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DEVELOPMENT OF ACCOUNTING PRINCIPLES IN THE UNITED STATES

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It is very difficult to decide what should be included in a paper of this kind to be presented to such a well informed audience. Very little can be said that has not already been put in writing. A comprehensive coverage of the subject is out of the question in the time available. Accordingly, only a few of what seem to be among the more significant events will be touched upon.

Accounting is a very young profession. Even double entry bookkeeping is only a few centuries old, and financial reporting is in its infancy.

For a great many years accounts in this country were kept for the primary, if not the exclusive, purposes of management. This was true in the United States long after the Companies Act in England required the recognition of the interests of investors in the financial reporting of companies in that country.

Widespread concern with respect to the significance of accounting principles, as such, began to evidence itself in the United States for the first time during the early 1930's, that period of time commonly referred to as "the depression". Many persons, rich and poor alike, had lost heavily as a result of the crash in the Stock Market in the autumn of 1929. They had bought corporate stocks at unreasonably high prices in relation to their issuer's earnings or future prospects. Many, if not most, of those small investors who could least afford the loss had bought, on small margins, shares in companies of which they knew absolutely nothing purely on the basis of rumors or tips from persons who knew no more than they themselves.

As an aftermath of the Stock Market debacle in the fall of 1929 many people became very much interested in learning its causes and what could prevent a re-occurrence. It was only natural that both the conduct of the stock exchanges and the financial reporting policies of the corporate issuers of listed securities came in for severe criticism. The results were serious self-appraisals by the accounting profession and the New

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York Stock Exchange, and passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The latter created the Securities and Exchange Commission. All of these were important influences affecting the development of accounting principles.

In starting our consideration of the development of accounting principles with these events of the early 1930's we must, in fairness, recognize that this was not the beginning of constructive thought in the field. Uniform systems of accounts by Federal and State regulatory authorities and the Federal and State income tax laws together with their interpretations had introduced concepts of accounting that were completely new to many companies. As early as April 1917 the American Institute of Accountants (now the American Institute of Certified Public Accountants) had, at the request of the Federal Trade Commission, prepared a "Memorandum on Balance Sheet Audits" which was published by the Federal Reserve Board under the title "Uniform Accounting" for the use of companies seeking bank loans. Also there was a considerable increase in accounting literature during the 1920's. Nevertheless, the first concerted, serious action toward the development of accounting principles took place in the early 1930's.

The New York Stock Exchange, in its efforts to improve the reporting of many of the companies whose securities were listed with it, sought the help of corporate officials, the Controllers Institute and the American Institute of Accountants. The American Institute appointed a special committee to cooperate with the Exchange. Meetings were held and correspondence conducted between this Special Committee and representatives of the Stock Exchange from 1932 through 1934. The release of this correspondence in 1934 as an Institute pamphlet under the title "Audits of Corporate Accounts" is generally recognized as the first milestone on the long road in the development of accounting principles.

This special committee was made up of well qualified and highly respected members of six leading accounting firms. Furthermore, a committee of the Controllers Institute gave its approval to the conclusion reached between the accountants and the Stock Exchange. With these powerful forces behind the final recommendations they carried far more weight than any previous statement that had ever been made on accounting matters.

In addition to stating five principles of accounting which were immediately accepted by all concerned, the correspondence laid great stress on the necessity for disclosure of the accounting methods employed and consistency in their application from year to year. Also, it is interesting to note that the committee, in considering the type of audit report to be furnished with financial statements submitted to the Exchange, recommended for the first time that auditors state whether the accounts

were presented in accordance with "accepted principles of accounting". This was the forerunner of our now standard phrase "Generally Accepted Accounting Principles".

It was also the Committee's idea that each listed company should be required to prepare and file with the Exchange a statement of its methods of accounting and reporting which would be accompanied by an agreement that if any material change was made the Exchange and its stockholders would be fully informed. This provision was never put fully into effect, however, probably due to the fact that not long afterwards the SEC came into being and required all listed companies to disclose in their registration statements the accounting methods they followed with respect to certain matters which the Commission deemed important. Since registration statements were open to public scrutiny and copies had to be filed with the Exchange the aims of the correspondence in this respect were actually accomplished.

The next important steps in the development of accounting principles, and probably the most important ones of all, were the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 Act was first placed under the jurisdiction of the Federal Trade Commission but fear of the penalties prescribed by the Act together with the sluggishness of the investment market resulted in few offerings being made. Since few registration statements were filed and the Securities Division was only one of the responsibilities of that Commission, little was done under the Act during its first year except to recruit and organize a small staff and familiarize it with the provisions of the law.

With the passage of the Securities Exchange Act of 1934 in the late summer of that year, however, things began to happen. The Securities and Exchange Commission, created by that Act, was given regulatory authority over all National Securities Exchanges. The administration of the 1933 Act and the staff of the Trade Commission's Securities Division were transferred to it and all companies wishing to have their securities listed on any national securities exchange were required to have them effectively registered with it not later than July 1, 1935.

Major emphasis was given in both Acts to the importance of financial statements to be filed with the Commission by every company wishing to have its securities listed on a national securities exchange and by most companies wishing to sell securities in interstate commerce or through the mails. Accordingly, the new Commission, as an important part of its early activities, quickly took steps to recruit an accounting staff and to develop forms and regulations governing the filing of financial statements and other financial data.

Fortunately, due to the freedom from Civil Service restraints, the

determination of the Commissioners, particularly its chairman, to resist the pressures of politicians to hire their favorites, the depressed business conditions that made high grade accountants available, and the challenge which the administration of the laws offered, it was possible to employ a well trained, high grade staff of accountants rather quickly.

In addition to recruiting permanent staff the Commission called upon and accepted offers by prominent members of the accounting profession, teachers, financial analysts and investment bankers to help in developing the forms and regulations that would provide the kind of financial data that would be most useful to investors and prospective investors in whose interests the laws had been passed.

