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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

JOHN L. CAREY, *Managing Editor*

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EDITORIAL

A Familiar Controversy

THE old subject of reproduction costs versus prudent investment is in the newspaper headlines again. Accountants, lawyers, economists, businessmen and other citizens whose direct interest is limited to paying monthly bills for utility services are all expected to have definite views about it.

A recent comment has been that this controversy resembles a football game. While the utility officials have always been on the opposite team from their opponents, the teams have frequently reversed their goal posts. When prices have fallen, the friends of the people say that consumers should no longer be compelled to pay rates which were based on an inflated price level; and when prices have risen, the same persons insist that the rate base should be the amount invested in the plant, and not what it would cost to reproduce it at the higher prices of the day.

The leading public-utility rate-case decision is commonly agreed to be that made in 1898 by the United States Supreme Court, usually cited as *Smyth v. Ames*. This was a railroad rate case. The court had before it the question as to whether or not rates prescribed by the statutes of one of the states were so low as to amount to such a confiscation of the property of the railroad as is forbidden by the due-process clause of the Federal Constitution.

The Supreme Court, always careful to see that the scales of justice are evenly balanced, stated that all the facts relevant to the question must be made available. It held that original

cost, cost of reproduction, market value of securities, and earning capacity, as well as any other factors pertinent to each particular case, should be considered.

In the late nineties of the last century the prices of commodities had reached the bottom of the long decline which came after the inflationary influence of the Civil War. Most of the construction of railroad properties had been done when prices were substantially higher. The outstanding railroad securities were representative of the high-cost property constructed from the proceeds of their sale. The financial officers of the railroads hoped, quite reasonably, to be able to collect rates for the transportation of passengers and freight which would provide revenue sufficient to pay reasonable dividends on the common stocks outstanding, and that was the burden of their contention before the Supreme Court. Their opponents thought that the costs of the property should be scaled down to a figure equal to the cost of reproducing the railroad in its condition at that time, at the price and wage levels then prevalent.

The court thought that evidence should be presented covering both viewpoints. That ruling has been controlling ever since. It seems to be a rule of reason and to be particularly desirable when the question presented is that of confiscation of property. It is well to have in mind that the Supreme Court's rule is not that cost of reproduction shall be used, or that original cost shall be used, but that both (and anything else that is pertinent) shall be considered.

There is much that may be said on both sides, and much has been said.

The cost of reproduction, or of replacement of the property by similar property in like condition, is what a prospective purchaser would desire to ascertain; it is what would be awarded if the property were to be taken under the right of eminent domain; it is what would be paid by an insurance company if insurable property were to be destroyed by fire.

In these days of thinking about all matters of value in relation to their places in the economic cycle, it may well be said, at a time when the measure of value (the dollar) has shrunk, that there should be, when occasion calls for it, a restatement of the values of public-utility properties, in terms of the shrunken dollar. This thought was recognized, and was stated very clearly,

in a United States court decision in a Consolidated Gas Company case of something over a dozen years ago, as follows:

“A profit based upon the enhanced value of the capital adds nothing to the company’s wealth. Though its capital be measured in more dollars and so, too, its profit, that profit is still paid in the fallen dollar and has not greater buying power than it had before. The increased valuation of the capital will for the years of the depreciated dollar leave the company exactly as it was; it will merely prevent its being compelled to share its putative fair profit with its customers, which by hypothesis it should not be asked to do. The company gains nothing, the customers lose nothing.”

On the other hand, much has been said favoring the use of investment cost as the rate base, chiefly on the grounds of its convenience. This seems clearly to be the reason behind the advocacy by Mr. Justice Brandeis of the prudent-investment method.

But as long as the total amount invested is subject to attrition by those who complain—(1) that property acquired somewhat in advance of the actual need therefor is not “used”; (2) that other property, which though in excellent working condition is less efficient than newer mechanisms would be, is not “useful”; and (3) that, in the opinion of the claimants, the investment was not “prudent”—it is quite clear that justice requires the courts to look on all sides when the question of the confiscation of private property is presented to them.

