The sequence of events leading to the concept of generally accepted accounting principles (or GAAP) was followed by three phases of institutionalizing the concept. In the first of these, an attempt was made to identify a body of knowledge designated accounting principles (1932-1940). In the second, a set of rules was laid down by the accounting profession, to the accompaniment of rationalizations emanating from its members (1938-1973). In the third, the pursuit of principles has been abandoned in favor of standards, both national (through the Financial Accounting Standards Board) and international (through the International Accounting Standards Committee).

In this chapter we shall see how an early movement toward uniform accounting proved abortive, and how the subsequent search for universal principles seemed to lead the accounting profession in a direction which it did not choose to follow. Nevertheless, the search for principles has not ceased; it has taken the form of seeking answers to questions of usefulness and use as a preliminary to formulating propositions having general applicability.

THE PROTAGONISTS

The principal participants in this were the accountancy profession, the New York Stock Exchange (NYSE), and the Securities and Exchange Commission (SEC). Playing significant roles were the American Accounting Association (AAA) and the National Association of Accountants (NAA).

The American Association of Public Accountants, founded in 1886, was the predecessor of the American Institute of Accountants (AIA) and of the American Institute of Certified Public Accountants (AICPA). The American Association had few members, some of them originally from the United Kingdom, and neither this association nor the New York State legislation first licensing Certified Public Accountants (CPAs), required any examination to test their qualifications. The AIA, formed in 1916, established a Board of Examiners in 1917 to create a uniform CPA examination. The AIA became the AICPA in 1957.
The New York Stock Exchange was organized as such in 1794 to facilitate the transfer of government and corporate securities. As early as 1866 it attempted to obtain financial statements from corporations listed on the exchange, but the NYSE had little success until 1906, when it required all corporations applying for listing to agree to publish annual financial statements. In 1926 the NYSE required listed companies to provide stockholders with financial statements prior to the company's annual general meeting, which was already a provision of the company laws in other countries.

The Securities and Exchange Commission was established by an act of Congress in 1934 to protect the public from losses through ignorance. The Securities Act of 1933 required companies to register all new offerings of securities, and the Securities Exchange Act of 1934 stipulated for the registration of any securities listed for sale to the public. The SEC was set up to administer these two acts and give broad powers to prescribe the form and content of disclosure documents filed, including financial statements.

The American Accounting Association began life as the American Association of University Instructors in Accounting in 1916; its name was changed in 1935. The AAA in 1935 expanded its scope to include research and the development of accounting principles and standards.

The National Association of Accountants (formerly the National Association of Cost Accountants) was established in 1919. From its inception the NACA, later the NAA, published research studies and monographs on managerial accounting, including both financial and cost accounting. Emphasis was on problems of practice, and many managerial accounting techniques were first presented to the public through the medium of the monthly NACA Bulletin.

Other organizations which have concerned themselves with the development of accounting principles in the United States include the Financial Executives Institute, the Financial Analysts Federation, and research groups centered on universities.

BEGINNINGS OF UNIFORM ACCOUNTING

The search for uniform cost accounting in the United Kingdom and the United States began in the late nineteenth century as a response to lethal cut-throat competition. The adoption of uniform cost accounting schemes by a number of trades and industries did not of itself lead to any degree of standardization of accounting generally.1

Most of the capital needed in the United States for economic development in the nineteenth century came from Europe, and the financiers sent their accountants to check on the use of their money. These accountants, mainly Scottish and English, brought with them standards for the form and content of financial statements which were those laid down in the U.K. Companies Acts. As the American economy developed, the banking system became the principal source of capital, and bankers tended to set standards for financial accounting. Not surprisingly, they tried to make business financial statements as much like bank accounts as possible.

In response to this pressure, the Federal Reserve Board and the Federal Trade Commission in 1917 requested the AIA to put forward proposals for standardized financial statements. The resulting memorandum received the endorsement of the Federal Reserve Board and, after being submitted to the banking community nationally for their reactions, it was published in the April 1917 issue of the Federal Reserve Bulletin. This memorandum became the publication Uniform Accounting2 and was republished in 1918 as Approved Methods for the Preparation of Balance Sheet Statements. The Federal Reserve Board published a revised edition, Verification of Financial Statements, in 1929.3

Uniform Accounting placed emphasis on the balance sheet. As might be expected in the context of its publication, assets were to be presented in order of decreasing liquidity, liabilities in the order in which they were to be met. Inventories must be stated at the lower of cost or market value. Fixed asset changes must identify value changes recorded separately from movements. As for the profit and loss statement (note the terminology), depreciation was to be shown as “a deduction from income” together with interest and taxes. Net income became profit or loss by the addition or deduction of special credits or charges.

A 1936 revision of this publication was published by the AIA; entitled Examination of Financial Statements by Independent Public Accountants, it proclaimed its object to be financial statements for creditors and also annual reports to stockholders.4 The 1936 revision, in the jargon of the time, adopted the going concern convention and the cost basis of valuation. It provided a new emphasis on the income statement and earning capacity; in order to improve the reporting of income, special credits and charges for nonoperating and extraordinary items were to be included with incomes and expenses as “other income” and “other charges.” The heading “net income for the period” disappeared, and the statement ended with a figure labelled “net profit (loss) for period carried to surplus.”

It is doubtful whether this 1936 revision can be said to have had much effect on the development of accounting theory. It contained a combination of tentative steps forward and backward and did not succeed in eliminating the term “net income.”

THE GREAT DEPRESSION

In the 1920s the general public, flush with cash from World War I and the subsequent boom, began buying corporate securities heavily. The United States went through a period of speculation similar to the English “South Sea Bubble” of the early 1700s or the Dutch “tulipomania” of the preceding century. Lacking any company laws worth mentioning, these investors were unprotected from fraud or the consequences of their own ignorance. In particular, they could not rely on audited financial statements for their information.