As a result, most of the forms and regulations were completed and available to prospective registrants by the beginning of 1935. During the first six months of that year probably more questions on accounting matters were raised and resolved, rightly or wrongly, than ever before or since in a like period of time. Over twenty-five hundred companies whose securities were listed on one or more of the twenty national securities exchanges filed registration statements which had to be examined and questions raised and answered regarding them. Furthermore, as the result of a relaxing of fears of liability and an increasing market for securities, many more companies filed registration statements under the 1933 Act during that time than had previously been filed. Every registration statement contained Income and Surplus statements for at least three years and one or more balance sheets, all in greater detail than most companies had ever previously issued, and each was accompanied by a substantial amount of supporting financial data. Never before had so much information regarding the accounting principles, methods and procedures of business concerns been made known as that which became public during the first six months of 1935.

Since this information was available for public inspection and copies could be obtained by anyone for ten cents a page, financial analysts, investment bankers, brokerage houses, rating agencies, financial writers and a host of others were soon studying, comparing, criticising and commenting on what these registration statements disclosed. For the first time it was possible to know of the many areas of differences that actually existed among the accounting practices followed by well known business enterprises. These differences soon became the subject of discussion, criticism, defense and analysis. From these sprang much of the impetus for the consideration that has been given to the subject of accounting principles in the years that have intervened.

Mention should be made of the fact that in 1935 the American Association of University Instructors in Accounting changed its name to the American Accounting Association, opened its membership to anyone

interested in accounting and broadened its objectives to include the development of accounting principles and standards.

The merger of the American Society of Certified Public Accountants with the American Institute of Accountants under the latter's name in 1936 was also important. It brought all of the leading practitioners into one national body. This made possible the heavy impact which subsequent activities of the Institute have had on the development of accounting principles.

During the year 1936, about a year after the disclosures through the SEC filings, two documents were published which were designed to bring some order out of the chaos. One was a statement prepared by a committee of the American Institute of Accountants and published by it under the title "Examination of Financial Statements by Independent Public Accountants". Although primarily designed to help the auditor in his selection of auditing procedures, it also dealt with some accounting principles. The other was a statement prepared by the Executive Committee of the American Accounting Association and published by it under the title "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements". This statement was designed to afford a broad base of principles which would function as guides in the selection of procedures to be followed in preparing corporate reports. The Institute's pamphlet was viewed primarily as a helpful audit manual by most practicing accountants, particularly the neophytes. The Association's statement did not create much interest among practicing accountants at the time. However, it was widely studied in academic circles and the extent to which it and its numerous revisions were used by textbook writers and classroom teachers has undoubtedly had a substantial effect on practice as students who studied them became influential practitioners.

During the latter part of 1936, 1937 and the early part of 1938 an increasingly heated controversy was taking place within the Securities and Exchange Commission among the commissioners themselves. Two of the commissioners, both lawyers, were of the opinion that the Commission itself should promulgate a set of Accounting Principles that would have to be followed by all companies required to file financial statements with the Commission. The others were either strongly opposed to that procedure or were not convinced that it was desirable. The then Chief Accountant was very much opposed to the proposal. He argued that the development of accounting principles and the elimination of the areas of differences should be left to the accounting profession, whose members dealt so intimately with the problems in their day to day practice, and that the Commission should cooperate.

During these internal discussions the Chief Accountant took the

opportunity, during the fifteenth anniversary meeting of the American Institute of Accountants in the fall of 1937, to make it clear to the members that unless the profession took steps to reduce the areas of differences in accounting practices the Commission would.

In April of 1938 the Commission decided to give the profession a chance to lead the way and issued a statement of its administrative policy in the form of Accounting Series Release No. 4 issued on April 25, 1938. This statement read as follows:

“In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.”

Thus the Commission reserved the right to decide whether a particular accounting principle had “substantial authoritative support” and also to take a position rejecting any principle even though it had substantial authoritative support by issuance of a rule or regulation or an opinion by its Chief Accountant. On the other hand it agreed to accept statements in which the accounting principles had substantial authoritative support unless it or its Chief Accountant had previously taken a contrary position. This gave companies and their auditors a workable basis on which to prepare financial statements for filing with the Commission. It also opened the way by which any recommendations by the organized profession could be given recognition by the Commission as having “substantial authoritative support”.

In 1938 the American Institute of Accountants published for distribution to its members and others interested in accounting a report that had been made to the Haskins & Sells Foundation by two Professors of Accounting and a Professor of Law. This report, entitled “A Statement of Accounting Principles”, was developed by these three distinguished educators at the request of the Haskins & Sells Foundation and was financed by it. In its letter of July 15, 1935 to the chairman of the group,

the Foundation stated that it wished an independent and impartial study of the subject of accounting principles in the hope "that there may be established a body of principles which will become useful in unifying thought and which by its acceptance will serve to standardize accounting practices."

Without detracting from the great amount of work that went into the study and the comprehensive picture of what the accounting practices were, it must be said that the report did little, if anything, to narrow the areas of differences. However, anyone who read it could not fail to be impressed with the wide variety of procedures that were being followed in accounting for similar transactions and in that way undoubtedly it helped to point up the need for doing something to standardize practices.

About this time representatives of a number of the larger firms that had substantial numbers of clients registered with the SEC got together with a view to meeting the challenge of the Commission. Their idea was to see whether they could agree on a statement of principles which they would all follow. These they believed would be accepted as having "substantial authoritative support" and, because of the many companies upon whose statements these firms reported, would become the accepted principles.

As was to be expected, the persons who were in this small informal group were also active in the affairs of the American Institute. After concluding that it was desirable to work cooperatively in the development of accounting principles, it was a short step to the idea that any recommendations that might be developed in that way would carry a great deal more weight if the group were larger and were organized as a committee of the Institute. Recognizing the limited budget of the Institute, each of the firms agreed to contribute equally to a fund sufficient to finance the work of such a committee for several years. A discussion of the idea with officials of the Institute brought an immediately favorable reaction. Accordingly, a small existing three-man Special Committee on Accounting Procedure was used to recommend to Council that the committee be enlarged and given authority to issue statements on matters of accounting principles. The recommendation was approved and in the fall of 1938 a wholly new Committee on Accounting Procedure was created composed of twenty-one leading members, including the original cooperators.

