To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?

A Round Table

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TOPICS OF DISCUSSION

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THE MEETING convened at 2:30 P.M. on October 19th at the Waldorf-Astoria, New York, with Mr. Charles B. Couchman, of New York, presiding.

CHAIRMAN COUCHMAN: For many years the leading practitioners of public accountancy have been reducing the practice of accountancy to rules and standards as far as it has been found practical and logical to do so. The elements that make up financial statements have been reduced to standard classifications to the extent permitted by complicated and constantly changing transactions of the business world. Rules have been adopted covering, to a large extent, the various entries affecting the financial classifications. These classifications and these rules have been made widely available through books, articles, addresses and accounting curricula. Practically all the progress that has been made in reducing accountancy to rules and standards has been accomplished by the public accounting profession.

CRITICISM OF THE PROFESSION

I make these statements because in recent years public accountants have been subjected to unjustified criticism in this respect and have been accused of shirking their duty in not standardizing all practices and classifications which become the subject matter of accounting reports. This criticism has been voiced on the platform and emphasized in articles and even in books and unquestionably may have had some effect upon listeners or readers who are unaware of the lack of knowledge behind the attitude of the speakers and writers. I am not including in this the very worthy criticisms often voiced by public accountants themselves or by able teachers or others who have devoted great thought and study to the subject and whose criticisms are wholly of a constructive nature. I am, instead, referring to criticisms from those who have not made sufficient study, nor had sufficient experience in the practical problems of the profession, to enable them to present real constructive criticism, nor enough to allow them to recognize the inadequacy of the arguments they present.

That further progress has not been made in the reducing of accountancy practice to set rules and standards is not due to any indifference on the part of the practicing profession, but rather to a realization on the part of these practitioners that rules or standards which result in false presentation of facts in specific instances or which result in misleading financial statements cannot be supported and must not be tolerated.

AN ANSWER TO CRITICISM

If all of the transactions of business were susceptible to analysis into a definite and rigid number of effects that could be analyzed to an extent that would allow exact classification, then rules could be adopted that would cover correctly each one. However, that is not the case. No matter how long one is engaged in an extensive practice of accountancy, he is continually faced by new and unexpected transactions, each legitimate but each presenting combinations of effects not previously encountered. That is why the sorting of accounting transactions is rigid classifications to which rules and standards may be applied without distortion of fact is a slow process and cannot be otherwise.

No fixed rule may be laid down until all of the accounting elements that may fall within its scope have been studied and their effects determined so completely as to bring exact knowledge that the rule, when applied to them, will result in a proper statement of financial facts. Even then the rule must be subject to possible exception, as there is always the possibility that a new and unexpected set of circumstances may arise to which the rigid application of this rule would result in distortion of truth.

It is true, not only of accountancy, but of almost every other complicated subject, that the one who has only a smattering of knowledge of it considers that the subject is reasonably simple and that he can readily devise rules governing each phase thereof. To the simple, all things are simple. It is only when one goes deeply into the subject, whatever it may be, that he becomes aware of the complications and the difficulties of proper treatment that is applicable to each element. Long ago a poet said:

> "A little learning is a dangerous thing;
> Drink deep, or taste not the Pierian Spring;
> There shallow draughts intoxicate the brain,
> But drinking largely sobers us again."

All I want to do is to bring the subject, as I see it, before you, so that it may be discussed freely and fully here by all that are present. I referred a moment ago to the fact that there has been criticism which I consider unjust applied to public accountants in this country, in recent years particularly. I am referring largely to certain types of articles that have appeared and certain books that have been written, and at times to certain phrases that have been uttered by people in high governmental positions, which were detrimental or attempted to be detrimental, shall I say, to the accounting profession, rather indicating that we were not in this country sufficiently interested in doing the thing which these people desired to see accomplished.

I am going to ask an accountant of the United States to present what he considers his view of this subject, and then I want to follow that with a gentleman from another country.

Mr. Harold Simpson, I should like to have your views on this subject.

MR. HAROLD SIMPSON (New York): Our subject is one which offers almost endless possibilities of discussion; hence the few brief remarks which I am about to make by way of introduction must necessarily be of a very general nature.

No doubt most of you have read the article in the August, 1937, *Journal of Accountancy* entitled, "Accounting in the U.S.S.R." This article deals with a new law passed in 1936, regulating accounting procedure in Soviet Russia and contains the following observation with respect to such law: "It provides a solution of all disputable questions and removes the 'nebulous spots' of the previous accounting code." Here is Utopia at last.

I hope there are no accountants in our Institute so naïve as to think that laws or regulations can provide a satisfactory solution of the disputable questions and the problems with which accountants in this country are required to deal in their day-to-day lives.

We may assume from the phrasing of the subject for discussion that it is recognized that the practice of accounting may to some extent at least be reduced to rules and standards. The difficulty is in prescribing the limits within which standardization is practicable, without having the effect of unduly restricting the freedom of action of the accountant which is so necessary to the continued progress of the profession.

WHAT HAS BEEN ACHIEVED

It will, I think, be conceded that certain routine examination procedures are subject to standardization, that uniform terminology is desirable and to a considerable extent possible of attainment, that further progress toward uniformity in accounting classification is possible and that agreement on certain broad general accounting principles and accepted methods of application is a practicable matter.

It is perhaps safe to say that thus far there has been more standardization with respect to examination procedures than in other directions and it is worthy of note that the Institute has contributed materially toward this standardization through preparation of an outline of procedure to be used as a guide to the extent of work that should be performed as a prerequisite to the certification of statements for credit purposes or for inclusion in annual reports to stockholders. This recommended procedure, originally drafted in 1917 and revised in 1929, has recently been published by the Institute in a somewhat expanded form under the title *Examination of Financial Statements by Independent Public Accountants* and has been widely accepted as a standard for ordinary purposes. This standard, however, is not a rigid one to be slavishly followed. The Institute committee responsible for the publication took special care to emphasize the impracticability of setting forth in any single program procedures which would fit the widely varying situations which would be encountered and stressed the fact that the recommended procedures were to be used as a guide only; that the accountant must adapt his program to fit the particular circumstances and requirements of each engagement; and that responsibility for determining the procedures to be followed in a given case must, as it should, rest with the accountant. I believe most of you will agree that within the limits of its practicability, standardization of examination procedures does have a distinct educational influence and results in increased efficiency, but that it must be carefully controlled, as its overemphasis tends to lessen the effectiveness of an independent examination and to lower the quality of work done by subordinates.

As regards accounting terminology, the Institute several years ago appointed a committee to work with a view to developing greater uniformity. As a result of the efforts of this committee, I understand, a final report will be issued in due course containing definitions of approximately 1,000 terms commonly employed in a technical sense by accountants. This report should prove to be the most noteworthy contribution thus far made toward the development of uniformity in accounting terminology.

By uniformity in accounting classification I do not have in mind the adherence by all corporations of a given class to certain detailed rules binding on all corporations of that class, as is the case of railroads and public utilities. However desirable and satisfactory this procedure may be in the case of public service corporations, the extension of it to industrial corporations generally would encounter obstacles that are well-nigh insurmountable. And even if it were feasible, it is doubtful whether independent public accountants should voluntarily undertake the task, for it is one that would require coöperation from several sources. If, on the other hand, by uniformity in accounting classification is meant adherence to certain accepted principles or rules governing classification for statement purposes, then I think it is unquestionably true that there has been a gradual trend toward uniformity, in the promotion of which the Institute has played an important part.

Coöperation with Stock Exchanges

A few years ago a committee of the Institute, acting in coöperation with the committee on stock list of the New York Stock Exchange, gave official recognition to five broad general principles of accounting which the exchange regards as so generally accepted that they should be followed by all listed companies, and that any departure therefrom should be brought expressly to the attention of shareholders and the exchange. As the same time a standard form of certificate or report, in which emphasis is placed on adherence to accepted accounting principles and consistency in methods of application, was approved and is now in general use. These developments have been instrumental in bringing about a uniformly higher standard in corporate accounting and reporting and have contributed materially to the increasing confidence with which investors, bankers and business leaders accept our work.