As we have seen, the American audit began as a means of verifying transactions for absentee owners. It developed as a means of providing banks with information about solvency and liquidity; hence the peculiarly American concept of a balance sheet audit. Audit techniques used by
English auditors to verify transactions and report on the profit and loss account were largely neglected. Thus, financial statements presented to investors were either over-conservative, showing assets at their liquidation values, or over-optimistic, showing assets at written-up values and manipulated income figures.

In a speech at the 1930 convention of the AIA, J. B. Hoxyesey voiced several criticisms of contemporary accounting, which were particularly painful coming from the executive assistant of the Committee on Stock List of the NYSE. He drew attention to the diversity of approaches to depreciation accounting and the lack of information about depreciation policy, diversity of approaches to consolidation, absence of sales volume figures and a clear separation of non-operating income, failure to identify earned surplus in the balance sheet, recording stock dividends received at higher amounts than those shown by the companies declaring the dividends, and practices designed to undervalue profits. These criticisms echoed the earlier findings of William Z. Ripley, a Harvard University professor of economics, made public in a 1926 article.

The need for protection for the investing public was expressed by the accounting profession no less than by the stock exchanges and the federal government. The AIA set up a special “Committee on Cooperation with Stock Exchanges” under the chairmanship of G. O. May, of Price, Waterhouse & Co., which undertook to clarify the public accountant’s position in a correspondence, later published in extenso in May’s 25 Years of Accounting Responsibility.

The May Committee put forward the view that balance sheets do not show values, the real value of assets being their earning capacity. Hence, emphasis was placed on the income statement, or profit and loss account. Annual assessment of earning capacity, in order to value assets, was both impossible and unprofitable, so that a body of conventions of balance sheet preparation had been adopted, partly based on theory and partly on practice. While there was agreement on broad principles, there were differences in their application. The May Committee suggested that two alternatives were possible, either uniform accounting rules, which it rejected on the grounds that the arguments against were “overwhelming,” or every corporation free to choose its own accounting methods subject to rules of disclosure and consistency. There was, nevertheless, room for great improvement.

The May Committee specified five “principles”:

1. That income accounts should not include unrealized profit, realization being the consequence of an act of sale.
2. That capital surplus (reserves) should not be used for revenue items of charge.
3. That earned surplus (revenue reserves) of a subsidiary created prior to acquisition was not part of the consolidated earned surplus of the parent.
4. That dividends paid by a corporation to itself in respect of holdings of its own stock should not be credited to income.
5. That amounts receivable from officers, employees and affiliated companies should be shown separately.

This modest list of principles was quoted with approval in a statement issued the following year by the president of the New York Stock Exchange (NYSE) when it was announced that after July 1, 1933, all applicants for listing must henceforth agree to have their financial statements audited, and submit them on application (with the exception of certain railroads). The correspondence concluded with a draft form of audit report, and The Accountant (London) of May 19, 1934, commented favorably on the manner in which this result was reached, i.e., by cooperation between the AIA and the stock exchange authorities, and not by legislative sanction.

ORIGINS OF THE SHORT-FORM AUDIT REPORT

The correspondence mentioned included a letter from the NYSE Committee on Stock List to the Governing Committee of the NYSE dated October 24, 1933. This letter said:

It would ... be advantageous if audit reports were so framed as to constitute specific answers to the last three questions embodied in the (NYSE) President’s letter to listed companies of January 31, 1933, namely:

4. Whether in their opinion the form of the balance sheet and of the income or profit-and-loss account is such as fairly to present the financial position and the results of operation.
5. Whether the accounts, as in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.
6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto. (i.e., the May Committee’s five principles)

The Revised Suggestions of a Form of Accountants’ Report produced by the May Committee reads as follows:

To the XYZ Company:

We have made an examination of the balance sheet of the XYZ Company as of December 31, 1933 and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 1933 and the results of its operations for the year.
The short-form audit report subsequently adopted by the AIA for use by its members was as follows:

Addressee Date

We have examined the balance sheet of X Company as of December 31, 19—, and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It appears, therefore, that the short-form audit report in use in the United States is in essence the product of suggestions made by a former president of the NYSE.

THE SEARCH FOR PRINCIPLES

The implications of an audit report resting on generally accepted accounting principles were immediately apparent to the profession, which cast about for something more substantial than the five principles produced by the May Committee. A prize was offered for the best paper on the subject, and the winner, Gilbert R. Byrne, presented his list at the Fiftieth Anniversary celebration of the AIA in 1937. Byrne quoted with approval the Webster definition of a principle as “A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which other are founded; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate.”

Byrne rejected the assumption that accounting principles “like the axioms of geometry . . . are few in number . . .” It was Byrne likewise who stated the postulate that “Accounting is essentially the allocation of historical costs and revenues to the current and succeeding fiscal periods.” He also postulated that “while it is not in many cases of great importance which of several alternative accounting rules is applied in a given situation, it is essential that, once having adopted a certain procedure, it be consistently adhered to in preparing accounts over a period of time.” Finally, Byrne postulated that “income shall include only realized profits” and “profit is deemed to be realized when a sale in the ordinary course of business is effected.” From these four unnecessary assumptions the theory and practice of accounting are only now, forty years later, painlessly liberating themselves.