The first meeting of the newly formed committee was largely taken up with a discussion of the best way to proceed. At first it was thought that a comprehensive statement of accounting principles should be developed which would serve as a guide to the solution of the practical problems of day to day practice. It was recognized that for such a state-

ment to be of much help to the practitioner it would have to be much more comprehensive and in far greater detail than the "Tentative Statement" of the American Accounting Association issued two years previously.

After extended discussion it was agreed that the preparation of such a statement might take as long as five years. In view of the need to begin to reduce the areas of differences in accounting procedures before the SEC lost patience and began to make its own rules on such matters, it was concluded that the committee could not possibly wait for the development of such a broad statement of principles. Instead it concluded that it should set to work as quickly as possible to resolve some of the more pressing controversial matters that were responsible for the criticisms leveled at financial reporting and for the concern of the SEC. This decision was described by members of the Committee as "a decision to put out the brush fires before they created a conflagration."

At that same meeting the committee authorized the employment of a Director of Research to develop information for the committee and to assist in the preparation of such pronouncements as it might decide to make. The first appointee to that position was a university professor who was to spend one half of his time on the work of the committee.

The Accounting Research Bulletins that were issued by the Committee on Accounting Procedure with the help of the three men who functioned as Directors of Research and members of their staffs during the years of the Committee's existence from 1938 to August 31, 1959 are so well known to members and students of our profession that no discussion of them will be included in this paper. However, their influence on the development of accounting principles has been one of the major factors in the improvement in accounting practices and in maintaining the authoritative position of the profession.

Because the Commission has refrained from exercising its statutory authority to make rules and regulations governing a broad area of accounting principles in favor of letting the profession lead the way, it must not be assumed that it has taken no part in the development of accounting principles or in the narrowing of areas of differences.

Both the Accounting Procedure Committee and the Accounting Principles Board have been very careful to keep in close touch with the Chief Accountant of the SEC. He has been kept informed as to the subjects under consideration and the progress being made on each. He has been furnished with copies of drafts of proposed Bulletins and Opinions and his comments and criticisms have been invited and received. Efforts have always been made to secure his agreement which were usually successful. When he did not agree his reasons were always given careful consideration. In most cases any differences were resolved by frank

discussions of the arguments pro and con. On at least one occasion a subject was dropped from the agenda of the Committee because the arguments advanced by the Chief Accountant convinced members of the Committee that it would be unwise to proceed at the time.

On the other hand, there have been cases in which the Committee proceeded to issue a Bulletin even though the Commission had unresolved objections to the position taken in it.

The Commission has undoubtedly been a force in spurring the Institute on to covering more subjects more quickly than it otherwise would have done. From time to time members of the Commission or its Chief Accountant have needled the Committee and the Board into accelerating their activities by pointing out that the Commission has a statutory responsibility in this area and will have to exercise its authority if the profession does not make satisfactory progress. In my opinion this has been very salutary and we should be very appreciative of the fact that the Commission has both recognized the qualifications of the profession to take on the task and has prodded it into action that otherwise might have been too long delayed.

Because both the 1933 and 1934 Acts placed a great deal of emphasis on disclosure the Commission did not hesitate to move quickly into that area. There is a general belief that principles of disclosure are accounting principles. Whether that is so or not the SEC did not stand back in that area even though it did defer to the profession on the matter of accounting principles generally.

The very first forms and regulations that the newly formed Commission promulgated required the disclosure of information that had always been considered confidential by many managements. The one that caused the loudest and most angry protest was the requirement that the income statements disclose sales and cost of goods sold. Approximately twenty-five hundred companies had to file registration statements and have them accepted before July 1, 1935 (extended to July 15) or their securities would have been delisted. Of these, over six hundred at first refused to include sales and cost of sales data in the public file. It was filed confidentially under a rule of the Commission that information harmful to the company might be so handled unless and until the Commission made a finding that the company's reasons did not justify withholding the facts from the public. After notice of such a finding, the company had ten days in which to withdraw its registration, as a result of which its securities would be delisted.

Hearings were granted to a substantial number of these companies. After considering all the arguments presented (and there were few new ones after the first few cases) and after hearing extended testimony from security analysts, investment bankers and other users of financial state-

ments as to why the information was necessary, the Commission notified all of the companies affected that the information was necessary for a fair presentation and that this need overcame any arguments that had been advanced against it.

On one matter which everyone recognizes as an accounting principle the SEC took a stand from the very beginning. Because it established its position so early we often overlook the fact that in that area the Commission never gave the profession a chance to even consider the matter insofar as registrants are concerned. I refer to the basis for accounting for assets. As far as I know there have only been two exceptions to the principle that assets must never be accounted for at more than their cost, and they were very special types of situations.

As most of you know, it was common practice in the 1920's for companies to write-up their assets, particularly land, buildings, machinery and equipment. While accountants often encountered situations in which such restated values were based on very questionable appraisals or no appraisals at all, they had usually gone along on the assumption that this was a responsibility of management and required only disclosure on their part. They even accepted the practice of charging income with only the depreciation on cost and amortizing the amount of the write-up of depreciable assets by charges to the appraisal surplus.

One of the first members of the newly formed SEC to be appointed was a former General Counsel for the Federal Trade Commission who had been in charge of that Commission's very comprehensive investigation of the public utility holding companies. During that study the flagrant write-up policies of the holding companies and their subsidiaries and the havoc they caused when the crash came in 1929 and 1930 kept impressing themselves on the chief investigator to the point that their evil became almost an obsession with him. It was only logical to expect that when he had an opportunity to outlaw write-ups he would do so. So strong were his convictions and so convincing were his arguments against write-ups that all of the other members of the Commission were persuaded to take a positive stand against them from the very first case in which the question arose.

It is interesting to note that, although many corporate officers argued vehemently in favor of recognizing unrealized appreciation in their cases, very few accountants gave more than half-hearted support until nearly fifteen years later after the question of accounting for price-level changes began to intrigue some prominent members of the profession in both the practicing and academic fields. Suffice it to say, however, that the Commission has never appeared to waver. In 1950, at the suggestion of the Committee on Accounting Procedure, the Institute's Director of Research and the SEC's Chief Accountant attempted to

work out some criteria setting forth conditions under which assets might be restated upward. When they had reached agreement the proposals were submitted to the Committee and to the Commission. However, they were unacceptable to both, so the matter was dropped.