The foregoing examples are submitted merely as evidence of the fact that the Institute has been, and still is, active in the promotion of uniformity in accounting standards. It is unnecessary to remind you that responsible accountants are constantly aware of the need for progress toward higher standards and that they do continually work to that end. Improvements in theory, in practice and in form of presentation are continually being made through the constant effort of individuals and their continuous collaboration with one another both directly and through the medium of the Institute. However, despite the progress which has been made, it is often stated that there are many phases of our work to which we might profitably apply standardization to a much greater extent than has so far been attempted. In recent years the charge has been heard frequently that the possibilities of standardization of accounting principles and methods have heretofore been insufficiently explored by responsible bodies of professional accountants, and in this connection the apparent inconsistencies in methods used by us in preparing financial statements have been the subject of considerable criticism. It would seem that in these matters we are to be judged, not according to the measure of our accomplishments, but rather according to the degree of our failure to attain the theoretical ideal and without any thought being given as to the practicability of attaining the ideal.

What Remains to Be Done

The investor, banker or businessman who has occasion to examine many financial statements may well feel confused at times with the variety of treatments accorded such everyday matters as consolidation procedure, treasury stock, bond discount and expense, investments in subsidiary companies, discounts on capital stock, and particularly the allocation of various charges and credit as between profit and loss, surplus, and reserve accounts. In many cases readers of financial statements have insufficient training to understand fully the significance of accounts; this is the primary cause of their confusion. In other cases there is lack of appreciation of the fact that within the framework of certain broad general principles of accounting there may be several different methods of application any one of which is acceptable and the choice as to which method is to be used, as a rule, rests with the management and not with the accountant. Few persons appreciate that the treatment of almost any item may vary with the circumstances and the accountant must, of course, reach his own conclusions as to the propriety of the treatment accorded in the light of all the circumstances. His task in this is an unenviable one, for he must endeavor to maintain a reasonable balance between theory and practice; between his obligation to his client and to the general public; between his own immediate interests and the larger interests of his profession. It is small wonder that the accountant is criticized, for his is a task which, because of the various conflicting interests which he serves, invites criticism.

While I believe we are entitled to take some satisfaction in the results of our efforts in recent years to achieve greater uniformity in the practice of accounting, we must at the same time give serious consideration to the criticisms previously referred to and particularly to the charge that the possibilities of standardization of accounting principles and methods have heretofore been insufficiently explored by responsible bodies of accountants. This charge must either be refuted in a satisfactory manner or, if found to be merited, then it must be met by constructive action. I think the answer will best be found by approaching the problem with a view to determining what practical measures may be taken to promote the standardization of accounting principles and methods.

THE STANDARD FORM OF CERTIFICATE

Our standard form of certificate stresses the importance of accepted accounting principles. We acknowledge the existence of a set of principles as expressing the consensus of responsible accounting opinion, but in our individual practices we find no convenient reference medium or authority for guidance as to precisely which principles of accounting are generally accepted. Apart from the five specific principles officially recognized by the Institute, we have to depend upon widely scattered sources of information, such as articles and opinions by individual public accountants, a great deal of which is highly controversial in form and content, and upon educational textbooks which are essentially expressions of theory and may not necessarily represent currently accepted practice.

If it were practicable for the Institute to furnish its members with some authoritative guide to accepted principles of accounting, this would, in my opinion, contribute materially toward standardization. I should therefore like to offer for your consideration and discussion the question as to whether it is practicable for the Institute to undertake the task of preparing such a guide.

We recognize that within the broad general principles of accounting various methods of application may be used. In practice, questions frequently arise as to whether the methods of application are proper and in accord with good accounting practice, so it might be well to consider and discuss the practicability of preparing an authoritative guide not only to accepted principles of accounting but to what are regarded as approved methods of application as well.

We have seen that the Institute has taken the lead in the past in the development of standards of uniformity and we may expect that it will continue to lead in the future in the further development of such standards in so far as this may be practical.

Let me add in conclusion that, since the two national associations have now been merged into a single national organization, one would seem justified in assuming that we can now proceed, confident that any guide to accepted accounting principles and approved methods of application that may be prepared and endorsed by our national organization will truly represent the consensus of responsible accounting opinion and therefore must necessarily be recognized as such by all persons concerned with accounting matters.

CHAIRMAN COUCHMAN: Thank you very much, Mr. Simpson.

I have asked Mr. Kenneth Dalglish, of Montreal, to give us the benefit of his attitude and feeling with regard to this subject. Mr. Dalglish!

MR. KENNETH W. DALGLISH (Montreal, Canada): First of all let me say that I appreciate very much the honor of being asked to participate in this discussion. I do so with some fear and trembling. I am here principally in the capacity of one who is searching for some truth and not able to offer truth.

The day before I left Montreal to attend this meeting I met a brother chartered accountant and during the course of conversation I mentioned to him that I was going to take part in a discussion entitled "To what extent can the practice of accounting be reduced to rules and standards?" He replied "Oh, the answer to that is easy, it just can't be done." However, I don't suppose that Mr. Couchman, as leader of this discussion group, is going to be satisfied with an unsupported statement of that kind.

On referring to a standard dictionary, I find the word "rule" defined as "a concise direction respecting the doing or method of doing something." "Standard" is defined as "any measure of quality established by law or by general usage and consent."

The term, "practice of accounting," is an all-embracing one, but for the purpose of these remarks I will restrict it to mean the preparation of the annual accounts of companies.

Balance-sheets and related profit-and-loss accounts or income statements are prepared on the basis of certain broad accounting principles. There is, I believe, a considerable difference in nature between these broad accounting principles and a rigid adherence to a way of doing things which the definitions of the words, "rule" and "standard," imply.

DEVELOPMENTS IN CANADA

As to the form of the annual balance-sheet and accounts, I believe that considerable progress has been made during recent years. In the years 1934 and 1935, for example, extensive revisions were made to the accounting provisions of the Dominion companies act, their main purpose being to afford to shareholders of companies more information in the form of the annual accounts presented to them. We are now fairly well accustomed to see balance-sheets divided into the respective classes of assets and liabilities such as, fixed assets, current assets and deferred items, current liabilities and funded debt. It might be said that some progress has been made towards standardization of form, although that can never completely be achieved. There is, however, somewhat of a danger involved inasmuch as there may be a tendency to fit items into the classifications which we are accustomed to see, when they can be more properly treated as separate items with adequate descriptions to explain their nature.

Many of the general public are unfortunately under the impression that the annual accounts of a company are the result of an exact mathematical process. We have all seen statistically-minded people working out "asset values per share of stock" and attributing to the results obtained an importance which is not justified. May I mention in passing that the public accounting profession in Canada is endeavoring to enlighten the public in that regard so that the limitations of a balance-sheet may be more generally understood.

Opinion plays a very important part in the preparation of balance-sheets and accounts. The circumstances to be considered and upon which conclusions, based largely on opinion, have to be arrived at are many and varied.

It may be cited as a general principle of accounting that depreciable assets should be written off over a period of their expected use. The expected period of use is, of course, a matter of opinion. In one industry manufacturing a product which does not vary and where manufacturing methods are not subject to radical change, a period of ten years might be sufficient in which to write off tools and miscellaneous items of plant. In another, such as the radio industry with an ever-changing product and methods of manufacture, the writing off of such items of plant in one or two years may be justified. It would hardly seem possible to formulate rules and standards on this important matter of depreciation other than the general principle to which I have referred.

It may again be cited as a general principle of accounting, except in the preparation of accounts of certain peculiar industries, that inventories should be valued at cost or market, whichever is lower. There cannot, I feel, be any hard and fast rules regarding the determination of cost, as many of the elements entering into cost are largely a matter of opinion. In the case of the cost of finished product, for example, the raw material content may be based on a "first in, first out" basis or on an "average cost" basis or on a "last purchase" basis and one of these bases may be more suitable than another. The extent to which overhead, as an element of cost, is attributable to the various items in the inventory is again largely a matter of opinion. It may be determined on a basis of departmental loading rates or machine rates, and in the computation of these rates the distribution of expenses departmentally or by machines is dependent on the opinion of those who are responsible for the determination of costs. After the inventory has been priced at cost there arises the question of its valuation, having regard to its condition and prospects of ultimate disposal, which involves the writing down of slow-moving and other lines. The valuation of inventories, therefore, upon which the results shown by the profit-and-loss account for any year depends so much, is and must always be largely a matter of opinion and consequently it would not appear to be possible to adopt any rules and standards other than the broad principle respecting the valuation at lower than cost or market to which I have referred.

