If it's low, I'm in trouble, but I don't even know why.[1]

Then turning later to financial reporting, Elliott says:

> One of the few things that financial statement preparers agree upon is that the scoring rules should

[1]Robert K. Elliott, "The Third Wave Breaks on the Shores of Accounting," *Accounting Horizons* (June, 1992): 69.

> not be changed in the middle of the game. Thus, there is a powerful constituency in favor of the *status quo*. Add the attesters—who are dissuaded from change by unknown, but probably unbearable, legal liabilities—and you have an implacably conservative environment. The same managements that complain that they can't run the business with today's accounting information are the ones who make pilgrimages to Norwalk to lobby *against* changes.[2]

I do not find Elliott's "implacably conservative environment" at all congenial. It is not peculiar to the United States. One finds it throughout the English-speaking world and beyond. I wish that I could have been more persuasive in my own writing and more successful in helping to change that environment. It is a task that my generation must leave to our successors.

[2] *Ibid*, p. 75.

THE ACCOUNTING HALL OF FAME MEMBERSHIP

Year	*Member*
1950	George Oliver May*
	Robert Hiester Montgomery*
	William Andrew Paton*
1951	Arthur Lowes Dickinson*
	Henry Rand Hatfield*
1952	Elijah Watt Sells*
	Victor Hermann Stempf*
1953	Arthur Edward Andersen*
	Thomas Coleman Andrews*
	Charles Ezra Sprague*
	Joseph Edmund Sterett*
1954	Carman George Blough*
	Samuel John Broad*
	Thomas Henry Sanders*
	Hiram Thompson Scovill*
1955	Percival Flack Brundage*
1956	Ananias Charles Littleton*
1957	Roy Bernard Kester*
	Hermann Clinton Miller*
1958	Harry Anson Finney*
	Arthur Bevins Foye*
	Donald Putman Perry*
1959	Marquis George Eaton*
1960	Maurice Hubert Stans
1961	Eric Louis Kohler*
1963	Andrew Barr
	Lloyd Morey*
1964	Paul Franklin Grady*
	Perry Empey Mason*
1965	James Loring Peirce
1968	George Davis Bailey*
	John Lansing Carey*
	William Welling Werntz*
1974	Robert Martin Trueblood*
1975	Leonard Paul Spacek
1976	John William Queenan*
1977	Howard Irwin Ross*

*Deceased

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1979	Maurice Moonitz
1980	Marshall Smith Armstrong
1981	Elmer Boyd Staats
1982	Herbert Elmer Miller
1983	Sidney Davidson
1984	Henry Alexander Benson
1985	Oscar Strand Gellein
1986	Robert Newton Anthony
1987	Philip Leroy Defliese
1988	Norton Moore Bedford
1989	Yuri Ijiri
1990	Charles Thomas Horngren
1991	Raymond John Chambers
1992	David Solomons

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REVIEWS

PATTI A. MILLS, EDITOR
Indiana State University

REVIEWS OF BOOKS AND OTHER PUBLICATIONS

Peter Boys and John Freear (Eds.), *Accounting History 1976-1986: An Anthology* (New York: Garland Publishing, Inc., 1992, 402 pp., $70).

Reviewed by
Sudarwan
Case Western Reserve University

This book is an anthology of papers from *Accounting History*, the former journal of the Accounting History Society of England and Wales, published during the years 1976-1986. Boys and Freear selected 26 of 56 articles published in the journal. The anthology covers several eras and topics in accounting history from the 15th century to the 20th century. It is divided into eight classifications: General, Methodology, Auditing, Firm/Industry Studies, Corporate Accounting, Education, Bibliographies/Biographies, and Miscellaneous.

Three articles in the "General" section emphasize the importance of accounting history to the accounting profession and to the entire economic community. The subjects of this section are that: 1) accounting *history* ("was") has a relationship with the *present* ("is") and the *future* ("ought"); 2) present problems may be rooted in past solutions; 3) history provides parallels from which we can obtain lessons; and 4) the study of accounting history should be useful in solving current problems.

The "Methodology" section discusses methods and techniques available to researchers and provides a taxonomy for accounting history to satisfy requirements of historical research, 1) factographic (what was), 2) explanatory (why was that so), and 3) theoretical (what follows from the study of the past). Readers are exposed to the relationship between the concept of capitalism and the emergence of bookkeeping, and to the ways accounting history research establishes historical facts.

However, the discussion falls short of giving readers clues as to the circumstances in which a certain methodology is most appropriate. There is also no discussion about the advantages and disadvantages of each method. There is only a vague suggestion that a combination of methods can be used in the study of accounting history.

These first two sections seem to be intended to provide a basis for selecting from articles included in the next sections. One expects that the rest of the book will reveal a link between the past, present, and future development of accounting. On the contrary, most of the subsequent readings are confined to a description or discussion of accounting practice in specific periods. With the exception of the paper by Freear in the "Firm/Industry Studies" section, there is little provided to relate historical facts to current and future matters.

The "Auditing" section analyzes audit practices in the railway and marine insurance industries during 1840s-1860s. The matters considered include conflicts between managers, shareholders, and government commissioners in the enactment of the *1845 Companies Clause Consolidation Act* and the *1867 Railways Companies Act* as to who had the authority to appoint auditors for railway companies and what were appropriate auditor qualifications.

The audit requirement for marine insurance companies was established under the provisions of the *1844 Joint Stock Companies Act* and under the *1845 Act* mentioned above. What is important to recall about this period is that an auditor was required to own at least one share in the audited company; that auditors were not necessarily public accountants; and that audit reports had various forms, but were stated as a "true and correct" balance sheet.

The focus of the "Firm/Industry Studies" section is the relationship between cost accounting systems and pricing policy in a monopoly or free market system and the related profit measurement systems implemented during the period from the 16th to 19th century.