Practical men today will think of the question as largely academic. At the present time, few utility rates have much relationship to a rate base computed by either method. Most rate cases for many years have ended in compromises, in which the actual investment appeared to be the dominant influence. But fair-minded men will always wish to know what would be the cost to reproduce the property under discussion, so that the private owner thereof may be treated fairly, but no more than fairly, and that he may be able to maintain his proper position, not higher or lower than it should be, in the economic cycle.

Toward Higher Educational Standards

EVIDENCE that the accountancy profession is far from indifferent to educational problems is offered in concrete form by a resolution adopted at a meeting of the council of the American

Institute of Accountants on October 22nd. The resolution is reproduced in full in *The Certified Public Accountant* for November. In brief, its most important points are as follows:

First, a declaration of policy by the professional organization with respect to accountancy education is held desirable;

Second, high educational standards commensurate with those achieved in medicine and law are regarded as the goal of accountancy—specifically, a post-graduate technical course in accountancy, following a four-year liberal-arts course, is regarded as the ideal;

Third, the Institute approves of undergraduate collegiate courses designed to train students for the professional practice of accountancy, but believes that those courses should not be entirely technical—they should contain a liberal admixture of cultural subjects;

Fourth, the committee on education is asked to attempt to set up standards by which worthy courses in preparation for the practice of accountancy may be judged, and

Fifth, and perhaps most important of all, it is emphasized that, while the council favors a gradual increase in the educational standards for the certified-public-accountant certificate, it believes that the door should never be closed to the man who is unable to obtain a college education but is willing to serve a long apprenticeship.

The device suggested to give point to the last declaration would be a gradual increase in the experience requirement of candidates for the certified-public-accountant certificate who had not been graduated from approved collegiate courses.

It seems most important that, in their eagerness for higher professional standards, certified public accountants should not make it impossible or unreasonably difficult for men who have not had the benefit of college instruction to obtain the certified-public-accountant certificate. Such a step, which has been taken in New York (unfortunately, we cannot help believing) is bound to create grave problems. It is jumping to a higher standard of requirement even than that maintained by the older professions of law and medicine in most, if not all, states.

It seems to us obvious that the interests of the profession will be best served by attracting the most capable young men. Formal academic preparation for entrance into the profession should be

encouraged, but at the same time the way should be left open for the ambitious and able man who is willing to work hard and study privately, but finds it impossible to go to college.

No one should misunderstand the resolution of the Institute's council as an implication that the Institute hopes to assume a dictatorial position with respect to educational standards. It is eager to cooperate with the colleges and universities, to help them in their announced desire for indications of what practitioners think they should teach.

It may naturally be assumed that the Institute's committees on education will be composed both of experienced instructors in accounting and of experienced practitioners who have shown an interest in educational problems.

The result of the resolution and the new activities which it authorizes should be an acceleration of progress in accountancy education.

The Basis of Inventory in Quarterly Reports

THERE has been a rather sharp decline in prices of most commodities, and earnings of those industries in which inventory is an important factor undoubtedly have been or will be greatly affected. New emphasis should be given to the oft-repeated warning that investors examine carefully the basis upon which inventory is valued in financial statements—especially those issued quarterly.

Quarterly statements necessarily are a less accurate indication of the progress of an enterprise than are annual accounts. The influence of temporary or incidental conditions is unduly emphasized and this, together with the fact that adjustments resulting from physical inventories are not generally made until the close of the year, gives the quarterly statement a tentative and provisional character. In spite of this, quarterly statements should be prepared on the same basis and in accordance with the same general principles that are used in the annual accounts. For instance, if the company prepares its annual accounts on the basis of cost or market, whichever is lower, for inventories, then the same basis should be used in the quarterly statements. If any method other than that used in the annual accounts is used in the quarterly statements, the reader should be put on notice.

Competitive Bidding

THE unwholesome practice of competitive bidding for accounting engagements has not yet been entirely stamped out, despite the hearty wish of nearly all reputable practitioners. In Connecticut, however, patience has come to an end and the state society is determined to remove from the scene the last vestige of bidding. The following rule has been made a part of the by-laws:

“Competitive bidding is deemed to be detrimental to the interests of the public and the accounting profession. No member shall at any time knowingly, directly or indirectly, enter into bidding for any type of professional service whatsoever, in competition with other accountants. Competitive bidding is hereby defined as bidding for work in competition with other accountants on any basis.”