The five rules which Byrne laid down as principles of accounting (having “a coercive or compelling quality” based on business laws which must be obeyed if an enterprise is to survive) are: depreciation on plant

must be charged against operations, all expenses incurred in producing net income must be provided for, probable losses should also be provided for, proprietors’ contributions of capital consist of capital stock and capital surplus, and earned surplus should represent accumulated earnings less distributions to stockholders. The banality of these observations has long concealed the accounting problems which underly them. Even so, the precise phrasing of Byrne can be traced in APB Opinions, e.g., No. 10, December 1966, “Profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that the collection of the sale price is not reasonably assured.” (Para. 12)

In 1935, the Haskins and Sells Foundation decided to assist in the identification of accounting principles by requesting a committee of accountants to study the subject and prepare an impartial report. The committee consisted of two accounting professors, Thomas Henry Sanders of Harvard University Graduate School of Business Administration and Henry Rand Hatfield of the University of California, and a legal scholar, Underhill Moore of Yale University. Their report, A Statement of Accounting Principles, was published by the American Accounting Association in 1938.

The trustees of the foundation, in their letter of invitation to Dr. Sanders, specified the reasons why the need for accounting principles had become apparent. They were:

- Inconsistency between corporation and other statutes, some of which permitted indefensible accounting practices.
- Contradiction between federal agencies issuing regulations involving accounting, and between federal and state regulatory bodies.
- Questions raised by the stock exchanges and the SEC in their efforts to ensure adequate disclosure. In particular

Notwithstanding the difficulties involved, accountants who certify to financial statements filed with the Securities and Exchange Commission have been required by the regulations of that commission to express an opinion concerning such financial statements and the practices of the registrant in the light of accepted principles of accounting.

In the letter of transmittal, the committee reported that they had “made inquiry in four directions.” These were:

- Personal interviews, supplemented by correspondence, with competent persons
- Review of accounting literature
- Study of statutes and court decisions
- Examination of current corporate reports

The report stated as the objectives of accounting “Making effective and effectively maintaining . . . the distinction between capital and income of a particular enterprise . . . .” Hence, its findings could only be expected to apply to business accounting. The report recognized as conventional the balance sheet/income statement complex and the going concern assumption and the effect of legal considerations on liabilities; also the importance of the notes to financial statements.
The Common Law nature of accounting principles, that they exist in unwritten form, was one of the findings of the committee, based on their observation that controversy within the profession was restricted to a relatively small number of situations out of the much greater number which might lead to disagreement. However, instead of proceeding empirically to list those objects of agreement, the committee based its statement of accounting principles on economic definitions of capital and income in an attempt to force the principles into a framework of deductive reasoning. Hence the dubious proposition that "Income normally arises from the sale of goods or services for amounts greater than their cost."

The bulk of the report consisted of an enumeration of the items found in published financial statements, including consolidated statements, with rationalizations in some cases to justify contemporary practices. From this descriptive material certain generalizations were made, and Part VI of the report, "Summary of Accounting Principles," is reproduced below. These principles are reproduced here because they reveal, as recently as 1938, an unawareness of the problems with which accounting theory is concerned.

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PART VI

SUMMARY OF ACCOUNTING PRINCIPLES

The following enumeration of accounting principles is to be read as a very general summary of the report. Each proposition is to be construed in the light of the relevant discussion in the body of the report.

I. GENERAL PRINCIPLES

A. Accounting should make available all material information of a financial nature relating to (a) the financial condition or status of the business, (b) its progress in earning income.

B. Transactions which add to or subtract from capital must be distinguished from those which add to or subtract from revenue, and, where both kinds of change occur in one transaction, the extent of each must be shown.

C. A reliable historical record must be made of all transactions of the business; but this record must also be analytical, or susceptible to subsequent analysis, to preserve the necessary distinction between capital and income.

D. The use of long-term assets involves the apportionment of capital and income over the several accounting periods; the accuracy of the accounts depends in large measure upon the exercise of competent judgment in making these apportionments.

E. The basis of the treatment applied to the several items should be adhered to consistently from period to period; when any change of treatment becomes necessary, due attention should be drawn to the change.

F. The possible extent of unforeseen contingencies of adverse character calls for a generally conservative treatment of items to which judgment must be applied.

II. INCOME STATEMENT PRINCIPLES

A. The income statement should show, for the period it covers, (a) income from all sources, (b) costs and expenses of all kinds, and (c) net income.

B. Only income realized by the sale of goods or rendering of service to be shown in the income statement. Unrealized income should not be recorded, nor utilized to absorb proper charges against earnings.

C. Income from sources other than the main operations of the business should be stated separately.

D. Costs and expenses must include:
   (a) all current operating costs,
   (b) inventory losses of the period,
   (c) provision for losses on other current assets, which have become imminent in the period,
   (d) proper allocations for the depreciation, depletion, or amortization of all capital assets subject to those processes.

E. Nonrecurring items should be reported in terms which indicate their nature.

F. As far as possible net income should be so determined that it will need no subsequent correction. When, however, such correction becomes necessary, it may be made through current income only if it is not so large as to distort the statement of that income; otherwise it should be made through earned surplus.

III. BALANCE-SHEET PRINCIPLES

A. A balance-sheet should show (a) the nature and amounts of the assets, (b) the nature and amounts of the liabilities, (c) the nature and amounts of the invested capital, (d) the amounts of earned and of capital surplus.

B. With reference to fixed or capital assets in the balance sheet:
   1. The amounts should be based upon the amounts invested in such assets.
   2. Reserves for depreciation, depletion, and amortization should show the cumulative progress of prorating their cost over their useful lives.
   3. Proper distinction should be made between (1) tangible assets, (2) intangibles, and (3) investments.

C. The proper showing of current assets requires:
   1. that inclusion or exclusion of particular items be determined on the same time basis as is applied to current liabilities;
   2. that the values in general be the lowest of cost, replacement market, or realization, as may be applicable for the several items;
   3. that reserves be plainly associated with the current assets to which they apply;
   4. that separate mention be made of items not in the ordinary course of business.