It would, I am sure, be possible to go on for some considerable time outlining other items in the balance-sheet, the valuation of which depends upon opinion. Opinion cannot be regimented by rules.

Sometimes we are confronted with difficulties in the treatment of the most apparently simple principles of accounting. Additions to fixed assets, for example, should be made at cost. A purchase of machinery may be made by a company in country "A" from a supplier in country "B," the price to be paid therefor being quoted in currency of country "B." The purchaser in country "A" arranges terms whereby payment will be made some considerable time after the date of delivery. In accounting practice the machine in the first instance would be treated as an addition to fixed assets and the corresponding liability to the supplier set up on a basis of the rate of exchange ruling at the date when the purchase of the machine is contracted for and delivery made. In the interval between that entry and time of payment the currency of country "B" has depreciated in terms of the currency of country "A," and consequently the liability set up in the books of the buying company is more than sufficient. Should the profit arising be treated as an exchange profit and credited to income account, or should the book value of the machine purchased be written down by the amount of such profit, or should this profit be kept in reserve until another similar machine is purchased when the currency of country "B" might be back to normal or even at a premium? Any one of these three treatments may be justified.

A balance-sheet of a company is to a great extent a legal document and in its preparation consideration must be given to the provisions of the act under which the company is incorporated. Unfortunately companies are sometimes permitted to do things which seem to violate accounting principles, and this will always be so because the opinions of accountants are not extensively sought when company legislation is being drafted. For example, we feel that no part of the undistributed profits of a subsidiary company at the date of its acquisition should be regarded as surplus of the parent company either on consolidation or where dividends are paid by the subsidiary company to the parent company. Our Dominion companies act, however, permits the directors of a company which has acquired a subsidiary company by the issue of no-par-value shares to set aside to a surplus called "distributable surplus" an amount equal to the undistributed profits of the subsidiary as at the date of its acquisition. There are, I am sure, many instances where the provisions of various statutes do violation to accounting principles but which nevertheless must be recognized in the preparation of annual statements.

THE PROFIT-AND-LOSS ACCOUNT

The tendency in accounting practice during recent years has been to attach increasing importance to the profit-and-loss account or income statement. Auditors of companies in Canada have not been called upon, as yet, to make direct references to the profit-and-loss account when reporting upon the annual accounts, but it will occasion no surprise if amendments to the companies act in the near future make that necessary. We have viewed with considerable interest accounting developments in the United States in this regard. This trend would seem to make a search for additional accounting principles desirable. I have in mind particularly principles governing the determination of what items of loss or profit might properly be treated in the surplus account. One school of thought would like to see the entries in the surplus account restricted to appropriations of profits by way of dividends and in other ways and to treat all items of profit or loss arising during the year in the income account. The other extreme is to deal with unusual items, not strictly operating items, through the surplus account.

Accountants in Canada are also struggling with "capital surplus" in an endeavor to arrive at a uniform interpretation of what it should contain. Here again there is a considerable difference of opinion. Some would like to see realized profits on the sale of capital assets treated as additions to capital surplus and others would restrict it to surplus arising through reorganization of the share capital of the company and to unrealized surplus such as a surplus arising on the appraisal of fixed assets. I believe that our profession should endeavor to arrive at conclusions on matters of that nature.

In conclusion, I would like to summarize my remarks as follows:

1. The preparation of balance-sheets and accounts, involving the valuation of assets and the basis upon which amounts shall be written off is dependent to a very large degree on opinion and judgment.
2. Business is carried on in many different ways and the circumstances to be considered in determining accounting treatment are correspondingly many and varied.
3. In view of the foregoing, the practice of accounting does not lend itself to the formulation of rules and standards.

The practice of accounting can only be made subject to broad principles, and our profession should continue to search for and develop these principles, but any which are developed must be sufficiently broad in scope to permit of reasonable accounting treatment under all circumstances.

CHAIRMAN COUCHMAN: Thank you very much, Mr. Dalglish. The subject for this discussion is a question, and the question is, "To what extent can the practice of accountancy be reduced to rules and standards?" All of these talks have explored the idea of trying to give to us, if we are able to work it out here today, something in the way of a better understanding of the extent to which such developments can be made.

ESSAY CONTEST

The American Institute of Accountants is and has been for a long time tremendously interested in this subject—to such an extent that this summer a prize was offered in order to induce the active thought of some who may not have otherwise made a contribution to this subject, in the hope that through that we could get new light, new ideas. I think the Institute is to be congratulated upon the result of that prize because it has produced some excellent papers which have presented thoughts that perhaps have been vague in our minds before. They have crystallized them into very definite form.

The winner of the prize—the one whose paper was adjudged the best of those submitted —I believe is to give his paper at a later session of this convention, but I have asked him to come here today and to summarize it briefly in case that can be done. When I read his paper I didn't see how he could condense it at all, but nevertheless I have asked him to give us at least a fifteen-minute or twenty-minute summary of that paper. Mr. Gilbert Byrne!

[Mr. Gilbert R. Byrne, of New York, then summarized his paper, the full text of which is here reproduced.]

TO WHAT EXTENT CAN THE PRACTICE OF ACCOUNTING BE REDUCED TO RULES AND STANDARDS?

Modern professional practice of accounting covers a wide range of subjects, and its field, if the experience of the past decade can be taken as a guide, may be expected to widen still further in the future. For example, in 1931 a report of a committee of one of the professional bodies of accountants classified accounting services in six divisions; to this list would now have to be added those services performed by accountants in connection with registrations of securities and other matters for the Securities and Exchange Commission. To discuss the possibility of stating rules and standards relating to all of the matters coming within the practice of the present-day accountant would be quite impossible within the limits prescribed for this article, even if it were agreed that it is practicable to consider the formulation of rules and standards for, say, the installation of a cost system or the prosecution of a tax case.

It probably would be conceded that the major portion of the professional accountant's practice is concerned with the examination of financial statements and the accountant's report thereon; and the discussion which follows will be confined to a consideration of whether and to what extent this phase of the accountant's work can be reduced to rules and standards. As a preliminary to this discussion it will be helpful to recall that, broadly speaking, the accountant's purpose in making his examination is to determine that proper accounting principles have been consistently followed in keeping the accounts, and that clear and truthful financial statements have been prepared therefrom. To assure himself of these facts, he employs a technique of auditing procedures. There are, therefore, really three phases of the accountant's work in connection with the examination of and reporting on financial statements, each of which may be considered potentially subject to reduction to rules and standards:

(a) Accounting principles, and the rules derived from these principles,
(b) The practices and conventions relating to the presentation of accounts in financial statements,
(c) The technique of auditing.

TWO DIVERGENT VIEWS

The general question as to formulating and stating the principles, rules, conventions, or standards of the practice of accounting has engaged the attention of a number of writers and speakers on accounting subjects in recent months. There have been developed two quite divergent points of view; on the one hand, those who urge that a statement of accounting principles can and should be formulated, and on the other, those who envisage the impossibility, if not the undesirability, of the task. The following quotations, characteristic of the first school of thought, are interesting:

> "After a quarter-century and more of active discussion and experimentation in this country, many of the simplest and most fundamental problems of accounting remain without an accepted solution. There is still no authoritative statement of essential principles available on which accounting records and statements may be based. Public accountants . . . have been asked to certify to the correctness and adequacy of accounting statements, when no satisfactory criteria of correctness and adequacy have been agreed to."[1]

And another commentator has expressed similar ideas in these words:

> "Accountancy has . . . the tendency to rely on precedent and authority rather than on the scientific method . . . It is as if engineers had no agreement on the required strength of foundations, structural steel requirements for skyscrapers, or efficient design for power plants."[2]

It is perhaps not unnatural that the authors of the above are men of academic or regulatory-body training; expressions of the opposite view given below are those of practicing accountants:

> "The field of financial accounting is not one in which guidance is to be found wholly in fixed principles—it is a field of shadowy outlines in which the discovery of a correct course depends upon the possession also of an ability to recognize the essential facts and to appreciate their true significance (distinguishing where necessary between form and substance); upon informed and wise judgment; and upon objectiveness and honesty of purpose. It will be observed that these are not qualities which can be insured by regulation."[3]

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[1] A Statement of Objectives of the American Accounting Association, *The Accounting Review*, March, 1936.
[2] George C. Mathews—Address before Milwaukee chapter of Wisconsin Society of Certified Public Accountants.
[3] George O. May—Improvement in Financial Accounts, JOURNAL OF ACCOUNTANCY, May, 1937.