During this period both acquisition and repair of fixed assets were considered expenses and charged as incurred; business and personal expenses were not separated; accrued expenses were embedded in reserve and provision accounts; inventories were valued at current estimated price; income

smoothing was a common, practice; and accounting information was available and used for managerial purposes.

This section also gives examples of how cost accounting systems can be misused through the use and abuse of excessive profits from government contracts. The authors enrich the analysis by providing documents as examples of balance sheets and income statements of companies in the late 19th century. However, neither the illustrated financial statements nor the authors' analysis mentions "how" revenues were measured but only the measurement of expense. This omission prevents readers from obtaining a complete picture of income determination as commonly practiced in the period.

The remainder of the book indeed could be classified as "Miscellaneous". It contains historical facts and short descriptions about the development of accounting thought, accounting education, profiles of notable individuals in the U.K. accounting profession, and other short analyses of early accounting practices.

A critical paper about early 20th century accounting thought by Godfrey is the most interesting reading in this section. He argues that accounting thought before 1960 was: 1) developed by a piecemeal approach rather than by development of a single theoretical framework; 2) sought apologetics rather than appraised; 3) classified rather than analyzed; 4) particularized rather than synthesized. With the exception of Paton, Canning, Sweeney, and McNeal, who were major accounting scholars in this period, he argues, others reflected inherited deficiencies. However, Godfrey fails to elaborate on the impact of such alleged deficiencies on current problems or how such deficiencies might have been resolved. Further, he does not compare early accounting thought with current issues or assess relative advantages and disadvantages as such.

In general, this book of readings falls short of fully explaining selected elements in the development of accounting thought and practice. If explaining the progress is an essential part of historical study, this book does not fulfill one of its purposes. However, this book does supply reading material to discuss accounting practice and problems in the past. Willing readers will find the historical description a good starting point for further analysis and for undertaking their own agenda.

Junichi Chiba, *A History of British Financial Accounting* [in Japanese] (Tokyo: Chuo Keizai, 1992, 407 pp., 7,000 Yen).

Reviewed by
Yozo Sakaguchi
Case Western Reserve University

When Japan reopened its commerce to the United States of America in 1854, its doors had been closed to foreign countries for more than two hundred years. Needless to say, at that time, there was no bookkeeping or accounting system in Japan that was similar to those used today. But during the Meiji era (1876-1911), Japan's economy developed, expanded and encompassed almost every type of industry. Under these circumstances, Japanese financial systems that were primarily influenced by British financial accounting followed a European-style commercial code. Thus, until the early 20th century, the British system was the major influence on Japanese accounting.

This was the situation in Japan until after World War II, when a Japanese securities and exchange law was enacted which was strongly influenced by the U.S. Securities Acts. As a result, Japan's accounting system rapidly changed under the influence of the U.S. financial accounting system and the Securities Acts. Thus, two major external influences affected the basic framework of Japanese financial accounting.

From these two influences, Professor Chiba considers issues about social and historical problems in modern Japanese financial accounting, focusing on the influences of British financial accounting, the need to earn public trust, and the impact of political issues, which Chiba analyzes from a social science approach. He focuses primarily on the important period from the beginning of the 19th century through the 20th century.

The book contains ten sections. Sections 1 and 2 seek to define a basic structure for the British financial accounting approach using a social science methodology. The effects of passage of the modern Companies Act and of related accounts based on British processes is examined in sections 3 and 4; the "Lee Rule" is examined in sections 5 and 6. The accounting system under the British Companies Acts during a period of interventionism is the focus of sections 7, 8, and 9. Finally, the "true and fair" view is considered in the last section. Each of the sections is effectively related with others by the author's use of social science and economic historical perspectives.

Chiba's primary objective is to establish a basic structure of financial accounting by means of a social science methodology, relating the expected structure of a company's accounting to the Companies Act. He examines original documents, but he does not get distracted by legal form. Instead, he considers the social and economic functions of these acts. He uses the social science methodology of both Weber and Habermas to identify the public sphere.

This book identifies several contributions of the British financial system. First, there is a study of the Compulsory System from 1844 to 1855. Second, the "true" meaning of the 1879 Companies Act and its voluntary rule is considered. Third, the orthodoxy of a classified system of accounts defined by English rules is pointed out. Fourth, in judicial cases, both the doctrine of fiduciary trust and the duties of a corporate director as a "commercial trustee" are noted. Fifth, the social and historical meaning of the concept of a "true and fair view" is considered. Finally, the process of preparing a distinct form for both the "balance sheet" and the "profit and loss" statements is examined.

The author employs the title *A History of British Financial Accounting* to a characterize this project, a major focus of his scholarly career. The book, which is the summary of his many studies about British financial accounting, took more than twelve years to complete. The use of original sources and references such as accounts, judicial cases, British parliamentary papers, copies of the original acts, and related bibliographies involved nearly five hundred sources. The author found most of them in Guildhall Library in London while studying at the London School of Economics and Political Science in 1985 and 1986.

The book is published in Japanese and is not otherwise available to readers of other languages. References listed in the book alone are worth the effort of any scholars who have an interest in the origins of financial accounting in Britain, as well as "the accounts" during the period from the middle of 19th century through the middle of the 20th century.

As a side note, readers might also have an interest in Professor Chiba's next project, which will extend his study about the history of British financial accounting to contemporary times.

Louis Galambos and Joseph Pratt, *The Rise of The Corporate Commonwealth,* (New York: Basic Books, Inc. Publishers, 1988, 286 pp., $19.95).

Reviewed by
Nandini Chandar
Case Western Reserve University

Galambos and Pratt provide an insightful and fast-paced account of the growth and development of the American corporate economy over the past century. At a time when American business is yet again in the midst of a crisis, the book is a timely reminder of the value of history in analyzing contemporary problems. Free enterprise and the government have had various relationships over the years: friendly, adversarial, and sometimes both. The authors present in their book a dynamic picture of U.S. business and public policy in the twentieth century, which portrays the flexibility of the American business system and its tradition of successfully adapting to change.

