

10-1920

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### Recommended Citation

Gower, William B. (1920) "Advisory Accountancy," *Journal of Accountancy*. Vol. 30: Iss. 4, Article 4.  
Available at: <https://egrove.olemiss.edu/jofa/vol30/iss4/4>

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## Advisory Accountancy \*

BY WILLIAM B. GOWER

On an occasion such as this, a representative gathering of our national body of public accountants, a body which contains all that is highest and best in the profession, it is fitting that we glance at certain phases of the remarkable evolution in the science and application of accountancy and in the opportunities for service that the profession affords, which has taken place during the past twenty years. We ourselves are so immersed in the phenomena, we are living so close to the manifestations, that we scarcely realize their extent and significance.

Not so many years ago one of our leaders deplored the fact that in this country the profession had not obtained that full and complete recognition which had been accorded to it in Great Britain; but he declared that the future was with the rising generation. His optimism has been fully justified; but even he could hardly have foreseen the extent of our development, our achievements, our recognition by the community or the growth of our service and opportunities. We have risen to man's estate; we have discarded the old leading strings; we no longer rely upon parental guidance and instruction; we recognize no outside authority; we have surpassed the achievements of our predecessors, and our standing and usefulness in the community are not surpassed elsewhere.

Perhaps the greatest of our achievements is one which, in our crowded and strenuous efforts to keep abreast with our expanded business, we are apt to overlook. I refer to our accounting literature, particularly the works which have inquired into and thrown a flood of light upon the rational bases and principles upon which rules of accounting practice and procedure rest. I doubt whether, even yet, the importance of this achievement has been sufficiently recognized. It is not so long ago, however, that the writings and teachings of accounting authorities were confined almost exclusively to practice and procedure. We were taught what practice

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\* A paper presented at the annual meeting of the American Institute of Accountants, at Washington, D. C., September 22, 1920.

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was right and what was wrong, how to correct abuses, how to analyse accounts, classify business facts, ascertain and distribute costs, prepare financial statements, and how to deal with unusual as well as ordinary situations and circumstances. It was inevitable, however, as time went on, that a demand would arise within the profession itself for inquiry as to how far accounting practice and procedure rested upon permanent and fundamental principles, as distinguished from custom, tradition and mere expedients. We have seen this demand met in this country in the published works of university professors in accounting, among whom may be cited Professors Sprague, Hatfield, Paton and Stevenson. The distinctive characteristic of these writings is the framework or background of broad general principles, determined by deductive reasoning and represented as the rational basis of accounting. These general principles are relied upon for the solution of many difficult problems of the balance-sheet, of corporate proprietorship and of the determination of net revenue. The attempt is made to bring practice and procedure within the scope of these principles.

Time was when it was thought sufficient for the public accountant to be familiar with the practice or procedure and to be able to answer inquiry by saying, "Such and such is the practice, or such and such is the procedure," as the case might be. If his dictum was questioned, the accounting manuals could be relied upon for confirmation—and for little else. Those happy and simple times have passed, never to return; the extraordinary growth in the volume of modern business and in the complexity of the industrial situation has supervened. To-day the public accountant can no longer place sole reliance upon a knowledge of practice and procedure, however extensive and minute, and the chief reason for this has been his contact with the legal mind. Not only do lawyers rely upon him for technical advice, but the public accountant is frequently relied upon for expert testimony before the courts, in such proceedings as patent accountings, profit accountings and controversies relating to income and profits taxes. The legal mind is not impressed with the dicta of public accountants that such and such is the practice—it requires a great deal more than that and insists upon explanation of the rational basis for the practice and a demonstration of the broad underlying

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principles. It is this development in the scope of the accountant's work to-day which makes it vitally important that we should be familiar, not only with the practice, but with the principles which govern.

In this phase of advisory accountancy it is most important to avoid the easy assumption of one of our pioneers that the principles of accountancy may all be determined by a priori reasoning and in no way depend upon the customs and tradition which surround the art, or, as expressed by another writer, that most accounting problems admit of being carried back to elementary first principles. Unquestionably, a keenly logical mind is a most useful part of an accountant's equipment, but the failure to realize that important parts of our practice depend upon custom, tradition and expediency, and do not yield to rigorous logic, has been responsible for serious error. To those who are required to give technical advice to lawyers and before the courts, a thorough knowledge is indispensable, not only as to the practice which rests upon broad general principles, but also as to the practice which embodies custom, tradition and expediency.

The accountant must be familiar both with the practice and with the fundamental logic underlying the theory of each accounting question. For in accounting as in law the science is in a constant state of flux, and there is a persistent struggle between logic and custom, or, to put it another way, between what was logical in the past and what has become logical in the present. It is common knowledge, even to the layman, that our legal precedents have, many of them, been handed down to us from the middle ages. At the time when these precedents were created they were based squarely on sound logic, but progress and changing conditions have rendered such precedents no longer in accord with strict logic. In many cases the old precedents have become so illogical that they have been whittled away or completely overturned. In other cases the Anglo-Saxon mind, such a stickler for precedent, has clung to and maintained the old rules in spite of the changed conditions which make the old rules illogical and obsolete.