D. Particular care must be given in reporting deferred charges:
   1. to the distinction between charges inuring to the benefit of future periods and losses actually sustained;
   2. to the basis of amortization, which in general should be the periods to be benefited by the deferred charges.

E. Contingent liabilities should be noted in the balance-sheet or in
a footnote, if they are material, imminent, and of reasonably determinable amount.

F. Reacquired stock should be shown as a deduction from capital stock, unless exceptional circumstances justify showing it as an asset, when the reason should be given.

G. The restatement of capital assets at higher values results in capital surplus. Restatement at lower values may result in a subtraction from capital, capital surplus, or earned surplus, depending on circumstances.

H. Capital surplus should not be utilized to relieve either earnings or earned surplus of charges which should be made against them.

IV. CONSOLIDATED STATEMENTS

A. Consolidated statements should include only units which are effectively controlled by the parent company.

B. The amount at which the stock of a subsidiary is carried in the parent company's books constitutes in effect a revaluation of the subsidiary properties, either tangible or intangible, and is reflected as such in the consolidated balance-sheet.

C. Surplus of subsidiaries existing at the time when control of them was acquired by a parent company should not be shown in the consolidated balance-sheet.

D. Minority interests in subsidiaries may be shown in the consolidated balance-sheet at their net value in the subsidiary books.

V. COMMENTS AND FOOTNOTES

A. Comments, footnotes of reasonable length, and supplementary schedules may be used to elucidate items in the statements calling for explanation, or to supplement the statements.

ORIGINS OF THE APB

Two major influences on the subsequent pronouncements of the AICPA were 1) the "Student Department" of the Journal of Accounting, dating back to 1914, and 2) a series of Special Bulletins published by the AIA in the 1920s. The former was "a gold mine of information on the accounting principles of the time and the reasons for their existence."12

THE COMMITTEE ON ACCOUNTING PROCEEDURE

Prior to 1938, various committees of the AIA worked on specific projects aimed at clarifying points of practice. In 1936 the AICPA publication Examination of Financial Statements... referred to the phrase "generally accepted accounting principles." During the period 1936-1938 a Committee on Accounting Procedure existed, consisting of the seven chairmen of various AIA committees, which responded to specific questions from members of the AIA and thus built up a collection of precedents. In 1938 the membership of the CAP was increased to twenty-one, all appointed for one-year terms, which may have accounted for a certain lack of continuity; after that date what continuity there was came from the CAP's research staff, a small and diminishing number.

In spite of the need for generally accepted accounting principles, the CAP devoted itself to decisions of an ad hoc nature; few of its pronouncements were based on research studies. They were called Accounting Research Bulletins (ARBs) and forty-two ARBs were published during the first fifteen years. Most of these were consolidated into ARB 43, and between 1953 and 1959 a further eight were published, bringing the total to 51. The consolidated ARB 43 included eight reports of a Committee on Terminology, published separately in 1953 as Accounting Terminology Bulletin No. 1, "Review and Revision." This publication has been of great significance in that, to the extent that definitions and practices have not been revised subsequently, it represents the source of "generally accepted accounting principles" in the United States. ARB's 1-51, together with the APB Opinions available at the time, provided the basis for Accounting Research Study No. 7.13

The shortcomings of the CAP were revealed in the period following World War II, when new financing techniques such as conglomerate acquisitions, equipment leasing, convertible securities and leaseback arrangements created accounting problems which could not be solved from precedents. In addition, the decline in the purchasing power of money raised the prospect of the abandonment of historical costs, and changes in technology threw up intangibles of great value which were inadequately expressed at a memorandum figure of one dollar. G. O. May wrote at this time that there was a need for:

1. Continuous research on a high level; a service that a rapidly changing Committee on Accounting Procedure cannot render.
2. Consideration of questions in a longer historical perspective.
3. Consideration of problems, not in isolation, but in their relationship one to another.
4. More penetrating discrimination between phenomena that have in the past been considered as indistinguishable for the purposes in hand,...
5. A receptiveness to change...
6. More rigorous logic and presentations in which there shall be no begging of the question by making assumptions which leave the conclusions apparently inevitable.14

THE ESTABLISHMENT OF AN ACCOUNTING PRINCIPLES BOARD

As if in response to these proposals, the then president of the AICPA, Alvin R. Jennings, addressed himself to the question "how successful we have been in narrowing areas of difference and inconsistency in the preparation and presentation of financial information."15 He proposed that a new approach be taken and that the development of accounting principles should be regarded as "in the nature of pure research." A proper research organization should be set up, staffed with academically qualified
persons and financed by the profession and industry jointly. The function of the research organization should be to carry on continuous examination and reexamination of basic accounting assumptions and to develop authoritative statements for the guidance of both industry and the profession. Such statements would be submitted for approval or rejection to the Council of the AICPA.

Jennings set up a Special Committee on Research Program in 1957, and in 1958 the Special Committee recommended the dissolution of the CAP and its research department. They were to be replaced by an Accounting Principles Board (APB) and an appointed director of accounting research, with a permanent research staff. The Council of the AICPA accepted these recommendations in 1959, and the APB was duly established and given the mission "to advance the written expression of what constitutes generally accepted accounting principles."

The Special Committee's report stated that the problem required attention at four levels: the basic postulates, the principles themselves, rules or guides for the application of the principles, and research itself. It was again asserted that "postulates are few in number"; environmental postulates were indicated. A broad set of coordinated principles should be formulated on the basis of the postulates. Rules and other guides should be developed in relation to the postulates and principles. Adequate accounting research was necessary in all of these contexts.

The report suggested that although primary attention be given to published financial statements, in the long-run this work should be extended to institutions other than corporations regulated by the SEC.