The Connecticut Society of Certified Public Accountants knows quite well that it has firmly gripped the horns of perhaps the most recalcitrant creature in the pastures of accountancy. With the adoption of this rule, the struggle has only begun. Attempted reforms often collapse before the problem of enforcement, but there is a realistic—one might almost say grim—attitude in the Connecticut society which in our opinion augurs well for the experiment.

The bidder in accounting, like the “chiseler” in business, is likely to corrupt his most well-intentioned colleagues. In self-defense sometimes they feel obliged to resort to the very practice they condemn. Disappointment, disgust and despair for professional ideals are frequently the outcome of the adventure. It is partly because of this contagious effect that scrupulous practitioners regard the bidder with angry scorn. In no time at all he can undo the patient work of years by those who seek to raise ethical standards.

There are several reasons for bidding. None is excusable, but perhaps the least reprehensible is the bid based on a desperate need for work. The accountant who must have work at any price, however, is not likely to be the one to whom the client would entrust his affairs. We may sympathize with the needy bidder. He is no great menace to the profession.

The truly menacing bidder is the competent and prosperous firm which occasionally cannot resist the temptation to cut a

fee, either to gain a new client, to secure an engagement which carries with it some prominence, or to keep the staff occupied through an idle period. Apparent temporary advantages confront the accountant who yields to temptation in those circumstances. The advantages are illusory, however, because the bidder as well as all his fellow practitioners will suffer from the tendency to depress the gross fees of the profession, invariably induced by competitive bidding.

It must not be imagined, however, that loss of income to accountants is the chief concern. Far more dangerous is the inescapable temptation to curtail the examination when the fee has been curtailed in advance. Bad work and all its ugly consequences are to be expected in the field where competitive bidding for professional services prevails.

The Connecticut society's action is decidedly in the public interest. Both clients and reputable practitioners may expect to profit by it.

Students' Department

IN THE September issue it was announced that THE JOURNAL OF ACCOUNTANCY had discontinued publication of the Institute's examination problems and of the Students' Department, in which unofficial solutions of those problems were presented from month to month. The decision to eliminate this material was made after a questionnaire had indicated that it was of interest to only a relatively small number of JOURNAL readers. Provision was made to publish the examination questions and answers periodically in pamphlet form. It was intimated then that, should the change fail of its purpose, the former practice might be resumed.

Since the Students' Department was discontinued, THE JOURNAL has received a continuous flow of protests from apparently devoted followers of the department. Some of these letters have been published in the Correspondence section. Not only students, but instructors and seasoned practitioners as well, have asked that the department be restored. The conclusion is unavoidable that THE JOURNAL, in publishing this material, was rendering a service upon which many had come to rely, a service for which there could be no satisfactory substitute. Accordingly, the editors frankly admit a mistake of judgment and reverse

their earlier decision. The Institute examination questions for November, 1937, appear in this issue, and the Students' Department will be resumed in the January issue. All material which would have been published during recent months, had the department continued without interruption, will be provided in pamphlet form as a supplement to the January issue.

It was never the intention of the publishers to reduce the amount of material of interest to students. It was felt, rather, that the pages hitherto used for the examination questions and answers might well be devoted to articles and other departments, no less useful to students as such, but interesting also to other JOURNAL readers. THE JOURNAL will continue its policy of presenting the best available articles and the most useful departmental material that can be devised. It recognizes that from the ranks of students will come the future members of the profession, and hopes that it will always have them among its readers.

The volume of timely and interesting material at hand has made it necessary to include in this issue 16 pages more than the 80 which have been the size of THE JOURNAL for many years. The number of pages will be permitted to vary from time to time. It is the policy of the editors to publish with the least possible delay the best of the many fine papers received, and if this cannot be done in 80 pages monthly, they will not hesitate to go beyond those limits.