The reader is led from the world of J. P. Morgan at the turn of the century, where a few powerful private investment bankers could control an economy dominated by the entrepreneurial firm to the world of Iacocca in the 1980s, where the power of any individual is subordinate to that of the government. The authors make effective use of these powerful symbols of the American way of doing business during their times.

The framework for analyzing the development of institutions over time is their ability to strike a balance between innovations, efficiency, and environmental control. The authors also portray the changing role of the government in three major areas over the century: single industry regulation, cross-industry regulation, and government-directed activities.

J. P. Morgan's era saw the rise of the combine from the entrepreneurial firm of the nineteenth century. The entrepreneurial firm, with its flexibility to innovate, played a vital role in the nation's rapid economic expansion during that period. Out of its inability to take advantage of economies of scale and its lack of capital, came the centralized corporate combine. The authors suggest that Morgan and investment bankers, because of their unique role of selling securities to finance the combines, became the chief architects of the system. The authors describe the outstanding record of technical and organizational change and economic growth that characterized the Morgan era on the

one hand, and the abuses of power and natural resources and growing tensions between the corporations and society on the other.

The period 1901-1930 was characterized by an expanding public presence, generally intended to limit the power of private interests to manipulate the economy. The development of independent regulatory commissions, the passage of the antitrust laws, and the creation of the Federal Reserve System marked significant turning points in business-government relations. The authors characterize the process of change in these relations as "piecemeal, uneven, and at times, haphazard." These measures were, the authors claim, "a curious innovation," and "a political and intellectual compromise." It was also a "distinctively American approach to balancing public and private interests," a way to have more government without more politics. The coming of the Federal Reserve signalled the demise of the world of J. P. Morgan.

This was also an era when business consolidated its controls. Managers had to learn to balance the firm's need for innovation against the need for control of its environment, and the need to achieve high efficiency in mass production and distribution. Most of the large firms of this era were created through mergers of competitors. There was a need for administrative controls using more active and systematic forms of management. The results were organizations structured along functional lines, with increased specialization, a changed workplace in response to mechanization, more formalized labor relations, and vertical integration to achieve better control of the environment. The need for innovation and the great expansion of science and engineering at the turn of the century saw the beginnings of research and development and the modern industrial laboratory. Companies took a long-term view. Small business still had its role, transferring/generating innovations, and providing services where economies of scale or system could not be achieved. A new type of political system evolved, where local influence was becoming less important than effective lobbying on the state and national levels. It was an era of "the associative state," where cooperative forms of capitalism were practiced by trade associations. The general prosperity of the firms and the growing weakness of the labor unions lent support to the idea that a new "corporate-liberal commonwealth" under business control was here to stay.

The first crisis of the new corporate commonwealth was the Great Depression. The SEC was set up to regulate the performance of securities traders, and to provide for disclosure of financial information. Business was afraid that President Roosevelt was driving toward socialism. The authors feel, however, that "what evolved was a set of new public institutions that created a more stable capital economy and a more predictable and profitable environment for business." Banking reform measures were introduced under the New Deal in the from of the Banking Acts and the creation of the FDIC. One result of this was functional segmentation along commercial and investment banking lines. The authors state that no other nation chose this form of segmentation, but "no other nation's banking system had become so enmeshed in stock speculation."

The National Recovery Administration, the Reconstruction Finance Corporation and the Federal Jobs Program were attempts to combat the effects of the Depression. The labor policies of the New Deal hastened the emergence of "Big Labor" in the U.S. As a result of the impact of the Great Depression and the New Deal, the life of the CEO changed dramatically: it was increasingly difficult to strike a balance between efficiency, innovation, and control.

The American Era (1940-1969) saw "a process of reconciliation between business and American society." The war-induced prosperity eased political tensions and focused on the need for efficiency in mass production. The Federal Government's responsibility for the overall performance of the economy was recognized. Presidents Kennedy and Johnson embraced "new economics," which consisted of designing packages of monetary and fiscal policies capable of stabilizing and sustaining business growth while maintaining politically acceptable levels of unemployment and inflation.

Government spending for national security added to the potent economic impact of war. The authors suggest that it was the war expenditure and not the New Deal that pulled the country out of recession. There was, however, concern over the growth of this "military-industrial complex." Defense took over significant portions of the nation's resources and creativity, and affected two other areas of government investments: highway building and space programs. The American Era also witnessed a spectacular growth in science and technology, largely as a result of federal support.

The performance of regulated industries in this era was generally favorable. There were lower pressures from cross-industry regulation.

The American Era saw "the modern firm in triumph." To take advantage of favorable conditions, diversification, together with decentralization, became important. By the end of the 1960s, there were large numbers of "conglomerates" and the rationale of "synergy" began to appear. Decentralization enabled quick postwar expansion into overseas markets with devastated economics. In this scenario, "strategy flowed out of structure." The multinational firm accompanied America's political involvement abroad. "Business normally followed the flag."

The authors suggest that this era saw "the corporate commonwealth at its peak." With federal and monetary policies stabilizing aggregate demand, they felt that "by that time, America seemed to have discovered the proper way to harness corporate capitalism without seriously injuring the market-oriented process at heart".

By the late 1960s, there were increasing tensions at home and abroad, "as the fundamental conditions under the American Era started to shift." As the U.S. was preoccupied in containing Communism, new competition emerged from Europe and Japan. Governments of raw materials-producing nations asserted national interests. America and its competitors ignored growing evidence of the need for change and "were victims of their own success." Regulatory agencies became inflexible when the economic setting began to change and when there was mounting inflation.