Although the Committee on Accounting Procedure decided at its inception that it should turn its attention to current problems of pressing importance, it never gave up the idea that it would be desirable to develop a comprehensive statement of accounting principles sufficiently detailed to be a real guide to the practitioner in the settlement of his day to day problems. In 1949 the Committee decided to undertake to prepare such a statement. A subcommittee was appointed and a considerable amount of work was done by it and members of the staff with that in view. However, the results of these efforts were highly unsatisfactory to everyone concerned and the work was ultimately abandoned in favor of a revision and restatement of the bulletins that had previously been issued. This was completed and published in 1953 as Accounting Research Bulletin No. 43.

However, agitation for a codification or comprehensive statement of accounting principles continued with increased force. In addition, rumblings were heard from various sources that other organizations of accountants should participate in the development of accounting principles besides the Institute. Those most often named were the Controllars Institute (now the Financial Executives Institute), the American Accounting Association and the Federal Government.

In the fall of 1957 the incoming president of the American Institute, in his inaugural address, reviewed the progress that had been made toward the development of accounting principles and the narrowing of areas of differences and proposed that the Institute undertake to restudy the research program. Subsequently he appointed a committee known as the "Special Committee on Research Program." In the appointment of that committee the president took into account the agitation for recognition of the other accounting organizations and appointed to the committee the then Chief Accountant of the SEC, the immediate past-president of the Controllars Institute and the immediate past-president of the American Accounting Association. It was this committee's recommendations which were adopted by the Council of the Institute and brought into being the Accounting Principles Board and the Accounting Research Department as they exist today. It was the unanimous opinion of this committee that no other organization should be in a position to veto any proposed statements by the Accounting Principles Board. However, it was its recommendation that other accounting organizations should be kept in close touch with the work and should be given every opportunity to present their views on matters under consideration.

Since the creation of the Board in 1959 at least three members have always been presidents or financial vice-presidents of prominent corporations, three have been well recognized professors of accounting in universities and for a while the Comptroller-General of the United States represented the Federal Government. Since the Comptroller-General is the only accountant in the Federal Government who has the final say with respect to accounting matters in his department and cannot be overruled by a board, commission or cabinet member, no other government representative was selected when he resigned from the Board. However, in this way representatives of the other organizations primarily interested in accounting principles have a voice in the action of the Board. In addition, committees of the American Accounting Association and the Financial Executives Institute and the staff members of the Securities and Exchange Commission along with other interested persons are kept informed on matters under consideration and their views are sought on proposed opinions of the Board before they are issued.

There are those who seem to believe that very little progress has been made towards the development of accounting principles and the narrowing of areas of differences in the principles followed in practice.

It is difficult for me to see how anyone who has knowledge of accounting as it was practiced during the first quarter of this century and how it is practiced today can fail to recognize the tremendous advances that have taken place in the art.

Accounting is an art and not a science. Its principles are not natural laws but rules developed by man to meet the needs of the business community. Accounting evolves as the needs of business evolve. Just as our civil and criminal laws have evolved through trial and error on the part of legislatures and courts, so our principles of accounting have evolved and will continue to evolve. During the past thirty-five years there has been no standing still. Companies were faced with new problems they had to solve, and professional accountants have had to make decisions with no precedents to follow.

It has been my privilege to have watched and participated in a great many meetings in which well-informed men, determined to find the right answer, have honestly struggled long and hard through thousands of man hours to reach sound decisions on matters of accounting principles. In fields of social science, such as accounting and law, honest men often differ radically as to what is best. Basic differences in philosophy motivate people, yet each may be as honest and objective in his approach as another.

Lawyers and judges often differ widely as to the proper decisions under identical circumstances, and in spite of the centuries behind it law still has many, many unsettled areas.

It is very doubtful whether any way can be developed by which, on a comparable basis, changes in accounting principles can be made to meet changes in business or can be developed to meet new situations before companies are required to account for them. It has been suggested that some body might be set up to which new problems might be submitted for solution in advance of the time when they would have to be reflected in financial statements. Whether this would be good for accounting or whether periods of experimentation are desirable before a particular principle is decided upon to the exclusion of others is a serious question, the answer to which is far from clear. Furthermore, new problems often have to be dealt with before there is time for any authoritative body to consider the matter.

Some have advocated that the United States Securities and Exchange Commission should determine which accounting principle or method would be acceptable for particular types of transactions. Others have suggested that a new governmental body be created which would have jurisdiction over the accounting principles to be followed by all companies doing business in interstate commerce. Others have advocated the creation of a Federal Accounting Court which would have authority to settle all accounting matters.

In my opinion, it is not desirable to have a governmental body lay down rules governing accounting principles to be followed by companies of all kinds. It is doubtful whether the staff of any governmental agency could have the breadth of experience which would be needed to prepare such a statement of principles. Only a widely diversified group including certified public accountants of broad experience would have the knowledge necessary to make such a statement of principles that would be practical. Furthermore, rules by governmental bodies have a tendency to become solidified and it is questionable whether there would be sufficient flexibility in such a body to meet the changing needs of business.

So far as an Accounting Court is concerned, it could act only after there was controversy with respect to an accounting principle and could act then only after formal court procedures which would likely take considerable time. Its decisions would most likely be based on the facts in particular cases and would probably not be sufficiently broad in scope to be of a great deal of help until a very large number of cases had been resolved.

It is quite apparent that the need for greater comparability of financial reports has become quite widely accepted in both financial and governmental circles. The question then arises as to how this is to be brought about if we are to avoid having accounting principles dictated by governmental fiat.

In a few of its bulletins the Committee on Accounting Procedure

spelled out criteria that should govern the determination of the principles to be applied under transactions which superficially appeared the same but differed in fact. The treatment of long term leases and of business combinations are examples. The Accounting Principles Board has used this method also.

However, in these and in many other opinions the Institute's position has not always been stated clearly and concisely, in terms that left no room for quibbling. Sometimes this has been due to differences among members of a committee which forced compromise and equivocation in order to obtain the two-thirds majority necessary to issue any statement. Sometimes the entire committee thought the time was not ripe to go as far as it would have liked to go. Sometimes it was thought that a contrary position was so well established that a recommendation that it be considered unacceptable might result in the whole bulletin being rejected.