A familiar illustration of the changing rules of law due to changed conditions and greater education of the masses, etc., is furnished by the decisions with regard to seals upon instruments.

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For many years seals were necessary on certain classes of instruments and they were void in the absence of a seal; and on the other hand once a seal was put upon an instrument it could not be attacked for lack of consideration. Both rules have been whittled away until to-day practically all instruments are binding even though no seal be affixed, and on the other hand they are generally open to attack no matter how many seals are affixed. Yet the effect given to the seal in the middle ages still lingers and produces odd results. A release under seal cannot be questioned and is binding without consideration; whereas if the seal be omitted a lack of consideration is a complete defense. So also the time within which an action may be brought on an instrument under seal is twenty years and the time within which such an action may be brought where the seal is omitted is only six years.

As the lawyer must recognize the deviations from the lines of logic caused by the forces of the past and must recognize the law as it actually exists and not as it should exist from a purely theoretical standpoint, so the accountant must recognize the potent influence of past custom and must follow rules that are not always logical, where those rules are well established and are generally observed.

I need mention only a few instances of this conflict between precedent and logic, so far as accounting practice is concerned, which an advisor must keep constantly in mind. The best illustration is the inventory valuation rule of "cost or market price, whichever is the lower." It is a rule which has a considerable vogue; it received the official endorsement of the London committee of consulting accountants in their report to the board of inland revenue; it was declared by that committee to rest on a sound principle and theory, and to be of universal application; it was adopted by the British board of inland revenue, and finally adopted by the internal revenue bureau in this country. Yet the rule is to-day indefensible from a purely theoretical standpoint, as many writers have pointed out; and both the British board and the internal revenue bureau now admit that it is not adapted to all cases.

Another illustration may be cited: the booking of capital losses arising from fire, shipwreck, default of capital investments, depletion of natural resources. Professor Hatfield has pointed out in his study of this subject that while it may be logical

to claim that all losses should go to profit and loss account, and not direct to some other proprietorship account, such a claim does not at all conform to accounting practice of any land or time.

Other illustrations will occur to those whose advisory work brings them in contact with contentious accounting questions, such as the rule under which fixed assets are retained in the accounts at cost and may not be subsequently revalued and the rule against booking interest on capital owned, as a manufacturing charge complementary to interest on borrowed money, and the rule against booking as a profit a saving of expenses such as vendor's profits taxes paid under contract by a purchaser of property. A variant of this latter rule arises in the private accounts of individuals, in the saving of 2 per cent income taxes on the interest from bond investments containing the so-called tax-free covenant clause. The tax bureau contends that logically this saving is in the nature of additional income to the individual; the bureau will hardly assert, however, that under accepted accounting practice such an item would be entered in the books of the individual as additional income.

In our younger days, before the immense development of commerce and industry, the main duties of the accountant in this country were said by one of our leaders to consist of the audits of the accounts of corporations, firms and individuals. His special skill conformed at that time to the stage of accounting practice then existing, and it related mainly to the best, the safest and the most economical methods of keeping the accounts and records and to presenting clearly and concisely the financial condition at a given date and the results of operation for a given period. The advice expected and required from us in those days was limited naturally by the condition of business and was confined in a great measure to technical methods, to improvement and standardization of accounts, to safeguards against waste and fraud, to economy and to the best means of conveying prompt and useful information to owners. The immense expansion of our commercial life gradually emphasized the importance of applied accounting and created a greater demand for competent advice of this kind. The advent of combinations, trusts, consolidations and holding companies and the evolution of corporate securities which this type of organization brought with it opened a new

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chapter in accounting science and raised a series of accounting questions of extraordinary complexity, which we alone could solve. The development of large scale production compelled us to close, analytic study of the phenomena of costs and the problems of cost accounting. The need for efficiency and economy in productive processes created a new demand upon our skill and advice. Finally, the initiation and subsequent expansion of federal and state supervision, control and regulation of public utilities and the tendency toward similar authority over important basic industries resulted in the formation of a multitude of commissions, wielding considerable powers and demanding a mass of statistical and accounting information as a basis for rate-making and price-fixing. As a result of these important changes and developments our duties and opportunities were immensely expanded, for our advice and coöperation were indispensable to the new situation and conditions.

It is evident that these increasing demands upon the profession required a more extensive knowledge and equipment and a higher standard of ability and skill than sufficed in the early days; but we have been equal to the demands and have met them fully. Necessity compelled us to closer study, required of us creative ingenuity and forced us to the solution of all the problems with which we were confronted. The rapid expansion of our experience and the greater call upon our skill involved our own education on a liberal scale. We have been brought into close contact with the affairs of business, of finance, of management and executive control, of trading, rate-making, buying, producing, transporting and marketing. Heretofore we had regarded such matters as somewhat outside our province, as matters upon which we were bound to consult with other business advisors having special skill in those directions. We had looked at them rather casually and incidentally, as their manifestations appeared in the accounts and records over which we worked. To-day it is recognized that our experience has brought with it that special skill and judgment which is required for the solution of important and practical business questions.