U.S. business faced internal problems due to lack of creativity, taking a short-term view, being conservative about innovations and overly concerned about stability. Government policies toward business did not work as well in the shifting international economy. Not until international competition began to intensify in the 1970s did "the foundations of the corporate commonwealth visibility begin to crack."

The authors suggest that the period 1970 to the present marks "the second crisis of the corporate commonwealth." The nation had grown accustomed to international economic success and could not easily make adjustments. "The American Era was certain to end." Suggestions made in panic that America should borrow ideas from other nations to solve its problems,

"slighted the inherent strengths of the corporate commonwealth and ignored the barriers to rapid, basic change."

There were "new misdirections in the public sector" as the government tried to grapple with the change. The problems of the weak domestic economy were compounded by rising energy prices. "Something was wrong, but the experts could not agree on the diagnosis or the cure." The government could not control spending for defense and welfare. New areas of government regulation provided added pressures on businesses' ability to compete. Expenditures for R&D dropped off sharply, as corporations began to take a short-term view.

In this new era of international competition, reconstruction began. The authors state that the late 1970s saw "the beginning of a process of reconstruction that demonstrated convincingly the single most important strength of the U.S. corporate commonwealth: its responsiveness over the long-term to the forces of change." The authors claim that the most obvious shortcoming of the corporate order "was the lack of effective integrative institutions that would enable the United States to recognize the interrelated nature of its problems and to implement intelligent, system-wide solutions."

Strategies in the private sector to cope with this new era included de-conglomeration and scaling down, in an effort to improve efficiency and innovativeness in the markets they still served. There was a belief that small is innovative. New concepts of labor relations emerged in response to the challenges posed by labor-management relations. Yet, according to the authors, "in no area does the historian's search for useful precedents in our past produce less evidence for optimism." There has been a strong surge in deregulation in the face of increased international competition. Deregulation fostered competition, and, to some degree, innovation.

The Reagan programs attempted to reduce social security spending and cross-industry regulation "to give U.S. companies a breathing space in which to adapt to increased international competition." Reagan's supply-side economics did not produce "the miracle cure" and the budget deficit kept mounting. Deregulation increased takeovers and the unanticipated results were crises in the financial and airline industries, accompanied by a rash of bankruptcies.

The authors present their personal analysis of the current crisis and suggest measures for speeding up reconstruction.

Some of their suggestions include significant changes in the public sector, reducing the deficit through reduced defense spending, the judicious use of protectionist measures either through tariffs or quotas, and direct aid to strategic firms by setting up narrowly focused independent agencies.

Galambos and Pratt have provided a well-researched, well-written analytical perspective of the growth of American capitalism, and the interaction of American business and public policy. The book is invaluable to students and leaders in business, and those who wonder how and why "the American Century" lasted only 25 years.

Yuji Ijiri and Rona A. Watts, (Eds.), *Bill and Ruth Cooper and Their Friends* (Pittsburg: Carnegie Mellon University Press, 1990, 138 pp., Not Priced).

Reviewed by
Rodney K. Rogers
Case Western Reserve University

This book provides an introduction to the life of William W. (Bill) Cooper. Bill has served several disciplines as a prolific researcher, teacher and area administrator. He is a member of the Accounting Hall of Fame. This volume is a collection of speeches and essays in his honor written by former students and colleagues, expressing appreciation for Bill's professional and personal influence on them. As such, this volume does not provide a critical perspective as to the significance of Bill Cooper's contributions; it is clearly appreciative in tone. However, it does provide the reader with a personal insight into the career of Bill Cooper.

The former students and colleagues who participated in this activity came from all eras of Bill Cooper's career including the undergraduate days at the University of Chicago, graduate school experiences at Columbia University, and faculty and administrative positions at Carnegie Mellon, as well as his current faculty and administrative responsibilities at the University of Texas at Austin. Through these speeches and essays one begins to understand events that have shaped Bill Cooper's approach to problems. Herbert Simon discussed their time together at the University of Chicago. This was during the Great Depression

and such world events as the Spanish Civil War. These events caused people to question the *status quo* and discuss alternatives. Simon posited that the "real education at Chicago was the education of revolution" [p.10]. Many of the speeches and essays describe Bill Cooper as a "revolutionary" because he looked at problems in new and different ways.

In Cooper's response to the various remarks, he provides an insight about those factors which influenced his approach to problem solving. He received his formal academic training prior to World War II in an era of "subject matter development." During this time, Freud, Einstein and Keynes were all proposing new theories. However, his academic career was after World War II, during an "age of great methodological change." Thus, he was forced to struggle with this new era and apply new methods and approaches to various problems. Cooper's continuing interest in change is shown by his discussion of the need for research in the area of bureaucracies and how organizations deal with social problems. He proposes development of "flexible" bureaucracies and the need to consider ways to "inject creativity and innovation into large bureaucratic organizations" [p.97].

On the personal side of the subject, the volume contains several "stories" regarding Cooper, such as his early career as a professional fighter.

Several persons present aspects about Bill Cooper's years at Carnegie Mellon University. During this time he was extremely involved in the development of the Graduate School of Industrial Administration and the creation of the School of Urban and Public Affairs. The approach that Cooper used in these activities sheds light upon his creative approach in shaping and creating new organizations.

Bill Cooper has had an impact upon the accounting profession and this book provides the reader with interesting background information regarding his life and career. One should read the book for what it is, a collection of speeches expressing appreciation of Bill Cooper.

R. H. Jones, *The History of the Financial Control Function of Local Government Accounting in the United Kingdom* (New York: Garland Publishing, Inc., 1992, 187 pp., $62).

Reviewed by
Leon Hay
University of Arkansas

The author, Rowan Jones, notes that this book is a "slightly modified version of the author's Ph.D. thesis, submitted to the University of Lancaster in 1986" [p. 3]. In the "Preface to the Original Thesis" Jones wrote:

> We do not know what local government accounting is, or was: what has been written during its long history has the abiding characteristic of being atheoretical and ahistorical. It remains essentially a practice, borne out of past practice [p. 5].