The APB consisted of between eighteen and twenty-one members, mainly representatives of public accounting firms but also including representatives of industry and government, and academicians. The Accounting Research Division consisted of a director and a research staff.

ACCOUNTING RESEARCH STUDIES

The Special Committee's report specified that "immediate projects of the accounting research staff should be a study of the basic postulates underlying accounting principles, and a study of the broad principles of accounting." The first director of research was Dr. Maurice Moonitz, an academic of the California school, strongly influenced by Fisher and Canning. He started work on the postulates study, and appointed Dr. Robert T. Sprouse to work on the principles study. The products, Accounting Research Studies Nos. 1 and 2, were published in 1961 and 1962 respectively.

The Accounting Research Division was intended to produce rigorously argued studies heavily dependent on deductive reasoning, and these two publications disappointed the AICPA and the accounting profession. Instead of a carefully argued position, Moonitz and Sprouse produced two polemical papers attempting to move the profession toward basing financial statements on exit values, i.e., valuing assets at market prices. Deinzer has shown that the postulates presented in "ARS No. 1 could have equally supported diametrically opposed principles."

The principles laid down by Sprouse and Moonitz included the assertion that "profit is attributable to the whole process of business activity," which contradicted the realization principle. The restatement of capital for general price level changes, and the recognition of specific price changes as gains or losses, whether due to accretion or market events, were asserted as principles. Valuation principles involved three steps: determine if future services exist; quantify the estimate; multiply the quantity by a past, present, or future price. Monetary assets and liabilities should be recorded at present values.

Of these, the two propositions which proved most unacceptable to the AICPA were probably the necessity to account for general and specific price-level changes and the need to record "inventories which are readily salable at known prices" at net realizable value. The two studies were rejected by the AICPA and published with a leaflet insert stating that the postulates and principles were not acceptable at the present time. A statement by the APB to the same effect which appeared in the May 1962 issue of the Journal of Accountancy contained these words:

The Board believes, however, that while these studies are a valuable contribution to accounting thinking they are too radically different from present generally accepted accounting principles for acceptance at this time.

After a period of exposure and consideration, some of the specific recommendations in these studies may prove acceptable to the Board while others may not.

It is noteworthy that none of the principles of ARS No. 3 has yet been endorsed by either the Accounting Principles Board or the Financial Accounting Standards Board.

The rejection of ARS No. 1 and No. 3 resulted in the commissioning of Paul Grady's ARS No. 7 which merely inventoried accounting methods sanctioned by ARBs, APB Opinions, or other precedent. Other products of the Accounting Research Divisions proved more fruitful and will be referred to at appropriate places in this book. They were:


ARS No. 4, "Reporting of Leases in Financial Statements," by John H. Myers, AICPA 1962.


ARS No. 6, "Reporting the Financial Effects of Price-level Changes," by the staff of the Research Division, AICPA 1963.

ARS No. 8, "Accounting for the Cost of Pension Plans," by Ernest L. Hicks, AICPA 1965.

ARS No. 9, "Interperiod Allocation of Corporate Income Taxes," by Homer A. Black, AICPA 1966.


In a thoughtful article, Professor Horngren looked back over four years as a member of the APB and attempted to diagnose its weakness. In his view a great mistake had been made in believing that the power to set principles rested in the private sector. "The increasing role of the federal government in our society" wrote Horngren, "is an unstoppable phenomenon." The APB had formulated principles subject to the constraints set by the SEC, to which organization Congress had delegated its powers in this area. The APB had been used by the SEC as a buttress, insulating the SEC from pressures and criticisms and doing an enormous amount of unpaid work for the government. Horngren cited as evidence the sequence of events accompanying APB Opinions 2 and 4 on accounting for the investment tax credit; the establishment by Congress in 1972 of a Cost Accounting Standards Board has served to underline this point.

The APB was criticized for failing to define the objectives of accounting, for failing to construct a comprehensive and internally consistent theory of accounting, and for failing to understand the interrelatedness and repercussions of its decisions. Dale Gerboth has referred to this view as "the comprehensive approach to policy-making" and pointed out that it postulates an ideal world which is useless as a standard. In his opinion, the APB had adopted the "incremental approach" as a standard, which consists of rational behavior as a substitute for perfection. The allegations that the APB acted ad hoc, repeatedly confronted the same problems, and adopted short-run solutions at the expense of long-run objectives, were misguided and arose from a false conception of policy-making. The subsequent history of the successor organization, the Financial Accounting Standards Board, lends some credence to Gerboths's position.

Finally, it has been suggested that the increasing volume of litigation against public accountants in the United States was a factor in the demise of the APB. Most APB members were partners in CPA firms, and there was a real possibility that the defense of compliance with generally accepted accounting principles might be rejected in court on the grounds that these principles had been laid down by those who sought to hide behind them.

**BIRTH OF THE FINANCIAL ACCOUNTING STANDARDS BOARD**

Following the 1968 stock market crash the usual drive to blame the accountability profession began. It was alleged that "creative accounting" was responsible for fostering imaginary earnings growth, and the SEC publicly charged some accounting firms with failure to safeguard investors. Many investors had recourse to the courts for compensation; such lawsuits as Westec, Mill Factors, Four Seasons Nursing Homes, Continental Vending, Revenue Properties, Black Watch Farms, Orvis Brothers, and Penn-Central threatened to undermine the auditing profession's reputation for reliability and independence.

The thrust of this criticism was that accountants had been "managing" the income statement by selecting from different generally accepted accounting principles those methods which would result in the highest
reported earnings per share. In a report to Congress on the Penn-Central bankruptcy, dated August 3, 1972, the SEC stated that:

The whole pattern of income management which emerges here is made up of some practices which, standing alone, could perhaps be justified as supported by generally accepted accounting principles, and other practices which could be so supported with great difficulty, if at all. But certainly the aggregate of these practices produced highly misleading results.