Undoubtedly this lack of clarity and positiveness has been responsible for much of any lack of adherence to the bulletins that there has been. It has seemed to me that in those cases in which the Institute's position has been stated in unmistakably clear and positive terms its opinions usually have been followed almost immediately.

There is evidence that the Accounting Principles Board will act more promptly and positively than it or its predecessor has in the past. It is very important, in the interests of better financial reporting and of the well being of the profession, that accountants who find themselves out of sympathy with the recommendations of the Board will nevertheless get behind them and give them a fair trial. If this is done I firmly believe it will produce far better results than rules by governmental fiat. Moreover, it would leave the way open for further evolution of accounting principles by those most qualified by their day to day activities, their training and their experience to do it.

In conclusion, it is my opinion that true comparability in the accounting principles followed by different companies in the presentation of their financial reports is desirable. For the application of principles to particular facts, criteria requiring intelligent, professional judgment should be established as guides to getting true comparability. Such criteria and the principles to which they relate should be established by a highly qualified group of experienced accountants selected by the accounting profession and not by the government. The profession should accept such leadership and put its recommendations into effect. Governmental bodies should support its recommendations. Such a body should be flexible enough to recognize the need for change or for new principles and their application, and to act as promptly as sound judgment will permit.

DISCUSSION BY CARL DEVINE *

The task of offering meaningful comments on this paper is difficult indeed. Mr. Blough was deeply involved emotionally and intellectually in the making of important financial history while most of us were only observers from distant ivory towers. Nevertheless, there are advantages to be gained from detachment, and some of them are illustrated here. Mr. Blough has given us a useful chronicle of events, but apparently he was too deeply immersed in details of the situation to give us an integrated history, i.e., a system of related events with explanations in terms of probable antecedents and consequences.

The S.E.C. was established in a time of wild social turmoil. The traditional rights associated with private property and the place of government in western civilization were being re-examined and rapidly modified. Sit-down strikes and similar techniques became accepted as more or less legitimate invasions of traditional ownership rights. Berle, Means, and others were deeply concerned with the imbalance of managerial power and managerial responsibility. Strachy, Burnham, and others with sensitivity to power structures saw the rising managerial elite as a threat to both traditional enterprise and idealized socialist institutions.¹ The general public, caught in the harshest kind of depression and disoriented by charges of business imperialism and war profiteering, was no longer sympathetic to aggressive business methods and tended to use businessmen as convenient scapegoats for existing economic ills. The fantastic decline in security values wiped out numerous amateur investors, and, like so many other human beings, they were reluctant to accept responsibility for their own unfortunate experiences. The accounting profession was a related suspect group, vulnerable and close at hand.

All professions have leaders who act as antennae for sensing changes in their social functions.² An important question is whether leaders of

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¹ John Strachy, *The Coming Struggle for Power*, (New York, Modern Library, Inc., 1935). James Burnham, *The Managerial Revolution*, (New York, The John Day Co., 1941). The Berle and Means thesis is set forth in *The Modern Corporation and Private Property*, (New York, The Macmillan Co., 1933).

² A profession consists of a group of persons with similar orientations, attitudes, and perceptions of their duties and responsibilities. Dr. Scott felt that the relatively less institutionalized field of statistics would have to provide flexibility that was already lacking in the accounting profession. *The Cultural Significance of Accounts*, (Republished 1965 by Lucas Publishers, Columbia, Missouri). Originally published by Henry Holt in 1931.

the accounting profession were alert to the need for a drastic reorientation before social legislation was considered to be necessary. If so, did they lack adequate influence to insist that necessary changes be made? The general impression from reading Mr. Blough's paper is that professional leaders either failed to interpret the changed environment or were sluggish in reacting to it, but it would be interesting to have Mr. Blough's explicit appraisal of professional leadership in this respect. The Commission's own leadership was less reluctant to define its role and outline its policy.

The Commission's *strategy* has been directed to bringing about an improvement in stewardship reporting, and the desirability of improving the relative position of outsiders has apparently not been questioned. The problem is a continuing one. Many present-day accountants may be surprised at early reluctance to disclose sales and cost of sales, but the problem continues today in the form of reluctance to disclose profits by lines and divisions. Most economists agree that more adequate disclosure in this direction should improve the allocation of resources, and the Commission has held tenaciously to this view.³

An urgent need for *guidelines* and *directives* to implement the Commission's strategy could not be avoided. Mr. Blough's paper discusses "principles," and we turn now to a discussion of this area. Of special interest to students of accounting is the implied support for the contention that principles function as imperatives, and that the terms are synonymous, i.e., that (disregarding possible differences in operating detail) principles are policy directives not significantly different from rules, regulations and other types of imperatives.

It is unfortunate that in general usage the term "principles" has often taken on mystical overtones. Many definitions refer to some "basic fundamental source." These source-directed definitions may represent devices at the semantic level for gaining legitimacy and support for the directives in question. Identification with "first," "basic," "fundamental," "duty," and even "ethical" may mean that the term will have more coercive power and be transgressed with greater reluctance.

For the Commission both legitimacy and sanctions were furnished directly and unmistakably by legislative action, and there was little need to adopt special honorific titles. (Historians may be appalled with Mr. Blough's authority and pleased with his restraint in using it.) The

³ it is only recently that the desirability of adopting disclosure as a ruling strategy has been seriously questioned. It is suggested that the right of insiders to withhold information (along with patents and other monopolistic grants) sweeten possible returns and encourage "entrepreneurship." The contention of Mr. Manne that such secrecy will improve the "market" and the allocation of resources is not only contrary to the policies of the Commission but is clearly an unwarranted conclusion. Henry G. Manne, *Insider Trading and the Stock Market* (New York: The Free Press, 1966), especially Chapter 4.