Jones' thesis, of course, relates to local government accounting in the United Kingdom, but a similar comment could have been made in relation to state and local governmental accounting in the United States until the late 1970s.

The main purpose of the book, according to the "Preface to the Original Thesis," is to answer the following questions:

> Why do local authorities account the way they do? Why is this accounting, in crucial respects, so different from commercial accounting (fund accounting, capital accounting, budgetary accounting)? Why in other aspects is it so like it (double entry, accruals)? Why did these differences and similarities emerge [p. 7]?

Jones' research led him to conclude that the answers to the above questions lie in the past; "indeed, they lie pre-1914" [p.7]. Evidence that the book is derived from Jones' Ph.D. thesis is given by the title of Chapter One: "What is Local Government Accounting? A review of the literature." The stated purpose of the chapter "is to discover what is already known about local government accounting and to explain why we need to know more" [p. 9]. Readers who are familiar with the structure of local government in the U.K., and the accounting model used by those local governments, may feel that the chapter accomplishes its stated purpose. Other readers are advised to skip Chapter One and read Chapters Two, Three, and Four, which present Jones' synthesis of local government accounting from the

Middle Ages through the first decade of the twentieth century. Chapter Five, "Local Government Accounting as Statutory Financial Control," follows logically after the three historical chapters. These four chapters provide the reader with the background needed to appreciate Chapter Six, "Implications for Theory and Policy Making."

In Chapter Six, Jones discusses the following implications for accounting theory as it relates to local government accounting in the United Kingdom: (1) budgeting and finance are inextricably bound up with local government accounting—therefore; the matching concept is irrelevant; (2) statistics of annual net expenditure drawn from the "revenue accounts" [revenue accounts in Great Britain are apparently equivalent to governmental fund types in the United States] are not costs, so cannot be used as measures of economy or efficiency and are not useful for comparative financial analysis; (3) the present accounting model ignores holding gains and, also, ignores cost savings on debt outstanding resulting from liabilities being fixed in monetary terms; (4) the recording of depreciation expense is irrelevant, and it would be inappropriate because it would affect the (tax) rates collected; and (5) fund accounting is important in distinguishing non-rate funds from rate funds (*non-rate funds* appear to be equivalent to *proprietary fund* types in the United States, and *rate funds* seem to be what Jones called *revenue accounts* in earlier pages and what are called *governmental fund types* in the United States). Jones' implications (1), (2), (4), and (5) are equally valid in regard to state and local government accounting in the United States; his implication (3) is also true in the U.S., but it is not clear how it relates to the other four implications for governmental accounting theory, or even to the rest of the book.

Under the heading *"Implications for Policy-making,"* Jones observes that "the only unequivocal, intended users of local government accounting we have identified are the auditors" [p. 152]. In the United Kingdom, "the audit certificate has traditionally been a statement to the effect that the accounts are in conformance with the law" [p. 152]. The law, Jones indicates, is the financial control system established by the Treasury.

The implications for policy-making drawn by Jones from his historical study of the financial control function of local government accounting in the United Kingdom contrast markedly with the evaluation of governmental accounting in the

United States. Here, the objective of financial reporting is to enable governments to fulfill their duty to be publicly accountable in a democratic society. The independent auditor's report attests to the conformity with generally accepted accounting principles (defined as financial reporting standards set by the Governmental Accounting Standards Board, a body in the private sector).

Richard Mattessich, (Ed.), *Modern Accounting Research: History, Survey, and Guide* (Vancouver: Canadian Certified General Accountants' Research Foundation, 1984, 487 pp., C$30.00)

Reviewed by
Stephen J. Young
Case Western Reserve University

The book, *Modern Accounting Research: History, Survey and Guide*, by Richard Mattessich, contains a broad survey of academic accounting literature. Thus, it provides a valuable collection of material for those wishing to review the development of recent accounting thought.

The book is divided into six major parts. Each contains an introduction by Mattessich and several articles addressing a major field of accounting research. The work also includes an index of the names of accounting academics.

The first two sections of the book deal with the development of theories and methodology in accounting research. The first part is a general introduction to the field of accounting research. It consists of an article discussing the "Scientific Approach to Accounting" written by Mattessich himself.

The second section considers concepts of theory construction and the roots of accounting thought. It addresses the concepts of Thomas Kuhn[1] on scientific revolutions and the period in which his thought influenced social sciences, including accountancy. The section also looks at the relationships of accountancy to economics and finance, and the socioeconomic consequences of standard setting.

After these Introductory sections, the last four sections each address a major field of continuing research in accountancy.

[1]Thomas S. Kuhn, *The Structure of Scientific Revolutions*, International Encyclopedia of Unified Science, 2nd enlarged edition (University of Chicago Press), 1970.

The third section deals with the controversy between positive and normative research and contains several papers discussing or using the positive accounting methodology. The section is closed with two papers addressing public choice and economic interest in the standard-setting process.

The fourth section deals with the subjects of agency and information economics. In order to assist the reader in understanding the influence of this literature, there are several survey-type papers that cover the fundamentals of this subject area.

The fifth part of the book deals with the empirical/statistical literature in accounting. It is composed of four papers dealing with a broad array of topics ranging from market studies to behavioral accounting research.

The final section deals with "other" issues. This omnibus section contains papers on managerial accounting, auditing, and non-business (e.g., a survey paper written by William Vatter) accounting.

Appended to the book is a comprehensive index of North American accounting academics (as of 1984). This is an invaluable, although somewhat dated, addition to the book.

