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**Better Objectives Needed
To Improve Accounting Principles**

By GEORGE R. CATLETT

**Based on Comments Included in Several Addresses
Before Business and Accounting Organizations**

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Better Objectives Needed To Improve Accounting Principles

By GEORGE R. CATLETT

The accounting profession in recent years has made a valiant effort to improve the accounting principles which underlie the financial reporting of business enterprises. The program of the Accounting Principles Board is unprecedented in its scope and in the resources dedicated to it. The members of the APB are devoting a tremendous amount of time to this program. Nevertheless, the achievements to date leave a worrisome question as to whether there has been sufficient progress in terms of present-day requirements and whether the APB is accomplishing what needs to be done.

What Is The Goal?

The APB has been giving particular attention to the elimination of alternative practices and to the narrowing of differences in financial reporting. However, the mere reduction of alternative practices should not be the primary goal, since the elimination of practices does not necessarily result in the best ones surviving. In some areas, a minority practice may be preferable, but it also may be the simplest to abolish. It is just as easy to be uniformly wrong as it is to be uniformly right—and sometimes easier—particularly when attempts are made to achieve a “consensus” as to what is preferable and to use “general acceptance” as the guiding light.

Generalizations—such as the much quoted desire of “making like things look alike, and unlike things look different”—also becloud the issue with respect to comparability of financial statements. Looking alike does not always represent a proper reflection of the facts in either of two cases; also, looking different does not give any assurance that the differences as between two cases are fairly presented in either case.

The goal of the APB should be the establishment of uniform accounting principles on a sound and authoritative basis in order to have the fairest presentation of financial facts to all segments of our society under today's conditions and circumstances. This goal can be attained only if there is a clear and concise statement of the objectives and concepts which should be used as the foundation upon which to build a solid set of principles. These base points could then be followed in solving accounting problems in a consistent and coordinated manner.

The APB, as well as its predecessor Committee on Accounting Procedure, has been so busy "putting out fires" and dealing with a large and ever-increasing backlog of current problems that it has never established an adequate basis upon which to build. This deficiency results not only in the waste of a great deal of time in debating each subject on a more-or-less isolated basis but also in makeshift conclusions which could in the end defeat the entire effort to improve accounting principles. The accounting profession has tended to fall into the trap of working furiously on how to do something before establishing what it is trying to do. This approach can be compared to building a room for a house without having either a foundation or plans for the house.

The APB should be dedicated to the identification and establishment of principles to meet present needs rather than to the refinement and extension of what presently exists. Reiteration of what exists, with patches applied to cover up the holes, serves only to magnify the many inconsistencies and outmoded customs which have accumulated over the years. The rationalizations which are fabricated under the guise of accounting theory to support some of the existing practices are subject to serious question.

The view is occasionally expressed that the basic objectives and concepts which would be the framework for a set of sound principles cannot be established on an overall basis; but, rather, each problem (such as leases, pension plans, tax allocation, intercorporate investments, and business combinations) must be solved separately and then the concepts and principles will evolve. This reverse procedure has been followed by the APB and its predecessor committee, and the ultimate futility of this approach is evident from the continuing frustration and controversy which results from unsupported conclusions. The accounting profession should awaken to the urgent need for clear-cut objectives, which have not yet been identified and defined.

Another view is that progress can be made only by evolution of practices through usage and acceptance and that improvements will emerge by the irresistible force of their desirability. Neither history nor human nature supports this line of reasoning. In fact, evolution does not produce such a result, and this is one of the reasons that so much government regulation exists today. When a laissez-faire approach to accounting is combined with the present-day pressures for growth, performance and earnings, deterioration in the principles followed is much more likely to occur than improvement. The only way progress can be

made is to carefully and clearly establish the most desirable goal and then work diligently to get there—step by step—on an authoritative, coordinated and professional basis.

Purposes and Objectives of Financial Statements

Proper solutions which will stand up for any reasonable period of time cannot be determined for our current problems unless there is a foundation upon which to build. Such a foundation must include a comprehensive statement of the purposes and objectives of financial statements. Many questions need to be answered. What is the general objective of financial statements and what characteristics would make them most useful and result in the fairest presentation of the facts? What is the purpose of a balance sheet? What kinds of assets should be recognized and, in general, how should they be valued? What types of liabilities should be shown? What is the purpose of the income statement? What represents income realization? When do costs become expenses to be charged off?