The chairman of the SEC blamed the APB for writing detailed opinions, pointing out that some circumstances were bound to occur which would make the literal application of these rules produce misleading disclosure.

In response to this kind of criticism the AICPA announced in April 1971 the formation of two study groups. One, entitled "The Study Group on the Objectives of Financial Statements" was chaired by Robert M. Trueblood, a prominent CPA, and will be analyzed in Chapter 6. The other, entitled "The Study Group on Establishment of Accounting Principles," was chaired by Francis M. Wheat, a former SEC commissioner and long-time critic of the profession. The Wheat Committee reported on March 9, 1972, and proposed a new structure for establishing accounting rules and standards, based on a Financial Accounting Standards Board. The organization of this new structure is shown in Exhibit 4-1.

EXHIBIT 4-1
FINANCIAL ACCOUNTING FOUNDATION ORGANIZATION STRUCTURE

At the top of the structure is the Financial Accounting Foundation (FAF) with nine trustees of whom five are public accountants, two retired corporate executives, one a financial executive, and one an accounting educator; the president of the AICPA is a trustee. The FAF is charged principally with appointing the seven member Financial Accounting Standards Board (FASB) who depend upon a research and administrative staff and are advised by a thirty-member Advisory Council. The FASB consists of four CPA practitioners and three others with extensive experience in financial reporting, and to assure the status and independence of the FASB its members received salaries of $125,000 annually, (1976/77). The public accounting profession was quick to promise substantial financial support to this new body, which would separate them from GAAP.

Criticisms of the structure revolved around the FASB and its funding. It was feared that the seven members would operate in an ivory tower environment, that was removed from actual practice. Fear reinforced when the FASB moved into an elegant new building in Stamford, Connecticut. It was also feared that a substantial commitment called for from the accounting profession—a projected annual cost of $2.5 million—would result in the Big Eight firms, some of which offered to pay as much as one million dollars each over a five-year period, forming a powerful pressure group. Organizationally it was pointed out that, by being separated from the AICPA, the FASB would have no apparent constituency and that the system had no appeals mechanism.

In spite of these criticisms, the Wheat Report met with a remarkable display of enthusiasm, and the FASB was endorsed by the AICPA at its 85th annual meeting in 1972 and was in operation by the following year.

The method of operation of the FASB is this: a problem is identified and a task force appointed, led by a board member and consisting of individuals believed to be knowledgeable. A member of the research staff is assigned to this task force and produces a discussion memorandum, which attempts to pose the issues as seen by the task force, and to review the solutions found in practice or recommended by writers. After a period for consideration, the FASB convenes a public hearing at which interested parties may present their viewpoints orally to members of the board. Subsequently an exposure draft of a standard is issued, with notice that a final standard will be issued after consideration of any responses. Eventually a standard is promulgated, which frequently contains modifications of the exposure draft. In some cases a revised exposure draft may be issued prior to the determination of a standard.

THE ROLE OF THE SEC

The role of the SEC as an influence on accounting practice in the United States cannot be overstated. The SEC's requirement that corporations file data on sales, other operating revenue, cost of goods sold, operating expenses, and other details, undoubtedly led to the expansion of financial reporting generally to the same ends. Again, the SEC's stand in opposition to recording appreciation has been a major factor in restricting the growth of current value accounting in the U.S. The influence of the SEC was exercised largely behind the scenes, but it seems obvious that, possessing the authority of the legislature, the SEC must prevail
on any issue joined with an essentially voluntary body such as the Accounting Principles Board or the Financial Accounting Standards Board.

In the fiscal year ended June 30, 1936, two years after the passage of the Securities Exchange Act of 1934, there were 2,303 issuers required to file annual financial reports with the SEC, and 781 registration statements were filed for $4.8 billion under the 1933 Act. Twenty-five years later, in 1961, 4,789 issuers were required to file annual reports, and 1,830 registration statements were filed for $20.7 billion.23 It is obvious that, the task of ensuring that this flow of information was reliable rested on the public accounting profession, as the SEC, which has never had more than a few hundred professional employees, could only look at a fraction of the total volume of filings.

At the beginning the SEC relied upon the accounting profession to set standards, although it reserved the right to prescribe for financial statements generally and to advise on specific matters through its Accounting Series Releases. The first chief accountant of the SEC, Carman G. Blough, stated before the commission that:

... the policy of the Securities and Exchange Commission was to encourage the accountants to develop uniformity of procedure themselves, in which case we would follow ... only as a last resort would the Commission feel the necessity to step in ... If the time comes when the Commission is convinced that a procedure which is not generally accepted in the profession is a procedure that should nevertheless be followed, the matter will be handled not through the release of an opinion by the chief accountant, but through a rule or regulation of the Commission requiring that such procedure be followed. (Emphasis supplied.)

The policy of the SEC was laid down in Accounting Series Release No. 4, which stated that the commission would accept only financial statements prepared in accordance with accounting principles which have substantial authoritative support or in accordance with rules, regulations, or other official pronouncements of the commission or the chief accountant. As the latter, the commission has issued nearly 200 Accounting Series Releases and, through the publication of Regulation S-X prescribing for disclosure, has heavily influenced the form and content of financial statements in the United States. The SEC's opposition to writing-up asset values for any reason undoubtedly underlies the inability of the accounting profession to make progress on this question. The SEC's reliance on the accountancy profession was underscored by ASR No. 150. This stated that accounting principles, standards, and practices therefore or thereafter to the detriment by Statements and Interpretations of the FASB, the Opinions of the APB, and the Accounting Research Bulletins of the Committee on Accounting Procedure that are still in effect will be considered by the commission as having "substantial authoritative support." ASR No. 150 also indicated that financial statements prepared in accordance with any accounting practices for which "substantial authoritative support" was lacking were presumed to be misleading.