There are at least two principal concerns about the monograph. First, one can argue that "depth" has been sacrificed for "breadth." The work does attempt to cover a wide range of research topics at the cost of "depth." Many of the papers are surveys, and therefore brush over major contributions. For example, seminal articles such as Jenson and Meckling [1976] in agency research and Ball and Brown [1969] in market studies are not included. Much of the spirit of subsequent research in these areas cannot be fully appreciated without reading such works.

The second principal concern, not inherent in the work but caused by the timing of this review, is the date of the monograph. A great deal of work has been done in academic accounting since 1984. Empirical studies have developed into two massive branches: market studies and behavioral research. These fields were far less developed eight years ago. Agency research and the application of information economics to accounting has also blossomed beyond any level conceived of in 1984.

Fortunately, a second monograph by Mattessich, intended to be a supplement to this comprehensive 1984 effort, is now available [Mattessich, 1991].

Tradeoffs in content are necessary, but no major issue in accountancy is unattended. Regarding the second criticism, all books become outdated. Time is never particularly kind to authors, but the 1984 monograph has aged remarkably well. Many of its topics form the foundations of accounting research today, and therefore this work remains a useful item in a scholar's library.

This publication's greatest value is as a "survey and guide" to contemporary academic accountancy research. It therefore meets its promised "mission". It also provides a base for further inquiry, and the index of authors is most helpful. I recommend the work both as a reader for an advanced accountancy theory course or for practitioners who want to understanding the academic side of accounting.

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John T. S. Melzer, *Bastion of Commerce in the City of Kings: The Consulado de Commercio de Lima 1593-1877* (Lima, Peru: Editorial Concytec Peru, 1991, 208 pp., Not priced).

Reviewed by
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Eastern Illinois University

This book is a history of the Consulado de Lima, the mercantile regulatory body for Spanish South America. It follows the course of events (1593-1877) for this institution and makes references to numerous Peruvian documents and other sources. The author states that very little has been written about this exceptionally powerful Crown institution that controlled trade from the City of Kings. For that reason, the book contains an English, German and Spanish version of the text.

The Spanish government had made use of the *consulado* several centuries before introducing it to Peru. In time, "the new consulado in Lima was to dominate the trade of the viceroyalty of Peru in much the same way as the Seville consulado dominated that between Spain and the colonies" [p. 6]. This was because it was given royal jurisdiction for all of Spanish South America. The author includes a discussion of the role that the *consulado* played in terms of the Council of the Indies and the *Casa de Contratación* that preceded it.

In addition to the history of the *Consulado de Lima*, Melzer describes the basic operation of the institution as a court and as a major financial contributor to the Crown. He also gives general background information on the Spanish empire while narrating how the *consulado* responded to various economic and political pressures. The Crown needed the Lima Consulado's judicial power and the taxes it collected for them. It was the tax collecting function that gave the *consulado* its major source of power during the seventeenth and eighteenth centuries.

During the mid and late eighteenth century, changes occurred in the imperial bureaucracy that abolished the *Casa de Contratación* and took away the power of the Council of the Indies. By the nineteenth century "the institution's prime concern was the financing of the vice royal government against the encroachment of the forces for Independence" [p. 34].

With the Republic of Peru winning independence, its survival was dependent on collecting taxes. To that end, a new constitution in 1828 reestablished the *consulado* in its full pre-independence institutional form, except for some changes in the court structure. The *consulado* continued to serve as "the financial palace guard for the kingdom of Peru" [p. 37] until 1887 when it was legislated out of existence.

The *consulado's* existence was very important to the financing of the Crown and later to the Republic of Peru. Because detailed records of its collections have been maintained, it is now also important to historians. This information is valuable to researchers investigating the economic conditions that prevailed during this period and the trade that took place in South America and overseas.

Melzer is to be commended for his research on this little known, but important financial institution in the Spanish colonization of South America.

Lee D. Parker and O. Finley Graves, (Eds.), *Methodology and Method in History, A Bibliography* (New York: Garland Publishing, Inc., 1989, 247 pp., $75).

Reviewed by
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University of Wollongong, Australia

It is difficult to know how to review a bibliography, but presumably it must be relevant (and useful) and complete. In the Introduction, it is stated that

> The objective of this bibliography is to provide the accounting history research community with a comprehensive reference tool that will ultimately enhance their (sic) understanding of methodological issues and enable them to employ research methods appropriate to their subject of study [xiii].

It is tempting to ask whether this is an aim which is as noble and romantic as the setting for the origins of the project ("a curbside cafe on a balmy summer's night in Pisa" [ix]). It is difficult to believe that merely presenting a list of titles will enhance the reader's awareness of methodological issues. The editors obviously are aware of this and have designed a taxonomic grouping of the titles. It would seem that they have given this matter some considerable attention and there are thirteen such groups. Even so, they are not likely to please everyone and it would be easy to take issue with the rationale for the taxonomic divisions. In selecting their categories, the editors have indicated their vision of history; for example, why are there separate groups for historiography, philosophy of history and the historical rationale? Can evidence and sources be separated from interpretation and social dimensions? The editors, it would seem, are not convinced of either: some titles included under one heading in one section of the book are included in a different group in the another section.

The book is divided into four parts. The first introduces the taxonomic groups with summary reference lists. That is, the works, numbered for cross reference, are listed under a particular group. The next section forms the main part of the book, with the full reference (and numbered) citation being given. The third section contains an annotated selected bibliography. The final, very brief section lists accounting history review and

method papers. It is unfortunate that this last section is so brief and any charges of incompleteness may justifiably be laid here.

The broader question concerns the extent to which readers can be made aware of the methodological issues in undertaking historical research: the editors have certainly led the horses to the water, but will (or can) they drink? If they do not, the editors cannot be blamed for they have made every effort to present the material in a manner they believe will help the would-be accounting history researcher come to terms with most of the types of historical research that have become accepted over the years. This is especially true of the annotated bibliography section, and the editors are to be applauded for the admirable way they have tackled this immense task. The question, then, is do researchers learn from what others claim is the way to proceed with research, or is it better for them to see actual examples of (accounting) historical research and decide for themselves what is "good" and what is "bad" accounting history, what is an appropriate approach to their research and what not? That is, are there universal standards by which accounting history can be judged? If so, who will do the judging - accountants or historians?