Whether goodwill is an asset for accounting purposes depends upon what kinds of assets are to be recognized. Whether marketable securities or long-term intercorporate investments should be carried at cost, at fair value or on the equity basis depends on the general concepts for asset valuation. Whether financing leases are liabilities to the lessee depends upon what is the most useful basis of determining obligations.

The APB and the entire accounting profession are rapidly heading into a period when the objectives must be established and the pieces put together on a rational and consistent basis. Investors and other users of financial statements will not continue to accept the pronouncements of a profession which has not developed sensible and understandable objectives in the light of the current needs of those who use financial statements.

Ten research studies have been published by the AICPA Director of Accounting Research on a wide variety of accounting problems, and several more are in process. With no agreement as to the objectives and concepts, and with none having been established by the APB, the authors have found it necessary to assume or establish their own before proceeding to a recommended solution for particular problems. The effectiveness of the research has been considerably impaired because of

this lack of a common set of base points. Thus, the research has flown off in all directions. And, as a result, the studies have generally been criticized as representing personal viewpoints and either being too far ahead of what is presently acceptable or merely supporting what is already occurring.

Assets as an Illustration

The accounting for assets can be used as an illustration of the kinds of questions which need to be considered in establishing overall objectives before trying to solve individual problems.

What kinds of assets should be recognized for accounting purposes? Many items of economic value are generally not shown as assets. This is evident when a company's common stock is selling for substantially more than the recorded stockholders' equity. This difference may result from carrying certain assets below their current fair value, but more frequently the difference is represented by the many intangible values which are not accounted for in terms of assets and stockholders' equity.

When should assets be recorded in relation to the legal, economic and business aspects of transactions? What factors should be considered?

At what amount should assets be recorded? There is a general presumption in present accounting that assets are to be carried at cost. Consistent with the heavy reliance now placed on transactions with independent parties for the recognition of assets, valuation has generally been based on exchange prices generated in these transactions. But, should the so-called cost basis of accounting become an insurmountable hurdle to progress? Also, there are several departures from the cost basis in practice now. The term "asset" when used in relation to "financial position" has a connotation of value which cannot be ignored.

The past reliance on cost for the initial valuation of assets has rested on two grounds: (1) experience indicates cost is generally reflective of value at the transaction date, and (2) cost is objectively determined and subject to verification. However, as the time interval increases between the initial transaction which brings the asset under the control of the business and the subsequent financial reporting dates, cost may lose its close relationship to value. Thus, cost may become less significant. There are a whole series of propositions which should be considered, such as—the closer the valuation of assets is to current values and to

current costs determined in an objective and reliable manner, the more useful and significant is the information presented.

“Realization” as a test of the carrying value of an asset may be equally as much of a problem when an asset is carried at cost as when it is carried on another basis, above or below cost. While cost is an objective test of value at the date of acquisition, that basis does not have any particular relevance to realization when viewed at a later date. Many of the ancient rules relating to realization are under pressure for change, but an overall plan based on sound concepts is needed for improvement to be achieved on a lasting basis.

Valuation of assets is related in some respects to the recognition of income; and while these two problems have certain aspects which should be considered separately, they both should be related to one overall objective.

Locked in by Outmoded Conventions

The difficulties involved in trying to overcome some of the practices presently in existence seem to be almost endless. Excuses of all kinds exist for not making significant changes. The reasons which are put forward for maintaining the status quo are baffling.

Most of the so-called fundamental concepts and principles which presumably exist at the present time to support the existing conventions and practices are a hodge-podge of theories. Some of these theories are the ones which have created and perpetuated many difficult problems, and such theories are hardly the ones to follow in solving those same problems.

Financial statements are used for different purposes and in different ways by a great many more people than was the case 30 years ago. Stewardship accounting is less significant, and the presentation of accounting data for making decisions as to the future is more important. Vestiges of “venture” accounting still are with us, even though investors today are far more interested in current values and the earning power of a business enterprise. Yet, we seem to be locked in by many conventions (some of which are nothing but old bookkeeping rules) as to the cost basis, realization concepts, liability determinations, and many other customs which may have once served a useful purpose but are now out of date.

The argument is frequently advanced that a change cannot be made in one area, because the new approach would then be inconsistent with the current practices in other areas. Yet, it is obvious that new approaches cannot be made in all areas at once. Thus, this all-or-nothing attitude is really a perpetual roadblock to significant progress. If overall objectives and concepts were clearly established, as discussed above, then each step could be fitted into a master plan, and progress would be on an organized and consistent basis which could be understood and explained.