Commission considered participation from the profession to be desirable and was in harmony with the managerial philosophy that insists on budget participation by all parties affected. Certainly, if participation could be arranged and "principles" could be established, the overt governmental coercion might be less obvious and more acceptable.⁴

The practical effort to build and support the enunciated principles took the specific form of looking for (and weighing) authoritative opinion. The Commission itself judged the existence or non-existence of authoritative support and, if necessary, also decided which one among contending doctrines was most authoritative. Regardless of how well the process of judging evidence and authority is actually performed, there is still some doubt as to the usefulness of the doctrine of authoritative support. Whitehead once pointed out that the use of the similar doctrine of "common sense" makes the criterion of acceptance the similarity of the new concept to existing concepts and therefore tends to inhibit progress and perpetuate the *status quo*.⁵ An administrative tribunal, dedicated to inducing change, can hardly be expected to rely heavily on existing authoritative opinion! Of course, even in times of sharp social change, the heritage from the past is never completely abandoned and is usually modified with caution. As opposed to the butcher-knife approach, appeal to authority may foster orderly transitions and reduce tendencies toward caprice. (Consider the doctrine of *stare decises*.) However, the advantages of relying on authority probably peak out rather quickly by inhibiting adaptability, and unfortunately there is little indication of attempts by the Commission to determine optimal or even acceptable transition rates.

Mr. Blough has also been a strong supporter of the attitude that the "area of differences" in accounting should be narrowed. This expression has become popular with the profession as well as with the Commission. This view may be interpreted in many ways, but most of the interpretations are simply inadequate for this explosive era in communication techniques.

The most obvious interpretation is that the output of accounting systems should lead to more comparability of some kind. Comparisons—to assert a triviality—are made by people. People, in turn, are armed with attitudes, special orientations and various behavioral sets. It is

⁴One might ponder the probable result if the Commission had constructed and enforced rules that were entirely capricious. Opposition could be expected, and to the extent that the rules themselves were not modified a supplementary service activity might have arisen to fill the needs. The rise of managerial accounting, operations research, and managerial economics may be existing examples in a broader context.

⁵Alfred N. Whitehead, *An Introduction to Mathematics* (New York: Oxford University Press, 1948). "Now in creative thought common sense is a bad master. . . . it can only act by suppressing originality." p. 116.

usually assumed that these attitudes may be changed (that people—even analysts—are educable), and determining the proper mix of long-run influence and short-run processing rules is an important part of the problem.

As a rule, the wider the classes, the fewer the necessary principles (guidelines). With wider classes, fuzzy areas that initially require careful discrimination are fewer, and the diverse inputs are more highly abstracted. Notice that broad classes and wide grids will “narrow the differences” in processing rules but will lead to a coarse-grained output, i.e., less information content with a higher level of abstraction. Thus users must make discriminations from statements that are more “comparable” at a cost of less information content, i.e., the number of required principles is reduced at a sacrifice of less specific output.

The meaning of “narrowing difference” may relate to removing confusion and overlap in classes or to reducing the number of permissible processing rules. Clearly, the optimum number of alternatives must be based on both the diversity of input data and the diversity of objectives. To complicate matters, not only are objectives diverse but the attitudes of individuals who connect reported data and objectives are far from uniform. One concludes that the leaders of the profession and the Commission oversimplify the problem.

It is now clear that the Commission might have started its work with an investigation of objectives and the prevailing attitudes of investors. This process might then have associated changes in attitudes with changes in measuring and reporting techniques. With such information the Commission might have been in a better position to influence the activities of the accounting profession more constructively through appropriate educational programs and operating guidelines.

For a final area of criticism we turn to Mr. Blough’s assertion that accounting is an art and not a science. This statement is common in accounting literature, but what does such a statement mean? Such references to “art” may indicate inability to find explanations and proofs that are convincing in a society oriented toward science. Scientific assertions concern antecedents and predicted consequences with supporting evidence that can be shared. Art, then, might refer to actions and thought processes that are not shareable or replicatable. Apparently what is meant is that the effectiveness of an “artistic” performance can be appraised, but the effectiveness is not the predictable result of communicable actions.

This distinction can be expanded in terms of the confidence one has in his antecedent-consequence relationships. If the consequences can be determined to follow and be predicted within specified limits, the operation may be termed “scientific.” If the distribution of consequences

is so diverse (flat) that the outcomes are more or less random, the one who selects and manipulates effective inputs may be said to be practicing art (or perhaps “managing” costs). Under either interpretation, those who attempt to teach accounting or to set up rules for the practice of its art are in deep trouble. Is the process of sizing up objectives and designing feasible processing rules actually so imprecise and non-communicable? Perhaps what is meant by the art-science classification is that all useful knowledge is science and the shifting, but ever-present, area of ignorance is art. But if the area of ignorance is art, how do we learn (and teach) aspects that are relevant to it? Mr. Blough’s assertion may serve as a stimulus to such an inquiry, and hopefully his “narrowing of differences” will require less artistic judgment and increase our predictive power.

We must regard Mr. Blough’s paper as an interesting and extremely useful chronicle of some specific events and struggles of the early years of the Commission. Yet most readers—like this reviewer—will probably feel vague to keen disappointment. There is little attempt to search for integrating hypotheses, causative relationships, and behavioral explanations. From the record here, one is forced to conclude that the work of the Commission itself was restricted in a similar sense. The early attitude emerges as a combination of high resolution to aid investors through improved reports, a willingness to cooperate in a hard-nosed way with accountants and managers, and the required determination and necessary industry to contain a fantastic number of brush fires. Mr. Blough deserves the gratitude and respect of the profession for competent, effective leadership in these areas.

DISCUSSION BY STEPHEN A. ZEFF *

The paper presented by Carman G. Blough, "Development of Accounting Principles in the United States," deals with three interrelated subjects:

- I. Development of the Administrative Process by which Accounting Principles are Authoritatively Determined.
- II. Development of a Series of Authoritative Expressions of Accounting Principles.
- III. Development of a Foundation from which Accounting Principles may be Derived.

Mr. Blough seems to use the term "accounting principles" in the sense of "generally accepted accounting principles."¹

I

No one is more competent than Mr. Blough to discuss from first-hand experience (a) the accounting problems that faced the Securities and Exchange Commission in its first four years, and (b) the first twenty-five years' evolution of decision-making on accounting principles in the American Institute of Certified Public Accountants. Not only was Mr. Blough the SEC's principal staff accountant from December, 1934 to November, 1935 and Chief Accountant from December, 1935 to June, 1938, he was the full-time Director of Research for the Institute from 1944 to 1961. His name appears on all but five of the 51 Accounting Research Bulletins (including revisions and addenda) that dealt with accounting principles and on the first five Opinions of the Accounting Principles Board.