In ASR No. 177, the SEC required companies changing their accounting practices from one acceptable method to another to file a letter from their auditors indicating whether the change is to an alternative principle which, in their judgment, is "preferable under the circumstances." In May 1976 the firm of Arthur Andersen & Co. filed a petition with the SEC. The petition objected, first, to ASR No. 130, on the grounds that the SEC had no authority to issue such a sweeping rule, and secondly, that the preferability statement required under ASR No. 177 would necessarily result in standard-setting and accounting standards. In effect, the SEC's distinction between disclosure standards, which it had previously claimed to establish, and measurement standards, which it had left to the accountancy profession, would be eroded.

Since the appointment of Dr. John C. Burton as chief accountant in 1972 there has been a considerable increase in the pressure from the SEC, both directly through Accounting Series Releases and indirectly through the use of the other acts, if the FASB failed to do so in a certain way if the FASB failed in doing so. In an illustration was the situation resulting in the publication of the FASB Standard on gains and losses from extinguishment of debt.25 A rate of articles appeared in business journals in 1974 drawing attention to the long-standing practice of crediting to the income statement profit arising through retiring debt by buying it for less than the maturity amount. The SEC obliged the FASB to issue an exposure draft at short notice and a standard without a public hearing by threatening to act on the issue itself.

The year 1975 saw the SEC pushing financial statements to disclose environmental data, forecasts, corporate payoffs, and replacement costs of inventories, fixed assets, cost of goods sold, and depreciation, none of which was high on the FASB's list of priorities. In addition, the SEC initiated a discussion of the concept of differential disclosure which had received virtually no attention from the AICPA or the FASB.

In this connection it is instructive to refer to an article written by Dr. Burton in 1971, in which he predicted the demise of accounting as an academic discipline because of the lack of eminent scholars in the field and the scarcity of high quality students.26 Besides criticizing the accounting profession for abdicating its professional responsibility to keep its distance from management, Burton suggested that the traditional accounting model may well be out of date. Users of accounting statements wanted "useful economic information" and not simply "generally accepted accounting principles." "The best answer," wrote Burton, "is to do something, not to consider it." Dr. Burton resigned as chief accountant of the SEC in September, 1976.

THE AMERICAN ACCOUNTING ASSOCIATION

In the reorganization which created the AAA out of the predecessor organization in 1935, the executive committee was assigned the responsibility for creating broad, fundamental accounting principles and standards, which could provide a framework for corporate financial statements. In 1936 the first effort in this direction appeared, entitled A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements. In spite of the objective, this publication was an amalgam of standards and rules, some of the latter aimed at reforming contemporary accounting practices.
In 1940 the AAA published Paton and Littleton's *An Introduction to Corporate Accounting Standards* which was destined to become the most influential AAA effort in this field. Paton and Littleton had been members of the original AAA Executive Committee which had prepared the 1936 Tentative Statement. The 1936 statement was revised in 1941, with the words "A Tentative Statement" omitted, and again in 1948, under the title "Accounting Concepts and Standards Underlying Corporate Financial Statements." Eight supplementary statements were prepared between 1950 and 1954, clarifying or expanding on the 1948 statement.

In 1957 a fourth revision appeared, entitled "Accounting and Reporting Standards for Corporate Financial Statements—1957 Revision." Five supplementary statements to this revision were published between 1957 and 1964.

During this period, 1940–1965, the AAA also published a number of research studies, notably Louis Goldberg's *An Inquiry into the Nature of Accounting* (Monograph No. 7, 1964) and R. C. Jones' *Price-Level Changes and Financial Statements: Case Studies of Four Companies* (1955).

A new departure was taken in 1964 with the appointment of a Committee to Develop a Statement of Basic Accounting Theory. The resulting report is known as *ASOBAT*. Some of the material in *ASOBAT* was taken over by the authors of *APB Statement No. 4* and has proved a fruitful source of reference to the basic standards of relevance, quantifiability, verifiability, and freedom from bias which it laid down.

The task of applying these basic standards devolved upon a number of technical committees, whose reports have been published since 1970 as annual supplements to *The Accounting Review*.

The AAA's involvement in identifying accounting standards reveals a shift from the inductive to the deductive mode of reasoning, the 1957 Revision being the transition point. The first statement placed emphasis on correcting improper current practices and while assuming the need for "a single coordinated body of accounting theory" nevertheless adopted the profession's view of accounting as a process of allocation. This Statement took the position that accounting was not a process of valuation; by 1941 the concept of value was being discussed, but in the 1940 Monograph no mention of Littleton set their faces sternly against such an idea.

The 1957 Revision proceeded from the principles of economics in general, and particularly the theory of corporation finance which had been developed from Fisherian economics. Revenue was defined as the monetary expression of the aggregate of products or services transferred to customers during a period. Assets were "aggregates of service-potentials," which become expenses (or losses) as they "expire," and stockholders equity "the residual claims to corporate assets." This framework was conspicuous in two subsequent supplementary statements, which recommended current cost for long-lived assets and replacement cost for inventories.

The significance of this move from a positive to a normative theoretical framework is that it provided the profession with a rationale for the abandonment of historical cost. By identifying an attribute to be measured in money (quantities of units of future services) the way is opened up to multiplying those quantities by prices other than the ones which relate to their acquisition. The immediate response to the 1957 Revision, however, was critical, although in time much of its terminology became familiar to U.S. accountants through classroom contact during their educational experiences.