One of the dilemmas facing the APB or any other organization which tries to develop improved accounting principles is the problem of usefulness vs. verifiability. Since the AICPA committees, government agencies, and stock exchanges have generally been influenced by enforcement problems and the possible danger of "abuses," verifiability has tended to win out over usefulness. Perhaps auditors have been more concerned with auditing problems than with accounting principles. For example, continued adherence to the cost basis and many of the realization rules may be more influenced by verifiability than by usefulness in meeting today's needs. While verifiability and conservatism have had considerable effect on many of our conventions, and they cannot be ignored now, the time is long overdue to take a fresh look at the obvious need for a modern and reasonable basis for present-day financial statements.

Professional Judgment

What part does professional judgment play in the determination and application of accounting principles? The answer to this question always seems to be a subject of fruitless debate, with the advocates for each of the various approaches to accounting principles claiming that they favor the maximum use of professional judgment.

The best abilities and competence available, both within and outside the profession, should be focused to contribute in the most constructive manner in establishing uniform principles. The biases and preconceived conclusions of individuals must somehow be minimized, without at the same time having the compromises of group action so dilute the effort that the results are ineffective.

If an adequate set of uniform accounting principles could be established, much more professional judgment would be required to apply them than is the case at the present time. Many of the present ac-

counting practices are based upon what is customary, and little judgment is required merely to follow what other companies are doing and what other CPAs are accepting.

Implementation criteria would be needed for applying the set of principles in order to have reasonable application to the wide variety of circumstances which exist. However, these guidelines should be consistent and in harmony with the principles; and such guidelines should not represent unsupported and capricious dogma. A proper balance is needed between the determination of sound principles on a sound basis and the exercise of professional judgment in applying such principles.

Avoidance of Arbitrary Rules

The accounting profession at the present time is in great danger of ending up with an odd assortment of arbitrary rules. Some of the leaders of the profession seem to be more interested in adopting a regulatory and police-type attitude to "plug holes" and to inhibit so-called "corner cutting" and "abuses" than in establishing proper principles. There is a tendency to overreact because of the unusual cases and to establish oppressive rules for everyone. A uniform set of principles of the right type would do more in the long run to avoid "abuses" than could be accomplished by a shelf full of rule books.

The APB has dealt in a substantive way with three major subjects which have significantly involved accounting principles. These subjects are: (1) accounting for leases—Opinions No. 5 and No. 7; (2) accounting for the cost of pension plans—Opinion No. 8; and (3) accounting for income taxes—Opinion No. 11. None of those Opinions is related to any basic objectives or overall concepts previously adopted by the APB or to any very convincing demonstration of why the conclusions reached produce the most useful results for investors and other users of financial statements; and the same can be said for the three related research studies. Those Opinions left open some serious questions, and they all will require reconsideration by the APB.

Opinion No. 9 on reporting the results of operations has little to do with accounting principles, since it relates primarily to the form of the income statement, and the classification of the items therein, rather than the underlying accounting. This subject, including the problem of prior-period adjustments, should be related to the overall purposes of financial statements, but such purposes have not yet been established.

Opinion No. 15 on earnings per share contains many arbitrary rules. That Opinion does not deal with accounting principles and sets forth only detailed guidelines for the computation of statistics (even though they are important ones) in a manner that the APB considered to be the most meaningful to the readers of financial statements. However, the conclusions are not related to previously established base points of any kind. In fact, the APB's conclusion that the philosophy of that Opinion should be limited to computations of earnings per share and not reflected in the accounting and the financial-statement presentation has the dubious effect of isolating such computations from accounting principles.

The Opinions of the APB should be based primarily on principles supported by properly determined objectives and concepts. The applicable principles should be set out clearly and separately in each Opinion. The Opinions need to include some guidelines and criteria for implementation purposes, so that there is a reasonably uniform approach in actual application. But the implementation rules, which of necessity may be somewhat arbitrary, should not be mixed up with the principles and should not overshadow the principles. As an example, neither an accounting principle nor its effective application should be based on a percentage, because principles cannot possibly be determined in that manner. The nature of a transaction, and not its size (assuming the amounts involved are material), should determine the principles to be followed in accounting for it.