Although Mr. Blough asserts that "Very little can be said that has not already been put in writing" (p. 1), he recounts experiences that, to my knowledge, have never before been expressed in the literature:

That he, as Chief Accountant, was architect of the policy by which the SEC looked to the accounting profession for leadership in developing accounting principles; the Commission itself, apparently, was deadlocked on the question.

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¹This meaning may be inferred not only from the manuscript under discussion, but also from Mr. Blough's comments appearing in the Sprouse-Moonitz study. "Accounting principles are not theoretical hypotheses untried in practice or tried and discarded as impractical." Comments of Carman G. Blough, in Robert T. Sprouse and Maurice Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, Accounting Research Study No. 3 (New York: American Institute of Certified Public Accountants, 1962), p. 60.

That the 21-member Committee on Accounting Procedure was the outgrowth of the efforts of a "small informal group" of partners of large firms who believed that through their leadership, an Institute committee could propose accounting principles having the "substantial authoritative support" mentioned in Accounting Series Release No. 4.

That it was proposed at the first meeting of the Committee on Accounting Procedure that a "comprehensive statement of accounting principles" should be developed, but that the proposal was abandoned in order "to reduce the areas of differences in accounting procedures before the SEC lost patience and began to make its own rules on such matters."

That a proposed Accounting Research Bulletin was once abandoned because of negative reaction from the Chief Accountant.

That the forceful arguments of of Judge Robert E. Healy, a former chief counsel of the Federal Trade Commission, led the SEC to adopt a firm policy from the beginning in favor of historical cost.²

These revelations tend to confirm the view that I have held for some time—namely, that much is yet to be told about the historical development of the administrative process by which accounting principles are determined. The literature contains only the results of decisions that the decision-makers wished to have published. Withheld from the literature has been the combined effect that pressures, vested interests, and unofficial attitudes have had on the decision-making process. To be sure, a history of the American Institute of Certified Public Accountants, now in its 80th year, is yet to be begun. If such a history is to discover, as it must, the silent stratum of knowledge that lay beneath the surface of official pronouncements and published committee reports, access must be had to unpublished correspondence and memos, and interviews must be arranged with the principals of that formative era. With each passing year, men who were active in the early and middle years disappear from the scene—Charles B. Couchman and George D. Bailey died only a few weeks ago. This work must be begun soon, else it may not be worth doing at all.

In his paper, Mr. Blough traces the development of the administrative process by which accounting principles are determined. The locus of authority to determine principles has been the subject of a number of articles and speeches in the last five years after having survived twenty years in which little was said. A definitive study of the history of the working partnership between the SEC and the AICPA is yet to be written. It seems, however, that this partnership has passed through three phases. If one relies on the recent analysis by Pines, the first phase came to a close at the end of 1945, when the SEC abandoned its "early, more tutorial role" and became more reluctant "to make categorical pro-

²For corroboration, see Ralph F. de Bedts, *The New Deal's SEC: The Formative Years* (New York: Columbia University Press, 1964), pp. 93-94, 103-04.

nouncements on accounting principles in areas where the accounting profession is sharply divided.”³ This second phase continued until sometime in 1965, when, I submit, the SEC reverted to its pre-1946 posture, perhaps with even more vigor and determination than before. The issuance of Accounting Series Release No. 102 and the recent speeches by Chairman Manuel F. Cohen⁴ signalled the beginning of the third phase.

Yet a third force, the Congress, is presently active in influencing the direction *and pace* of the development of accounting principles. On May 28, 1966, *Business Week* reported:

The SEC chairman has been under pressure from Senator Philip A. Hart (D-Mich.) to push for . . . “conglomerate” corporations [to] report sales and earnings by division as well as on a consolidated basis.⁵

It is not altogether a coincidence that the Institute’s Accounting Principles Board is today working at a faster tempo and with more attention to highly controversial subjects than at any point since its predecessor was established in 1938-39, although a recent innovation in the Board’s organization has materially abetted its working efficiency.

It now seems clear that the SEC, historically reluctant to act unilaterally on matters of accounting principle, is testing the profession’s ability and willingness to take decisive action in order to improve the comparability of financial statements.

II

The second of the three interrelated subjects discussed by Mr. Blough is the issuance of pronouncements on accounting principles.

While the series of Accounting Research Bulletins and Opinions have done much to rid financial statements of “bad” practices, they have seemingly permitted a proliferation of “good” practices.⁶ But do we know what configuration of practices these bulletins have left in their wake? Few attempts have been made to compile a catalogue of “generally accepted accounting principles.” Mr. Blough mentions the 1938 compilation by Sanders, Hatfield, and Moore, and the Committee on Accounting Procedure’s hopes in 1938-39 and 1949 to prepare a comprehensive statement.

The most recent attempt was Grady’s *Inventory of Generally Accepted*

³ J. Arnold Pines, “The Securities and Exchange Commission and Accounting Principles,” *Uniformity in Financial Accounting, Law and Contemporary Problems*, Vol. XXX, No. 4 (Autumn, 1965), pp. 731, 741.

⁴ The speeches were printed in the August, 1966 and December, 1966 issues of *The Journal of Accountancy*.

⁵ “Market briefs,” *Business Week*, May 28, 1966, p. 152. Senator Hart is chairman of the Senate Subcommittee on Antitrust and Monopoly.

⁶ For discussion of this thesis, see Reed K. Storey, *The Search of Accounting Principles* (New York: American Institute of Certified Public Accountants, 1964), pp. 49-50

Accounting Principles for Business Enterprises (Accounting Research Study No. 7), which in one important respect was less successful in its day than was the Sanders-Hatfield-Moore effort in the 1930s. Grady's decision to rely on the bulletins themselves is open to serious question. Unless he were to attempt a restatement or codification of all pronouncements then in force, he was constrained to accept the equivocation and indecisiveness that are so evident in the most controversial bulletins. His solution was to limit his catalogue to the principles that are readily accepted by all, and to let the ARBs and Opinions speak for themselves on the controversial principles. But this was surely a non-solution, for it was implicit in the very avowal that such an inventory was needed that the bulletins did *not* speak for themselves, and, more important, that they were an incomplete reflection of "substantial authoritative support." Presumably the part of the inventory dealing with controversial accounting principles could have been accomplished only by an extensive in-depth survey of the practices that companies actually use—a mode of investigation that was used by Sanders-Hatfield-Moore.