Many of us can testify from personal experience to the wide range of practical business questions upon which our advice is now sought by financiers, owners, creditors, even by executives

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and managers. The questions may relate to finance, such as an original investment or purchase or a subsequent acquirement of an interest or the financing of a contemplated expansion of the business or a temporary financing necessitated by growing inventories or the payment of cash or stock dividends. They may relate to questions of business policy, such as expansion of the enterprise, or embarking on new lines of trade or manufacture, acquisition of properties, volume of output and its relation to overhead expenses, cessation or curtailment of unprofitable lines, accumulation of inventories, work in process, or finished goods, the question of branches and departments and the policy of credits and discounts. They may relate to questions of management and administration, economical production, the prevention of waste, extravagance and useless expense, even questions of personnel. It is true that our early professional training does not incline towards a special skill in such practical business questions, but the modern growth of our service and opportunities has forced upon us a wide business experience, while our continual and close reading of the statistics of both successful and unsuccessful business enterprises has necessarily enlightened and informed us. It is this wide knowledge gained by experience and by our facility in reading, understanding and drawing correct conclusions from the business history of such enterprises which has caused our advice to be sought and valued upon practical business questions.

During the past three years the advisory functions of the public accountant have reached their highest stage as a result of huge taxes based upon profits, excess profits and invested capital. These factors of invested capital and profits are intimately related to what has been termed the "essence of accounting," namely the balance-sheet and the profit and loss account. These tax laws are so saturated with accounting concepts, principles and terminology that they are almost unintelligible to laymen and difficult of comprehension even by lawyers. The saturation may be illustrated by a recent dictum of the treasury to the effect that a certain phrase in the statute "incorporates into the law by reference the entire body of principles of accounting relative to the determination of surplus." Of course, such a dictum will not bear scrutiny; but, no matter whether we regard it as a rhetorical flourish or a flight of exuberant fancy or a phrase by means of which a con-



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tentious subject is dismissed, the dictum indicates the extent to which these tax laws are permeated with accounting ideas. They have required for their administration a mass of regulations and decisions still more impressed with accounting principles and practice and equally difficult of comprehension by the uninitiated.

The advisors responsible for the decisions upon which the administrative tax regulations are based were quite aware that accounting principles and practice involved many uncertainties, many disputed questions and many divergent usages and methods; and, as Professor Hatfield pointed out, "there is no ultimate arbiter to whom appeal can confidently be made." The exigencies of the situation, however, compelled these advisors to make decisions on these disputed questions, in order that administration of the laws might proceed. It was natural to expect that on close questions these decisions would be favorable to the government and equally natural that the taxpayer who was placed at a disadvantage by these decisions would question their validity. The disputed points involved incredibly large sums of money, and taxpayers in their extremity have been compelled to call upon us for advice and help to sustain the positions and theories upon which they relied. Our advice and assistance on these matters have been indispensable to the taxpayers and to the government during the past three years. In the near future, when many of these questions involving immense sums of money must be decided in the courts, our advice and assistance will be required and will be effective in proportion to the knowledge and skill which we bring to the discussion of the principles, customs, traditions, usages and methods which surround the art.

The larger part of the advice required from us in these income and profits tax matters deals with conditions arising from facts and business transactions of the past: situations the essentials of which no one can alter, but regarding which more than one interpretation and view may be possible and more than one treatment available. There is another class of tax advice, however, which is most important, and to which we may refer as anticipatory or precautionary: a warning for the unwary and incautious. In these days practically all substantial business transactions entail tax consequences, and the failure to foresee these consequences may be very costly. Whether it concerns the disposal

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of property of all kinds or the terms of its sale or the making of investments or the financing of a business, or the form under which property shall be held or business conducted or the liquidation of a business or the payment of dividends, we are forced to keep in mind that all roads lead to the tax collector's office. In these circumstances it is not sufficient to rely upon general or even special knowledge of the principles and practice of accountancy; nor even upon intimate knowledge of the anatomy of these tax measures and the infinity of administrative rules and regulations. In certain cases, particularly where unusual transactions are contemplated, something more than this equipment is required—and that is a measure of foresight as to the position which the tax bureau is likely to take and to which it is likely to adhere.

In these tax matters, most of the questions put before us involve accounting rules and practice which are well settled and are supported by general usage and custom and the weight of authority. On the other hand, many questions involving large sums are brought to us which hinge upon accounting uncertainties and accounting "rules competing for acceptance." There being no ultimate arbiter to whom appeal can confidently be made, the advisor is put upon his own resources and must rely upon acquired knowledge of all phases of the question and upon clear and skilful presentation of the issues. Under these conditions, the institute is playing an important part in opening the columns of *THE JOURNAL OF ACCOUNTANCY* to free and helpful discussion and in obtaining the views of specialists on accounting questions peculiar to various industries. It is filling the unavoidable gap in our accounting manuals and textbooks by dealing with the special problems of each industry. By such means, better than by any other, this institute exerts a real authority in accountancy matters, justly proportioned to its unique national position.