Another practitioner comments on the published discussion as follows:

> "First, what has frequently been spoken of as accounting principles includes a conglomeration of accounting practices, procedures, policies, methods and conventions relating both to the construction of accounts and their presentation; and second, there seems to be a general agreement among the commentators that the difficulty of any attempt to formulate so-called principles or prescribed rules and regulations on accounting matters is so large and the conditions encountered so diverse that few, if any, sweeping generalizations can safely be adopted."[4]

As indicated previously, there are three phases of the accountant's work in connection with the examinations of financial statements and his report thereon which may be considered potentially subject to reduction to rules and standards. First, the accounting principles which he must assure himself have been properly and consistently applied in preparing the accounts; second, the practices and conventions relating to the presentation of the accounts in financial statements; and third, the technique of auditing employed by the accountant in determining that the accounts and statements have been properly prepared. As indicated by the author of the last quotation above, recent discussions have used the term "accounting principles" to cover a conglomeration of accounting practices, procedures, conventions, etc.; many, if not most, so-called "principles" may merely have to do with methods of presenting items on financial statements or technique of auditing, rather than matters of fundamental accounting principle. It is not strange, perhaps, that lacking completely satisfactory definition of terms, or clarification of the fields of discussion, there has been little or no agreement among accountants as to what extent, if at all, rules and standards of accountancy practice can be stated.

In fact, the confusion with respect to the matter of differentiating between accounting principles, rules, conventions, practices, etc., is so great that some have despaired of reaching a solution, and have raised the question as to whether, after all, there *are* such things as accounting principles. It is proposed, therefore, first to inquire as to the nature of accounting principles, the distinction, if any, between an accounting principle and an accounting rule, and then as to whether accounting principles and accounting rules can satisfactorily be formulated. Some consideration will then be given to the extent to which the accounting practices and conventions relating to the preparation of financial statements and the technique of auditing can be reduced to rules and standards.

THE STANDARD FORM OF REPORT

The standard form of report used by most accountants in certifying financial statements of corporations whose securities are listed on the New York Stock Exchange is predicated upon the existence of known accounting principles, for it concludes, after an opening paragraph briefly describing the nature and scope of the examination made,

> "In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, *in accordance with accepted*

[4] F.P. Byerly—Formation of Accounting Principles or Conventions. JOURNAL OF ACCOUNTANCY, August, 1937.

principles of accounting consistently maintained by the company during the year under review, its position at December 31, 19--,and the results of its operations for the year."

Such a statement presumably represents the informed and well-considered opinion of an expert in the field of accounting; it presupposes that there are principles of accounting, known to the accountant, which can be applied to business transactions so that the resulting books of account and the financial statements prepared therefrom may fairly reflect the financial position of the enterprise at a given date and the results of its operations for a specified period. There must be agreement among accountants that there are recognizable principles of accounting, for if there is not this agreement, accountants have indeed stultified themselves.

THE NATURE OF ACCOUNTING PRINCIPLES

It is probably safe to say that all schools of accounting thought would agree that it is desirable to have formulated in an authoritative way the principles of accounting to which reference is made in the form of accountant's report quoted above. While there have been several attempts to enumerate them, to date there has been no statement upon which there has been general agreement. This lack of agreement, it is submitted, results in large part because there is no clear distinction, in the minds of many, between that body of fundamental truths underlying the philosophy of accounts which are properly thought of as *principles*, and the larger body of accounting rules, practices and conventions which derive from principles, but which of themselves are not principles. If accounting, as an organized body of knowledge, has validity, it must rest upon a body of principles, in the sense defined in Webster's New International Dictionary:

> "A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which others are founded; a general truth; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate."

President Coolidge said, "Laws, whether statutory or natural, are not invented—they are discovered, and discovered only after experience." In the development of any field, principles are discovered which represent the fundamental truths on which the field of knowledge rests. These principles are applied in the working out of problems that arise, and gradually, rules of practice evolve which, over a period of time, become accepted to a greater or less degree as reflecting the effect of the principle in oft-recurring cases. Such rules become the working tools of those engaged in the particular field of knowledge. While the principles upon which the body of knowledge rests cannot, from their nature, be subject to dispute, the rules derived therefrom have validity only to the extent that they properly reflect the principle. Pending complete demonstration of this fact, usually through experiment, there may be considerable disagreement as to whether a particular rule should be followed. Accounting, as well as law, engineering and many other fields, has followed, and is still following this pattern of development. It is probable that there are principles still to be discovered, and certainly accounting rules are still in process of crystallization.

As to the fundamental principles of accounting, there can be no more question of their "general acceptance" than of the moral rightness of the ethical principle that it is wrong to kill. But there are legal rules derived from the moral command, "Thou shalt not kill," which have differed at different times and in different countries. At one time no legal penalties attached to a noble who killed a serf, and even in our own colonial times no jail sentence awaited the Pilgrim Father who shot a stray Indian at sight. At present, legal rules derived from the moral principle are to the effect that an accidental killing is subject to less penalty than killing in the heat of passion without premeditation, and that the latter is considered legally less culpable than willful, premeditated murder. Legal rules in different states classify differently legal culpability for killing. In short, while there is no difference of opinion as to the moral principle that killing is wrong, there have always been, and still are, differences of opinion as to how the principle shall be reflected in legal rules, and also differences of opinion as to whether the legal rules have been properly applied to the facts in a particular case. The latter is one reason for the popular interest in murder trials.

Another example of the differences between fundamental principles and the effects of their application may be drawn from the engineering profession. There are, of course, principles of engineering governing the size, weight and design of the steel members of a bridge structure. In designing the Manhattan and the Williamsburg bridges, which were built in 1909 and 1903, respectively, and were proposed to span the same stream, presumably sound engineering principles were applied to the problem in each case. In the application of those principles the results, so far as appearance of the two structures are concerned, are quite different, yet no one accuses the engineers of having applied different principles to their respective problems merely because the results of such application have not been identical bridges.

Rules Derived from Principles

In much the same way, while there may be complete agreement as to the underlying principles of accounting, there may be legitimate and proper—one might say inevitable—differences of opinion as to the effect of the application of a particular principle of accounting to the facts in a particular case, or, in other words, as to the propriety of the accounting rules derived from the principle. Further, while the fundamental principles of accounting remain unchanged, the rules and practices derived therefrom will, and ought to, develop as required by changes in business practice. It should cause no surprise if financial statements a generation hence differ as much from those of the present day as these differ from those of a generation ago. The *principles* of accounting remain the same, and about them there should be no substantial disagreement; as to the body of accounting rules, practices and conventions derived from those principles, there may well be differences of opinion as to their validity in a particular case. As a result of such inevitable differences in opinion, therefore, it is not difficult, in reviewing the work of members of the accounting profession as exemplified by published reports of corporations accompanied by an accountant’s certificate, to find instances where apparently similar transactions have been given what appears to be different treatment by different accountants. When analyzed, however, the differences in treatment most frequently reflect, not incorrect nor improper underlying accounting principles, but merely differences of opinion as to the best manner of presenting the accounting effect of the application of such principles.