Thirty years ago, Carman Blough was the first to state publicly that he did not know the composition of "generally accepted accounting principles."⁷ Today, though we do not have the baffling variety of practices that Blough encountered upon becoming SEC Chief Accountant, we seem to be no closer to an answer.

III

The aspect of "Development of Accounting Principles" to which Mr. Blough gave the least attention in his paper is what I have called "Development of a Foundation from which Accounting Principles may be Derived."

Accounting writers disagree over the amount of progress that has been achieved by the Institute's "piece-meal" approach of determining accounting principles. Although Mr. Blough asserts that we have made "tremendous advances" since the first quarter of this century, we have Howard Ross's word that "financial statements published currently are depressingly similar to those of a generation ago." I suspect Mr. Blough refers to the disappearance, in large measure, of the "bad" practices, while Mr. Ross is bothered by the profession's adherence to historical cost. ("But for Judge Healy," Mr. Ross might be overheard to say, "current-value reporting would be closer to attainment today!")

The diversity of "good" practices bedevils many of us today: the practitioner who feels that his clients are taking unfair advantage of their latitude in choosing from among alternative "accepted" principles, and

⁷Carman G. Blough, "The Need for Accounting Principles," *The Accounting Review*, Vol. XII, No. 1 (March, 1937), p. 31.

the educator who has the thankless task of trying to explain to first-year accounting students that in several controversial areas (e.g., depreciation methods, inventory valuation methods, ways of treating the investment credit), companies are free to choose whatever "accepted" methods they like (subject to consistency) without regard to the salient facts in their particular situations.

It is natural, therefore, that many members of the profession, especially accounting educators, have begun trying to formulate a network of fundamental propositions in order to provide criteria by which good "good" practices can be retained, bad "good" practices can be discarded, and good practices that have not yet been considered can be introduced.

Since 1921, when Paton made what may have been the first significant attempt to discover accounting "postulates,"⁸ surprisingly little has been done to erect an empirically valid system of interlocking propositions. In his recent book, Chambers has made a valiant attempt,⁹ and we have, of course, Accounting Research Studies I and 3, and the recent American Accounting Association monograph, *A Statement of Basic Accounting Theory*, together with the series of concise principles statements issued by the AAA between 1936 and 1965.

In trying to unearth the "foundations of financial accounting," however, we should continually remind ourselves that we are not concerned with matters of present-day accounting policy, either as it faces the SEC, the Accounting Principles Board, or the financial vice president of a corporation. We are not warring on the discarded principles of the past, not ratifying the principles of today, and not summoning untried principles of the future. The accounting principles that emerge from the foundation that we construct will be virtuous not because of their resemblance to the accounting principles we know today, but because they do indeed logically emerge from what we have built. In fact, it would be best if, in the beginning stages of experimentation, we would ignore entirely the implications of each block in the model for the accounting principles that might emerge. We cannot engage in fruitful intellectual discourse unless we somehow free ourselves from the temptation to link the foundation with its output. For this reason, I think the approaches used in all three references we were asked to study for this Symposium (i.e., the AAA Statement, Studies 1 and 3, and Chambers' list of six propositions), while not necessarily defective, tend to divert our attention from the foundation to *the policy implications of the foun-*

⁸"Assumptions of the Accountant," *Administration I* (June, 1921), pp. 786-802. With minor changes, this article was reprinted under the title "The Postulates of Accounting" in William Andrew Paton, *Accounting Theory* (New York: The Ronald Press Company, 1922), Chapter XX.

⁹Raymond J. Chambers, *Accounting, Evaluation and Economic Behavior* (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1966).

dition, consequently causing us to invoke all our prejudices into what is supposed to be an objective, dispassionate inquiry into our system of thought.¹⁰ Let me suggest, therefore, that we either give no attention to implications for policy, or that we agree not to condemn a proposed foundation simply because the consequent accounting principles do not accord with what we know as "generally accepted accounting principles."

I do not suggest that it will be simple to concentrate on the foundation to the virtual exclusion of implications for policy. I believe, however, that if we can restrict our attention at this meeting to (a) the kind of methodology that should be used in formulating a cohesive accounting theory, and (b) the means by which we might identify the crucial propositions that lay at the base, we will have made a good start.

¹⁰I believe that the thrust of Accounting Research Study No. 1, *The Basic Postulates of Accounting*, lost much of its strength through the attempt, in Study No. 3, to translate the postulates into accounting principles. Readers who otherwise might have considered the proposed postulates on their merits, reacted almost viscerally to Studies 1 and 3 because the principles enunciated in No. 3 did not conform to their own prejudices about "generally accepted accounting principles." As a result, the Accounting Principles Board issued a "Statement" with every copy of No. 3, saying that the two Studies "contain inferences and recommendations in part of a speculative and tentative nature" and that they "are too radically different from present generally accepted accounting principles for acceptance at this time." Doubtless this disclaimer, which seems to have arisen more out of instinct than objective and dispassionate analysis, seriously attenuated the effect of these two pioneer efforts. (The Director of Accounting Research, Maurice Moonitz, seems to have had little alternative but to complete an Accounting Research Study on "broad accounting principles" shortly after publication of the Study on postulates. The Institute's committee which laid the basis for the Institute's new research program recommended that "Immediate projects of the accounting research staff should be a study of the basic postulates underlying accounting principles generally, and a study of the broad principles of accounting." Report to Council of the Special Committee on Research Program, *The Journal of Accountancy*, Vol. 106, No. 6 (December, 1958), p. 64).

The Committee to Prepare a Statement of Basic Accounting Theory, of the American Accounting Association, also felt obliged to translate their foundation into "General Recommendations" (pp. 30-36) for accounting policy. It will be interesting to see whether the criticism of the *Statement* is addressed to the foundation or the implications for policy.