For example, one of the problems presently facing the accounting profession is whether pooling-of-interests accounting should be continued and limited to combinations of companies of prescribed relative sizes, determined by specific percentages. Another question is whether the appropriateness of equity accounting for intercorporate investments should be affected by percentages of ownership of the outstanding equity securities of the other company. The accounting profession can never sustain, *as a principle*, that a transaction at a 30% level should be accounted for in one manner and at a 29% level in another manner, with vastly different effects on financial position and results of operations.

New Alternatives Sometimes Required

The desire to eliminate alternative practices for the same types of transactions and the need to establish more uniform principles may cause us to forget that progress sometimes requires the creation of new alterna-

tives. If alternative practices already exist, it may be possible to eliminate one or more of them. However, when progress requires a new alternative which has had little acceptance in practice, and particularly if the new alternative represents a major change, the new and old alternatives may need to co-exist for some period of time.

Thus, the primary objective of the APB is not necessarily to reduce alternatives but to eliminate undesirable alternatives and to seek improvements which may sometimes require new approaches. If new alternatives are not permitted, and if it is not recognized that new approaches cannot immediately replace previous practices, progress will cease to occur in many areas of accounting.

Examples of areas where experimentation and new alternatives may be needed are: discovery value accounting for certain natural resource industries; fair-value accounting; price-level accounting; full-cost accounting in the extractive industries; equity accounting for intercorporate investments; accounting for intangible assets; and the recognition of certain types of obligations.

Effect of Compromise

In any group of accountants, such as among the members of the APB, honest and sincere differences of views exist as to the best solution for the problems under discussion. Any democratic approach to achieving progress requires compromise; and, hopefully, the progress is in the right direction. However, in the case of the APB, compromises necessary to achieve sufficient agreement (two-thirds of the members in case of APB Opinions) can be fatal if the effect is to dissect the principles in a "tug-of-war." Principles can be identified and selected or changed. They should not be compromised; they cannot be negotiated; and they will not survive only by edict.

While accounting principles are not scientific truths which are discovered by research, such principles do need to be related to carefully determined objectives and concepts and to be supported by logic and reason. Two principles might each be supported by logic and reason, depending upon the objectives sought, but a position part way in between would not be a principle at all. The partial-purchase, partial-pooling accounting for a business combination is a current example of an attempt to rationalize an in-between answer, and the result is an aberration that defies any reasonable explanation. Arbitrary percentages and pre-

scribed periods of time used in the determination or application of accounting principles are usually the result of a compromise, which is not based on any principle. Pooling-of-interests accounting, as an example, has not been supported by a logical concept, and the results have been a chaotic condition which has been severely criticized in the public press and which has cast a cloud over the reliability of corporate reporting.

Leadership in the accounting profession, as in other phases of human endeavor, is the result of the efforts of individuals. Collective action, which is necessary in the case of a group such as the APB, must necessarily result in compromise, but the wrong type of compromise can seriously impair the objectives being sought. As is well known, the larger the group, the greater the need to compromise, particularly when a two-thirds vote is required for positive action. The profession will suffer if the effectiveness of its leadership and the results of its attempts to develop sound accounting principles are stifled by compromise.

Conclusion

The most productive approach which the APB could take on behalf of the accounting profession would be, first, to clearly and concisely set forth on an authoritative basis the objectives upon which to build a foundation, including the purposes of financial statements today—not some indefinite time in the future. This program should be accomplished with the full cooperation and assistance of all interested organizations and agencies in the business and financial community, academic institutions and government. Then, the basic concepts and principles necessary to carry out these objectives and purposes would be established. After that, the appropriate practices and methods would be determined on the basis of the principles involved in each of the problem areas. The arbitrary criteria and rules, to the extent necessary for a reasonably uniform application and implementation, would be indicated, but these would be kept to a minimum and identified separately from the principles.

To those accountants who take the position that the approach I have discussed is not practicable and cannot be done, my answer is—an admission of such inability represents (1) an abdication of the responsibilities of CPAs in reporting on financial statements, (2) a breakdown in the leadership role which the accounting profession has assumed, and (3) an undesirable reflection upon the financial reporting of all business enterprises which depend so heavily upon public acceptance of the reliability of their reports.

Significant progress can be accomplished on a lasting basis if there is sufficient determination, independence and vision to establish the necessary goals and work toward them in an organized manner. If this program is carried out on a hit-or-miss piecemeal basis that does not hang together as a part of a framework based on well-conceived goals, the outcome is certain to be not only off the target but also too little and too late. The accounting profession has a tremendous opportunity to be of constructive service to our society for a long time to come—and this cannot be accomplished without better objectives.