From the above discussion there begins to emerge, it is hoped, an outline of accounting as an organized body of knowledge resting upon a body of fundamental principles admittedly known to and utilized by accountants in the course of their examinations of financial statements. Certainly, then, these principles can be stated. From these principles, however, have been derived certain accounting rules which have validity only as they correctly reflect the application of the principle on which they depend. Since there may be considerable difference of opinion as to the propriety of accounting rules, the task of stating those rules with respect to which there may be said to be general agreement, is a formidable one. It would seem, therefore, that a long step forward in the solution of the problem which is the subject of this paper would be to establish a basis for distinguishing between an accounting principle and an accounting rule.

Dr. Henry Carter Adams, in discussing the claims of accounting to classification as a science, has said, "The commonly accepted proof that a body of organized knowledge has attained the rank of an established science is the coercive or compelling character of the generalizations to which it gives rise and which come to be known as scientific laws (principles)."[5]

Coercive Nature of Principles

The compelling character of the scientific laws of health is evident, because to disregard them in the long run literally results in death. Engineering principles have a coercive character, because to ignore them in the building of a bridge would probably result in the collapse of the bridge. Such principles are compelling in the sense that they are in effect self-enforcing; they cannot be disregarded with impunity.

The principles of accounting are also characterized by their coercive or compelling quality because inherent in accounting principles are business laws which must be obeyed if in the long run the enterprise is to survive. This does not mean, of course, that adherence to correct accounting principles is, in itself, a guarantee of business success; accounting has to do largely with the financial policies of business, and policies of sales, production, labor, and other management problems are important elements in the success or failure of a business enterprise. It should be apparent, however, that the basing of financial policies upon accounting statements which in turn are not prepared in accordance with fundamentally right accounting *principles*, may lead to courses of action which, if too long pursued, will adversely affect the financial health of the business. It is in this sense that the fundamental principles of accounting may be said to be coercive and self-executory.

Professor Arthur S. Dewing, in describing the financial difficulties of the United States Realty and Construction Company in 1903[6] said as to the causes therefor that "two of these causes were concerned with the methods of accounting tolerated by the company's management . . ." Both of these methods clearly violated the accounting principle that unrealized and undeterminable profits should not be included in the income account. Professor Dewing[7] gives as one of the causes of the failure of the Consolidated Cotton Duck Company in 1909 the "inadequate allowance for depreciation." Any list of accounting principles would include a statement to the effect that the investment in an industrial plant should be charged to operations over the useful life of the plant. Most experienced accountants will recall other instances where failure to follow correct principles of accounting has led to financial embarrassment.

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5 H.C. Adams—American Railway Accounting.

6 Corporate Promotions and Reorganizations, p. 239.

7 *Ibid*., p. 374.

ILLUSTRATIVE PRINCIPLES

Accounting principles, then, are the fundamental concepts on which accounting, as an organized body of knowledge, rests. Like the axioms of geometry, they are few in number and general in terms; they possess the distinguishing characteristic of a compelling and coercive nature, and they are the foundation upon which the superstructure of accounting rules, practices and conventions is built. It is not the purpose of this article to attempt a formulation of the principles of accounting, but for illustration, it seems desirable to indicate roughly what, on the basis of the above description, such a statement would include:

(1) Accounting is essentially the allocation of historical costs and revenues to the current and succeeding fiscal periods.

(2) The investment in an industrial plant should be charged against the operations over the useful life of the plant.

(3) In computing the net income (available for dividends) for a period, all forms of expense incurred in the production of such net income must be provided for.

(4) The income shall include only realized profits in the period during which realized; profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sale price is not reasonably assured.

(5) Losses, if probable, even though not actually incurred, should be provided for in arriving at net income.

(6) Capital-stock and capital-surplus accounts, taken together, should represent the net contribution of the proprietors to the business enterprise.

(7) Earned surplus should represent the accumulated earnings of the business from transactions with the public, less distributions of such earnings to the stockholders.

(8) 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 the accounts over a period of time.

It is not suggested that the above list is complete, and certainly not that it is free from all possible criticism. It is urged, however, that it represents, however imperfectly, some of the underlying principles of accounting about which there can be no dispute as to their validity, which possess the characteristic of compulsion in the sense more fully referred to above.

ILLUSTRATIVE RULES

From such principles are derived many of the rules, practices and conventions used in the practice of accounting. Some of these rules are really special cases under, or corollaries of, one of the fundamental principles, and as such have much of the compelling force of the parent principle. Such a rule is the familiar one that inventories should be priced at “cost or market, whichever is lower”; this rule is really an application of principle 5 above. On the other hand, many rules as to the pricing of inventories at “cost” have been developed, such as “first in, first out,” “last in, first out,” which cannot be considered as principles, because such rules obviously have no compelling character, of themselves. In the application of the principle that it is necessary to provide for probable losses, the accountant has full liberty to employ any one of these rules as to pricing, according to his judgment as to what is the most appropriate rule in view of all the circumstances, and, whichever one he selects, he should not be charged with violation of any accounting *principle*.

A familiar example is that of the numerous rules which have been proposed for charging to operations the cost of an industrial plant over its useful life. So long as this *principle* is applied, it can make little difference in the long run which of the *rules* for spreading the cost year by year is used. Such rules should not be confused with the principle, for they have not the coercive nature which characterizes a *principle*.

In the application of accounting principles relating to the allocation of revenues and expenses to periods and to the determination of the realization of profits in certain types of contracting business, there have been developed two accounting rules for use in appropriate cases. Where the contracts comprising the business on hand are few, large in amount, and require long periods for completion or fabrication, an accounting rule is invoked which permits the computation of periodical profits or losses based on the percentage of completion of the contracts in progress. On the other hand, if the contracts involved are numerous, moderate in size and the construction period is less than one year, it is considered that the accounting principles referred to have been correctly applied where profits (and losses) are determined when contracts are completed or deliveries made. It should be apparent that in borderline cases good accounting and business judgment based on long experience are essential for competent decision as to which of the above rules is property selected. Such rules are not principles, for they are not of themselves compelling, and have validity only as they correctly reflect the principles on which they are based.

A review of the published material relating to the matter of standardization of accounting practices indicates that it is largely the body of accounting rules derived from principles which the academically minded critics wish to see definitely formulated. They become impatient at the fact that, pending crystallization of accounting practices based on fundamental principles into generally accepted rules, there are differences of opinion among accountants and among business men as to the proper application of a given principle of accounting, or as to which of two or more principles are applicable in a given case, or as to which of several methods of presentation of the effect of the application of a principle is the more logical or informative. They apparently feel that swifter progress would be made if accounting rules were presently established by an accounting authority, or possibly by dicta of government commission. Presumably our democratic political philosophy would then require some judicial body to which appeal could be made for decision between persons of opposite view, so that, following the example of the legal profession, official precedents would be established for future guidance. As to whether such procedure would in fact facilitate the formulation of generally accepted accounting rules, it should be recalled that whereas legal rules have been in process of formulation and definition for many centuries, some of them are still far from final settlement, and differences of opinion are so widespread that they are reflected in five-to-four decisions in our Supreme Court. We may be encouraged, then, in insisting on the present laissez-faire method of development of accounting rules when we consider by comparison the progress made by the accounting profession in its less than one hundred years of experience. As was said by Mr. Justice Holmes,

> ". . . When men have realized that time has upset many fighting faiths, they may come to believe that the ultimate good desired is better reached by free trade in ideas; that the best test of truth is the power of thought to get itself accepted in the competition of the

market; and that truth is the only ground on which their wishes can safely be carried out."[8]

And with specific reference to differences of opinion regarding reporting on accounting matters, Professor T.H. Sanders remarked:

> "In the face of these difficulties the main reliance must be on accountants of sufficient experience, disinterestedness, and sound judgment to be able to make the best choices among alternatives. As experience accumulates, however, it becomes possible to embody it in general principles (rules) for the guidance of all concerned. Not that these principles (rules) can ever be a substitute for judgment and experience, but they may serve to supplement these in a helpful way and to reduce the area within which the application of judgment is desirable."[9]

There seems to be no good reason why the experience of the accounting profession to date should not be reflected in a statement of accounting rules, soundly based on fundamental accounting principles, provided it is recognized that such rules have validity in a particular case only if and to the extent that they correctly reflect the underlying principle. The choice between one or more rules, or between methods of applying the rule selected, must always rest upon the skill, experience, and informed judgment of the accountant. It has been well said that these are qualities which are not insured by rules and regulations.