This work was conceived and completed before the recent debates on the "new accounting history." Thus, there is no section that deals specifically with this issue. It can be claimed (unfairly) that the work, therefore, is incomplete. Those with a predilection for the so-called new accounting history are bound to find many sections unsatisfactory and even unnecessary, for example, the references to quantitative methods of historical research (cliometrics). However, this section would seem to be one of the most complete: and there are a substantial number of references for anyone interested in learning how to undertake research that warrants sophisticated statistical support.

As stated earlier, it is difficult to review a bibliography and it is easy to find fault with various parts of it. In this work, the editors have set out to provide a list of references for those interested in knowing the sorts of standards by which works purporting to be historical are judged. If the readers of these historical works are also aware of these standards, accounting history can only become more rigorous and intellectually demanding. The editors wish to see works on accounting history become more than mere chronological descriptions, more than anecdotal curiosities. Thus, they have tried to present a tool for

accounting history researchers, and they have completed a work for which they can be proud; one that contains a wealth of material and which should be in every accounting historian's collection let alone every institutional library.

Denise Schmandt-Besserat, *Before Writing, Volume 1, From Counting to Cuneiform* (Austin: University of Texas Press, 1992, 304 pp., $60).

Reviewed by
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Concordia University

Before Writing is a fascinating book on the evolution of communication in the Near East between 8000-3000 B.C. Much more than that, it is a book on accounting history itself. It argues that, writing was not, as previously thought, a sudden and spontaneous invention; the alphabet was not of divine origin as was believed until 1700s; nor did scripts start with picture writing as was put forward during the enlightenment period. Rather, writing emerged from manipulation of counting symbols.

Denise Schmandt-Besserat presents a unique hypothesis: Mesopottamian writing emerged from a counting device which existed at least two hundred years earlier than pictographics. She argues that tallies, tokens and pictographic tablets represent three distinct phases in the evolution of data processing [p. 166]. The emergence of tallies and plain and complex tokens reflects the needs of different societies and their specific lifestyles, economics and social organizations. The development of these societies and their economies and social needs influenced each phase of prehistoric counting and accounting devices or reckoning technology.

The first chapter of the book introduces us to previous theories and arguments about the evolution of writing as well as introducing its argument on the subject. The following chapters introduce the token system chronologically and geographically, tracing its evolution in prehistory. Two of these chapters distinguish between plain and complex tokens and depict their evolution with beautifully photographed illustrations.

The fourth and fifth chapters provide insight into the domestic and public uses of tokens, including their purpose and

storage as related to the economic and social changes occuring in the particular society under examination. The analysis establishes that storage of tokens created a need for marking signs on clay envelopes, which was a new trend in communication and an immediate step preceding writing itself.

While Chapter Six introduces us to the routine documentation of the impressed tablets (classifying and making available knowledge as a procedure), the strengths of the book are to be found in the remaining chapters. Those chapters introduce us to the author's revolutionary findings and, in particular, the fascinating interpretation of her findings on accounting.

Chapter Seven presents the author's classification system of the tokens. In this chapter, the author shows that tokens were concept symbols and, as such, conveyed quantitative as well as qualitative information. There were various types of tokens each of which carried discrete meaning. For example, the cone represented a small measure of grain and the sphere represented a large measure of grain. On the other hand, the number of tokens represented quantitative information about the goods, like two spheres or three cones. However, they always represented economic data of some kind, whether agricultural or manufactured goods. Even the repertory of shapes was systematized. Always cones signified a particular measure of grain. However, it should be stressed that this was an open classification system because new signs were added whenever needed. As well, it was flexible enough to manipulate economic information by facilitating the functions of addition and subtraction. The entire system was based on one-to-one correspondence.

In Chapter Eight, the author argues that the development of token systems and accounting was not commerce-related, but emerged as an outcome of the changes in the social structure and economies of respective societies. For example, in egalitarian societies, individuals had an equal share of resources and tokens were used to measure and count units for farming and grain hoarding. Plain tokens satisfied these needs and basically represented products of the farm. Later the emergence of ranked societies fundamentally changed the relationship between tokens and the needs of particular social groups in the society. Suddenly, tokens became devices of rudimentary accounting rather than counting, and complex tokens came to represent goods manufactured in the city. In ranked societies, temples acted as a sort of central location where individuals

made offerings and where collections were redistributed. At this stage, the function of writing served the purpose of keeping account of the resources collected at the temple or the palace and redistribution of this collection. Further, writing as a form of social control came into practice. Record keeping became imperative to provide information about the community's pooled surpluses and their redistribution. Unquestionably, the temple needed to control both functions, and therefore used tablets to record receipts. Tablet records contained all the necessary information of a receipt. The change from ranked society to the formation of the state brought about new social and economic needs. The state needed a system of continual resource collection (such as taxes) and needed to calculate the cost of the monuments which were built. Both kinds of tokens met those needs very well.

After rationalizing the social and economic functions of tokens and the development of communication, the author explains three major phases in the evolution of counting: one-to-one correspondence, concrete counting, and abstract counting. She postulates that writing was the direct outcome of abstract counting, and suggests that accountants of Uruk IVa themselves can be credited for devising the two types of signs: numerals (symbols encoding abstract numbers) and pictographs (expressing commodities) [p. 192].

The book concludes by showing how tokens and tablets illustrated and proved the interconnections between social structure, cognitive skills, economy, technology, mathematics and communication during 8000-3000 B.C.

Before Writing is indeed a very interesting and valuable book which makes a major contribution to the field and is of particular interest to those in the history of accounting. *Before Writing* deserves considerable success.