*ASOBAT* was a "new and different kind of effort"; its authors' ambitions went beyond anything previously attempted. They sought to occupy the field of information generally, not merely that part which can be expressed in terms of money. They arrived at propositions which would be applicable to all accounting—financial and managerial; individual, corporate, and governmental; not-for-profit enterprises, and so on. They did not restrict themselves to concepts of income and wealth, but spilled over into "the concepts arising from the growing body of knowledge about management."

Actually, the authors constructed an open-ended model which has not as yet been useful in explaining accounting as it is and is difficult to interpret as an explanation of what accounting should be.

**OTHER CONTRIBUTIONS**

The National Association of Accountants has investigated many of the same problems as the AICPA but from the viewpoint of the business executive—controller or financial vice-president. For reasons which are unclear, the NAA has failed to make an impact, in spite of several initiatives designed to improve the quality of its contributions, except perhaps in respect of foreign currency translation.

However, the NAA has placed great importance on research to identify the "entire range of socioeconomic information needed by those who manage a business and by those who provide its capital."

The various associations of financial executives and analysts from time to time publish studies of accounting problems, some of which have drawn attention to areas avoided by the professional bodies, such as accounting for multinational corporations. It is noteworthy that the international field was neglected by the AICPA and the APB.

In other English-speaking countries there has been a comparable surge of interest in reducing the number of alternative treatments available for apparently similar transactions. The extent to which arrangements of accountants outside the United States have been influential in developing accounting principles, as distinct from improving the general level of accounting practice in those countries, is debatable. The Institute of Chartered Accountants in England and Wales has since 1942 issued "Recommendations on Accounting Principles" to its members. In recent years the Accounting Standards Committee (ASSC), a body jointly managed by five of the principal British and Irish accounting associations, has issued exposure drafts and standards on many of the same topics as the APB and the FASB, often with contrary opinions. The Canadian Institute of Chartered Accountants has a research committee which has tended to propose more adventurous solutions than those favored by the AICPA but with little to show for its trouble. In Australia, the Institute of Chartered Accountants in Australia and the Australian Society of Ac-
countants have both engaged in accounting research and publications, often of a high standard. Several Australian scholars enjoy considerable reputations in the United States. In spite of this, Australian financial statements do not reveal the influence of accounting theories different from those which can be identified in the United States.

TOWARD INTERNATIONAL ACCOUNTING STANDARDS

A feature of accounting which has gone almost unnoticed until recent years is its international aspect.

Prior to World War II accountants from different countries met infrequently at International Congresses, starting in St. Louis in 1904. The purpose of these meetings was largely social and fraternal, although technical sessions were an important part. The largest British and American firms of public accountants already had worldwide practices. The growth of international trade, particularly international money markets, following World War II accelerated the internationalization of public accounting but did not lead to the establishment of any supra-national organization to regulate the profession.

The development of an international structure for the profession has proceeded since World War II on three levels:

1. Regular International Congresses of Accountants and regular meetings such as the Inter-American Accounting Conferences and the Asian and Pacific Accounting Conventions. A permanent organization, the Union Européenne des Experts Comptables Economiques et Financiers (U.E.C.) was established in Europe. In addition to biennial congresses, it has standing committees which work toward the goal of harmonizing the public accounting, auditing, and taxation systems of the European countries, particularly those belonging to the European Common Market.

At the International Congress of 1972 a committee was entrusted with the task of coordinating public accounting worldwide. This International Coordination Committee for the Accounting Profession (ICCAP) reported in March 1976 and recommended the formation of an International Federation of Accountants (IFAC) headquartered in New York.

2. The formation in 1973 of the International Accounting Standards Committee (IASC). Its nine original members had each been hosts to one of the International Congresses, and over twenty other countries are now associated with its work. The IASC is headquartered in London and has pushed ahead with the process of establishing international standards for published financial statements. Through June 1976 these included:

- **Standards issued**
  - IAS 1 “Disclosure of Accounting Policies”
  - IAS 2 “Valuation and Presentation of Inventories in the Context of the Historical Cost System”
  - IAS 3 “Consolidated Financial Statements”
  - Exposure drafts issued
  - **E4 “Depreciation accounting”**

3. The Accountants International Study Group was organized in 1966 by the three British Institutes of Chartered Accountants, the Canadian Institute of Chartered Accountants and the AICPA. It has published fifteen comparative studies of practices in the principal countries of the English-speaking world.

CONCLUSION

The development of generally accepted accounting principles or accounting standards, has been a difficult process. The present state, both in the United States and abroad, is a mosaic of opinions, rules, and official regulations which can by no means be regarded as satisfactory.

During the nineteen-sixties a mini scientific revolution appears to have started to bring some order into the chaotic situation. This phenomenon, which will be described in subsequent chapters, has been characterized as "a priori research in accounting" because it consists of hypotheses concerning accounting different from those underlying generally accepted accounting principles, but unaccompanied by any suggestions as to how they can be tested. There now exist two separate communities in accounting, one of which attempts to continue in the ways described in this chapter, and the other to establish a totally different method of developing in accounting standards.

ENDNOTES

2. See the *Journal of Accountancy*, June 1919, pp. 401-433.
9. Ibid., p. xxii.
10. Ibid., p. 4.
11. Ibid., p. 12.
SELECTED ADDITIONAL READINGS


Donald J. Bevis, "How It Feels to be a Gored Ox," TEMPO (House Journal of Touche Ross & Co.) Vol. 21, No. 1, 1975, pp. 45-49.


Gilbert R. Byrne, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" Journal of Accountancy, November 1971, pp. 364-79.


Thomas S. Higgins and Herman Bevis, "Generally Accepted Accounting Principles - Their Definition and Authority", The New York Certified Public Accountant, February 1964, pp. 93-94.


"Ibid, p. 33.


W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, American Accounting Association Monograph No. 3, AAA, 1940.

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