The fundamental principles of accounting followed in keeping the accounts are, of course, reflected in the financial statements periodically prepared therefrom. The manner of preparation of the statements, the classification of the data shown thereon, and the various methods of disclosure of pertinent information have, however, been the subject of many rules, regulations and dicta, which have frequently been dignified improperly with the title of "accounting principles." Such rules are properly designed to produce statements which are convenient and informative, but they are based almost solely on constructive and logical thought as to what presentation will most clearly inform the reader as to the facts desired to be set forth; they have not the quality of compulsion which it is urged is an essential attribute of a fundamental accounting principle.

Conventions Relating to Form

Many of the rules and conventions relating to presentation of financial statements are so completely logical and have become so imbedded in practice that to disregard them would be to mark the practitioner as inept and unskilled in his art. Compliance with them is assumed by those accustomed to reading financial statements. It is customary, for example, to prepare balance-sheets in statement form, with assets on the left and liabilities and capital on the right; to separate and subtotal current assets and current liabilities, property accounts, long-term debt and the like. But suppose the items, correctly described, were simply listed in alphabetical order on a balance-sheet; the fact that conventional arrangement was not followed might mark an unskilled accountant and might cause annoyance to the reader of the statement, but the violation of the

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8 *Abrams v. United States*, 250 U.S. 616, 630.

9 T.H. Sanders—Reports to Stockholders. *The Accounting Review*, September, 1934.

conventions relating to presentation would not cause financial embarrassment; they cannot be said to have compelling or coercive character.

An Underlying Moral Principle

Aside from the conventions as to form, the underlying principle relating to presentation and classification of items and accounts in financial statements is hardly an accounting principle at all but the moral principle that with respect to financial statements the accountant is bound to tell the whole truth. In other words, however an item is listed or classified, it should be correctly described. To include a note due five years from now in the usual balance-sheet under the caption "current notes receivable," to describe an investment "at cost" when it really had been written up 50 per cent, to include extraneous windfall profits in operating earnings, would violate this principle, and this principle is compelling in the sense that those who violate it are subject to moral and even legal penalties.

A number of rules which are really based on this principle are given in the text of section 2 of the bulletin, *Examination of Financial Statements*, issued by the American Institute of Accountants in January, 1936. For example:

> Funds subject to withdrawal restrictions should be so described on the balance sheet.
>
> The reserve for bad and doubtful accounts should be shown as a deduction from the corresponding assets.
>
> The amount of any accounts receivable that have been hypothecated or assigned should be so shown on the balance-sheet.
>
> Notes payable to affiliated companies and to stockholders, directors, officers and employees should be shown separately on the balance-sheet.
>
> Any default in the interest or sinking-fund requirements that may exist (as to funded debt) should be mentioned on the balance-sheet.
>
> Serial bonds, notes and mortgage installments due within one year should be separately disclosed and, if material, should be included with the current liabilities

Such rules as the above are essentially suggestions which, if followed, will tend to insure that no material fact is overlooked in the preparation of financial statements. A considerable body of this type of rule has been stated in the bulletin referred to; while others could no doubt be added, it is obviously impossible to foresee and provide rules to cover all possible situations. The busy practitioner knows how very frequently problems of presentation arise which are not covered by any stated rule; his recourse is to apply the moral principle that it is his duty to give the reader all pertinent information in a logical and understandable manner. The result must rest primarily on the integrity and skilled, informed judgment of the accountant. If, in similar situations, equally capable practitioners arrive at different solutions, it may well call for what Dr. Lin Yutang calls a typically Chinese point of view, that "A is right, but B is not wrong either."

THE TECHNIQUE OF AUDITING

There is a large volume of accounting literature dealing with the technique of auditing procedure employed by the accountant to assure himself that correct accounting principles have been employed in arriving at the balances in the accounts, and to afford him the necessary information for judging whether the pertinent facts are fully and truthfully displayed in the financial statements prepared from the accounts. Most of this literature represents an attempt to reduce auditing technique to rules and standards. Probably the most successful general statement of the rules of auditing technique is contained in the second section of the bulletin, *Examination of Financial Statements*, issued by the American Institute of Accountants in January, 1936. The text of the bulletin emphasizes that in determining the nature and extent of the examination, the accountant will necessarily take into consideration, among other things, (a) the purpose of the examination, (b) the amount of detail included in the statements to be covered by his report, (c) the type of business the accounts of which are to be examined, and (d) the system of internal check and control.

It seems apparent that the rules of auditing technique must be limited to rather general statement, such as that contained in the bulletin referred to above, and that the element of personal judgment, competence and integrity of the auditor is far more important than detailed specifications for making audits. With respect to auditing procedures to be undertaken is a specific engagement, however, an audit program written for that particular engagement is a desirable aid to a well-conducted examination, and is a valuable record of just what was done.

CONCLUSION OF THE ESSAY

To what extent can the practice of accounting, as it relates to the examination of and reporting on financial statements, be reduced to rules and standards? Accounting of the highest abilities and reputation are willing to give their considered opinion, after due examination, that the financial statements under review fairly present the position of a company based upon accounts determined in accordance with accepted principles of accounting. It follows that these fundamental truths upon which such opinion is based, and which may be properly dignified with the term principles, are known to the accountant and are matters with respect to which, by their very nature, there can be no general disagreement. These principles are characterized by their compelling or coercive nature, and this attribute distinguishes them from those rules of accounting which have been derived from principles but, of themselves, have no validity except as they logically depend upon principles. The principles of accounting, as herein defined, are capable of being stated and agreed to; the rules of accounting derived therefrom are subject to gradual crystallization as experience winnows those which are valid from those which are doubtful. The conventions and rules with respect to the presentation of data in financial statements depend on the moral principle that all material facts necessary to the proper and complete understanding of the statements must be given; many of these conventions are so firmly imbedded in practice that there should be no difficulty in enumerating them. As to the rules of auditing procedure, a general course may be charted, as in the American Institute bulletin, and certainly programs of audit for specific engagements are useful tools, but in preparing such a program the first essential is a high type of professional and moral equipment on the part of the practitioner.

CHAIRMAN COUCHMAN: I think, gentlemen, that you will agree with me that this search for the truth with regard to the foundation of principles and rules has been greatly accelerated by the papers that have been presented in this contest as exemplified by the one Mr. Byrne has been good enough to summarize for us.

Now, Mr. Simpson, Mr. Dalglish and Mr. Byrne have laid before you the subject matter of this conference as they see it. They are ready, I am quite sure, for your fire. Volunteers are not very numerous at the moment; you may be drafted.

MR. A.A. GARRETT (London, England): I listened with very great interest to the three papers which have been given to us on this subject, and I feel that one conclusion that we must draw from them is that we have a multiplicity of rules and we have some very definite accounting principles with which we all must be acquainted if we are to carry out our job as professional accountants.

THE PROBLEM OF PRESENTATION

I think one of the problems of the accountant today is to prevent the public from being misled by developing, not so much further statements of rules and principles, as methods of presenting the information which is prepared. Yesterday we had a remarkable lecture by Mr. LaRose, and that point was illustrated over and over again. There was an insistence on simplicity in presentation—the vertical method of presenting balance-sheets in reports. I think one does find that the client follows a balance-sheet with greater ease if there is a proper segregation of the fixed assets from the circulating or the current assets; similarly, the capital net worth figures from the current liabilities. We still have a long way to go before we get uniformity in this, as in many other respects.

The newspaper, which I suppose many of you have seen and which is the organ of accountancy in Britain, devotes about four pages every week to several accounts of public corporations which are submitted to the shareholders and criticizes the methods of presentation. If the corporation happens to be a very big holding company with very complex trading operations, probably with subsidiaries in various corners of the globe whose accounts are prepared two or three months before the accounting of the other companies, it is obvious to accountants that it is tremendously difficult to tell the story in the balance-sheet. One may have a regard, in auditing the balance-sheet of the holding company, for the accepted principles of accountancy as we know them today, but it is tremendously difficult to tell the story, and I think in considering a problem of this kind, the point that Mr. Dalglish raised, namely, the limitations of balance-sheets, should be kept well in mind.