Richard Vangermeersch, (Ed.), *Relevance Rediscovered, Volume III* (Montvale, New Jersey: Institute of Management Accountants, 1992, 351 pp., $29.95).

Reviewed by
Lamont F. Steedle
Towson State University

The third and last volume of *Relevance Rediscovered*, the anthology compiled by Richard Vangermeersch for the Institute

of Management Accountants (IMA), enlightens the reader with yet another sampling of the cost accounting writings of a particular decade in our past. At the same time, we are disappointed knowing that this IMA Classic Series will end with its publication. It would have been interesting to learn about the ideas post-1949, a time which is still well before many current cost accounting academics and practitioners began their study of the discipline. Why this series was not extended another decade is puzzling.

The current volume, which focuses on the National Association of Cost Accountants (NACA, original name of the IMA) bulletins and yearbooks from 1939-1949, does not disappoint the reader. While the initial volume covering the 1919-1929 decade remains this writer's favorite, Volume III is a close second choice. Clearly choosing a favorite volume reflects more on the issues of the times rather than the individual choices of the editor. Professor Vangermeersch always seems to select a mix of 25 significant articles that provide a broad area of topics, and he continues to provide stimulating and interesting introductory comments that relate the works to modern everyday problems.

What is most significant, however, is that each of the volumes in the trilogy contains a handful of gems among its 25 collected works. In this volume, these articles are: (54) "The Nature of Cost and Its Uses" by Wyman P. Fiske, which reviews four different cost concepts and relates them to five different costing applications; (55) "Accounting for Materials and Related Procedures" by the Systems and Methods Study Group of the New York City Chapter of NACA, which is a summary of existing procedures and methods in use in accounting for materials; and, (57) "Accounting by Causes Vs. Accounting by Accounts" by Joseph B. Copper, which proposes a different approach to variance analysis that looks similar to some of the newer activity management systems being proposed today.

When one first encounters the initial volume of this series, there is both anticipation and skepticism because of the claim that this volume will contain "the great accounting ideas of the past, to help you solve today's and tomorrow's problems." Not every work in the trilogy fulfilled this, but perhaps two out of every three did. Management accountants, academics and practitioners alike, should avail themselves of this resource. The reason to do so is well defined by Professor Vangermeersch:

> Our profession has to be more concerned with past literature, especially in light of our national quest to become competitive again and our reexamination of our management accounting roots brought about by today's completely automated factory. Let this past literature light our way to the future [Vol. III, p.7].

S. A. Zeff, F. VanderWel, and C. Camfferman, *Company Financial Reporting: A Historical and Comparative Study of the Dutch Regulatory Process*, (New York: Elsevier Science Publishing Co., 1992, 450 pp., $85).

Reviewed by
Kathleen E. Sinning
Western Michigan University

Although the Dutch have a keen awareness of developments in financial accounting outside their country, few non-Dutch accounting scholars know much about the evolution of Dutch financial reporting because little concerning it has been written in English. *Company Financial Reporting: A Historical and Comparative Study of the Dutch Regulatory Process* closes that gap. The authors have done a masterful job of analyzing the events leading to the current state of financial reporting in the Netherlands and providing the reader with a concise but thorough review of the economic, legal, political, and cultural environment in which the Dutch regulatory process has developed.

In the first chapter, the organizations, individuals, attitudes, and traditions that have shaped the Dutch regulatory process are introduced. The Dutch capital markets, the principal employer and employee federations, company law, and the evolution of the auditing profession are also examined.

Freedom in financial reporting has been a hallmark of Dutch accounting since the passage of the first company law. Over time, as changes occurred in the Dutch business climate, in the regulation of the Dutch auditing profession, and in the international accounting arena, attitudes toward financial reporting were modified. Chapters Two through Six of *Company Financial Reporting* analyze the events leading to the current state of financial reporting, in chronological order, beginning with the first attempts to regulate limited companies in the late

nineteenth century. The chapters are organized around major initiatives to improve financial accounting.

Since there is very little literature on Dutch accounting history, the authors relied extensively on original source material including parliamentary proceedings, court decisions, confidential minutes of committee meetings, committee reports, comment letters to exposure drafts, newspaper and magazine articles and editorials, speeches, and 90 interviews with key people involved in the regulatory process. The chapters contain a wealth of detail including the names and backgrounds of committee members, contents of exposure drafts and final guidelines, and reactions by businesses, the financial press, and the auditing profession to proposals and reports. The result is a lively account that does not merely outline the events that occurred, but reflects on the personalities, motives, and power struggles behind the actions.

Despite more than a century of activity aimed at improving financial reporting, Dutch companies still enjoy great flexibility in accounting practice. Compliance with recommended standards beyond the legal requirements is still not enforced. In Chapter Seven, the regulatory process in the Netherlands is compared with that in the United Kingdom and the United States. Differences in the legal systems, national cultures, and capital markets are examined to help explain the differences in the development of financial reporting requirements in each country.

The Netherlands is a country in which "progress is made through consensus and compromise" [p. 3]. The authors feel that an unfortunate consequence of the consensus approach in financial reporting regulation is that the guidance it produces is characterized by "ambivalence and the lack of clear direction" [p. 373]. In the final chapter of the book, they make specific recommendations for policy and procedural changes including strengthening the political process for promoting improvement in financial reporting and having the Dutch auditing profession and members of academe take a leadership role in setting norms of financial reporting.

Although *Company Financial Reporting* is a richly detailed study of the efforts to advance and reform financial reporting in the Netherlands, its analysis of the factors influencing the regulatory process makes it a valuable resource for any accounting scholar interested in financial accounting.

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Inquiries and submission of papers to:
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THE ACADEMY OF ACCOUNTING HISTORIANS 1993 VANGERMEERSCH MANUSCRIPT AWARD

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