Sir Gilbert Garnsey wrote an admirable paper some years ago on that very problem, and I think a great deal of the misleading information which is given to the public by financial columns in the press, and so on, arises from the fact that the people who are giving that information are basing their conclusions on a document which has very definite limitations. And I think that is a point which we practicing accountants should keep well in mind; we should endeavor to enlighten the public, our clients, and so forth, on the fact that it is difficult, in a statement drawn up purporting to give the position of a great corporation as at one particular date, for it to be an exact statement, say, of the net worth of that corporation. If you remember, Mr. LaRose threw a chart on the screen yesterday and he showed you the changes taking place from day to day in various industries which were found to affect stock values. For instance, the introduction of electricity tends to force up the sales of certain products and to retard or prevent the growth of certain industries which have been concentrating on the production of products which are not so competitive. So that a balance-sheet as of a certain date could not give a stockholder or a bank or a creditor a correct idea of the net worth of that business, although all accounting principles have been observed, such as the method of valuing stock and work in process. One has to go outside the document itself for a great deal of information which comes only after years, I presume, of practical experience in setting up ides of values which must vary as between one practitioner and another.

I do feel that a classification of fundamental principles is an essential piece of work that should be carried out by the profession, and I think the contributions which have been made by the three gentlemen who have just spoken are admirable ones. But I do feel that while we have textbooks running into possibly a thousand pages on the valuation of goodwill—one particular asset—and we have a mass of literature dealing with the principles of valuation and valuing fixed assets, current assets, and so on, still one of the problems arising after this consideration of the question of principles and rules should be the ultimate method of presenting the information in the form in which it is intelligible, together with a definite idea of giving the public an understanding that the document, when it is presented, has very definite limitations for the reasons which I have just endeavored to touch upon in these very few moments.

CHAIRMAN COUCHMAN: I am delighted with that expression. I am always glad to hear the viewpoint of the practitioner as given by the representative of Great Britain.

Dr. Taylor, I am going to ask if you will make a few remarks. Dr. Taylor is the head of an organization that has given a very great deal of thought to this subject, and before he gets away I should like to have him express a few words about it.

NEED FOR RESEARCH

DR. JACOB B. TAYLOR (Columbus, Ohio): Mr. Chairman, Gentlemen: I had not counted on saying anything today. You caught me unawares, but I listened with great interest to the remarks which have gone thus far. There has been a common agreement that there are principles underlying the practice of accounting and that there are rules emanating from those principles. If we will agree, as has been suggested, to a consistent application of rules once we adopt them in a particular case, and whenever a situation arises for which there seems to be no rule try by research to develop one, we will have gone far to correct the conditions which make it possible for people, more or less justifiably, to criticize accountants for the type of certificates and the kind of presentation which we have in our financial statements.

I think the one thing above everything else that we need to be careful of is becoming smug or complacent about the thing that we are doing.

The organization which I represent has done some little bit of work in connection with this development of rules and standards and is interested in developing discussion of the subject, to find out not so much what is meant as the way in which these things may be done.

CHAIRMAN COUCHMAN: I appreciate that viewpoint today, Dr. Taylor. I am delighted to hear from you.

One of the dangers, of course, about the question of rules, and one of the things which we have to face today in preparing things more or less under government control—perhaps a government control which is increasing constantly—is the failure of some of these officials to realize that the article to apply to the word “rule” is “a” and not “the.” If we could only realize that “a” rule is far different from “the” rule, I think we would go a long way.

Terminology

Mr. Walter Mucklow (Miami Beach): I should like to say a word or two on behalf of the committee on terminology. I have been on that committee for about fifteen years and for a while I was its chairman.

The object of that committee, you know, is to publish a book which would set forth the meaning of certain words used by accountants.

I do not know whether you remember the story of Sarah Bernhardt, but toward the end of her life, you know, she had to have one leg amputated. An American showman thought that the amputated leg would make a very interesting exhibit, so he telegraphed her and offered her a large sum of money if he might exhibit her leg. And she telegraphed back two words— "Which leg?"

Now, the accountant very often finds himself in that same position and the efforts of the committee on terminology are to tell him which leg is the better one. In the first ten years that the committee was in existence, it published a series of definitions in *The Journal of Accountancy* and asked the members of the Institute to criticize them. The replies were negligible. That is the point I want to emphasize now. It is under consideration that some other plan may be taken up in the near future under which words will be submitted, through *The Journal* perhaps, to you members. If that plan be adopted, I want to urge every one in this room to respond and also to ask him to ask his friends who are in the Institute to respond to the request that is made for suggestions regarding those definitions.

Chairman Couchman: That subject of terminology is getting right down to very definite things, even though we may talk in generalities today, and we realize that the problem that faces us is a very difficult one. It is very difficult to define those principles of which we were speaking, even though we know them. Most of you have read *Lucile,* by Owen Meredith— those of you who are as old as I am certainly have read it. It is said there,

> "Not a truth has to art or
>   To science been given,
> But brows have ached for it,
>   And souls toiled and striven."

And I suppose that is the way we will arrive at a statement of these principles eventually. Then, when it comes to the question of rules and down to the point Mr. Mucklow mentioned, the question of words, we find it increasingly difficult each time we add one to the list to make certain that it is right. After all, a definition, I think, is one of the most difficult of human accomplishments inasmuch as a definition of any classification must be broad enough to include every member of that classification and narrow enough to exclude everything that does not belong in that classification. So the work that Mr. Mucklow referred to has been going on, as he said, for fifteen years and the problems, I know, are great.

Mr. Kohler has been very active in that recently. Maybe he will tell us a few things about the difficulties of the question of the extent to which we can go in these attempts at establishing rules and standards.

Mr. Eric Kohler (Chicago): Mr. Chairman, that question I do not believe I or any one else here is competent to answer so far as accounting is concerned. The approach to problems like this is always very interesting to me, as to all of us. In looking at our profession or at the theory of accounting or whatever particular group of activity we happen to be interested in at the time, the means of approach is necessarily in the long run the philosophical one.

I think that one approach has been voiced this afternoon. That approach begins with the distinction between a standard and a rule. I think that distinction has been validly drawn. However, the speaker who was summarizing his paper indicated that at least two rules had been pretty definitely established: first, the principle of cost and the spread of cost over the useful life of assets and, second, the distinction between capital and earned surplus.

THE INCOME STATEMENT

There is one more rule or standard that I am afraid we have not arrived at yet—we perhaps are perilously close to it—but another speaker hinted at it a few moments ago when he mentioned the series of financial statements which are now being published in the English magazine, *The Accountant. The Accountant*, as was stated, is publishing a series of annual reports. Sometimes these annual reports consist of balance-sheets; sometimes they consist of balance-sheets and income statements; sometimes they consist of balance-sheets, income statements and analysis of surplus. It was not very long ago that a good many of us, as public accountants, permitted our certificate to be attached to a balance-sheet. Then the demand seemed to arise for attaching to most balance-sheets some sort of an income statement.

What is the situation with respect to the income statement? *The Accountant* very ably points out that an income statement should always be attached to a balance-sheet. The income statement does seem rather elementary to most of us at the present time, especially in view of the attitude that has been taken on the question of income statements by the Securities and Exchange Commission during the last two years. However, we are perilously close, as I said before, to setting up some sort of a fundamental standard for an income statement. That has not yet been evolved definitely, but I think the thing is in the air. I believe it is due to the fact—which has not been adequately thought of thus far—that we have so many different opinions as to where certain types of losses should be put; some go so far as to indicate that the income statement is a statement of earning power. I do not, but others will take the position that the income statement should be a complete account of what has taken place in the earned-surplus account between annual balance-sheets.

Just what idea will in the end prevail, is something that none of us can accurately forecast at the moment, but it is one of the ideas being evolved at the present time that I think we can watch with interest. Any principle that may issue which has the result of further consideration of the income statement will be a most interesting thing to observe, because no one as yet has been able to define income statements. That is a rather peculiar statement to make, but those of you who know something about what the committee on terminology has been struggling with in the way of definitions emanating from various members of the practicing and teaching profession, will realize that that is even a modest statement to make. Thank you!

CHAIRMAN COUCHMAN: Regarding that difficulty, I remember that twelve years ago some publisher (who is not a thousand miles away from this room) asked me why I didn't write a book on income. I said, "Sure, fine!" So I started out to do it. I decided, though, that one of the first things I should do would be to define what income is. That was twelve years ago; I am farther from it now than I was then. I thought I had some little inkling of it then but I know I have very little inkling of it now. That book will never be written by me.

MR. PARRY BARNES (Kansas City, Mo.): This problem, like every other, revolves on a matter of definition. You have admitted that you do not know what income is, although you did write a book on balance-sheets. Most of us, if we were honest, should probably be willing to admit that we do not know what accounting is.

To me, accounting is the algebra of commerce. It is the means of recording through the eyes of Arabic numerals the forces and values that represent everyday business, and some that is not so everyday. When I want to know what to do about it, there is really only one fundamental principle of accounting and I think you have all heard it—charge the account that receives value and credit the account that gives value. I think that is all you need to know.

Now, the answer to any problem of the estimate of a specific item in accordance with that principle is to be found in history and experience. If you read Dr. Littleton's book, *Accounting Evolution to 1900*, if you read Hogben's popular book, *Mathematics for the Million*, you get a historical background for your everyday problems that will aid you materially in solving them.

We know that having followed out our fundamental principle of debit and credit, we wind up with a series of accounts. The early-day practice of setting up the so-called balance-sheet did that.

Now there is another thing—what is a balance-sheet?

CHAIRMAN COUCHMAN: Don't ask me.

MR. BARNES: I went to the man from whom I was getting my training, and said, "Mr. So-and-so, why should we call it a balance-sheet? Let's call it a statement of assets and liabilities." He said to me, "My boy, we have been doing it that way for 400 years and I don't think we are going to start to change it now." So we did not, and after, not quite 400 years, but a few other years, I realized he was right. Your balance-sheet is a list of the balances remaining after you have closed out the accounts which belong in the income account or the income and profit-and-loss account, as we prefer to style it, or the income and surplus account, or the surplus account, combining all three in arriving at how much to charge up and how much to leave on there. You are obliged to exercise your opinion, and I don't think you can set up principles with regard to what that opinion can be.

NEED FOR FLEXIBILITY

I do think that there is a crying need for more uniformity of procedure, but I think that is a matter of a standard method of presentation. If we are to continue to be a profession and not become tradesmen, we must reserve the opportunity to form our own opinion as to how much of the plant shall have been charged to current operations, as to what constitutes a deferred charge, as to how to treat discount on bonds, and all of those other matters. I hope that we will not suddenly crystallize procedure at a point where any high school graduate can refer to the book put out by the Institute and become a practitioner of accountancy just the same as those of us who are here now think we are.

CHAIRMAN COUCHMAN: That is the way a Missourian looks at it.

MR. W.D. CRANSTOUN (New York): If it were not so late and so many auditors here a little bit sleepy, I would like to say a few words on this subject, but because these conditions exist those words will be very few. It seems to me—perhaps because I am a little older than some of the others—that I can find only one principle, and that is the principle of telling a story truly and telling it tersely and telling it in the language that every one understands. It seems to me that that is the only principle of accounting.

Now, when we are presented with a task of describing any complicated situation, if we want to do it thoroughly, we would have to write a book about it and even then perhaps we would not get the story told. But if you were to write a book on the affairs of any corporation, no one would understand it if they read it, and no one would read it. So that necessity has urged us in the direction of presenting these affairs in simple language; urged in that direction, we have not made much progress yet.

For that reason the statements that we have now have been instituted. At first they were criticized because they could not be understood. Then they were criticized by the client because they had too much in them. It seems to me that while it is desirable to have standardization, we must standardize on one basis—telling a story clearly and telling it truly.

As far as expressing the affairs of a corporation is concerned, standardization can be along just four lines, it seems to me: First, the general form of statement; second, the arrangement of statements; third, the terms in which statements are expressed; and fourth, the method of arriving at the values shown thereon. I am not going to pursue the subject because it is getting late.

CHAIRMAN COUCHMAN: Thank you very much, Mr. Cranstoun.

MR. A.C. LITTLETON (Chicago): I want to say a word referring to Mr. Byrne's paper, perhaps I should say from the standpoint of a teacher. I do not want what I have to say—a very few remarks—to be considered a suggestion of a deficiency in his presentation. I think he gave us a very excellent discussion of a much-needed issue. The issue, as I understand it to have been stated in his paper, was whether or not it is possible to distinguish soundly between rules and principles, and that issue, I think, he has resolved very satisfactorily.

Mr. Byrne mentioned, I think, five principles. Now, I think, naturally, of those principles from the point of view of us in the classroom, and he has not yet given us, I think, as much as we should have about those principles for classroom use. He mentioned the difficulties he had in compressing this material into 5,000 words, and I can well understand that. Perhaps what I am thinking of has been excised in the process, and if it has not, perhaps he may be persuaded sometime to amplify his views in one way or another. We speak of principles, and he named five. Now, why are they principles? That is what the teacher must face when he presents the subject to his class. If he does not, somebody in his class—usually there is one wide-awake man there, anyway, out of twenty—will ask him, "Why, what makes this a principle? How do you judge, and on the basis of your answer, are there not more than five principles?"

So I am hopeful that Mr. Byrne still will give us the benefit of his thought on that question. Just this—why are these principles? It may strike you as quite inappropriate, and yet in the classroom it is not. We say that it is a principle of accounting that income should be recognized only when it is realized. Well now, you may lay that down as a doctrine or an axiom, and most students may swallow it, but that twentieth man will ask you, "Why is that?" What would I say? I do not know, I am seeking an answer and I hope that sometime it will be supplied.

The other point is rather similar. He spoke about the coercive power of these principles. Now, that is a little vague in my mind, and if I were to say, as he did, that these principles have a coercive power, then my twentieth student is going to ask, "Whence comes this power? What is it that pushes us? What is compelling about it? It is not a matter of law; it isn't compelling in that sense. Is it a matter of morals? Just exactly what is the pressure?" And I hope sometime that he will amplify that for us, too.

CHAIRMAN COUCHMAN: Thank you very much, Professor Littleton. In justice to Mr. Byrne, he did state that those he mentioned were only illustrative of the principles. Of course, I am sure you gathered that.

Mr. Gordon, I wonder if you would give us a few words on this subject.

DEVELOPMENTS IN GREAT BRITAIN

MR. JAMES GORDON (Glasgow, Scotland): Mr. Chairman, I rise because you called me and not because I have anything of any value to contribute to the discussion. Like the gentleman who has just spoken, I have been wondering in the course of the discussion whether one could draw a hard line between a principle and a rule. As best I could make out, it simply amounted to this: That a principle was merely a rule which, by constant discussion and constant application, had more or less received general acceptance among accountants. Well, I gathered that a rule might be in the nature of a working concordat as to which there might be considerable difference in application.

Some reference has been made, Sir, to the various criticisms which are offered of balance-sheets which are printed in *The Accountant* and, as you know, there has been considerable discussion as to the modifications that will be required now that large consolidations have found their way from the American practice into the British field of industry. We are likely to find that we are somewhat hampered in adopting what we think will be sound conventions by reason of judicial decisions which have been given under the early days of more primitive organizations, and some of those judicial decisions as to what are profits legitimately divisible under these circumstances have been so phrased that without any anticipation of the large numbers of subsidiary companies that may be held in a holding organization, it has been possible for some of our directors to distribute on what they call the legal basis without, I am afraid, making due provision for the losses of subsidiary companies.

Now, there has been some discussion as to whether or not we might be able—perhaps by agreement among the members of the accounting profession—to have some sort of model forms for profit-and-loss accounts, but hitherto there has been no agreement about that. Of course, it would be difficult to get anything of general application which might apply to industries, banks, and insurance companies, but that difficulty might be surmounted by having different forms capable always of adaptation. But one of the real fundamental difficulties with us, I think, is the old question of the legitimacy of having secret reserves which will not be shown on the accounts—reserves as to which the stockholders really have no information. I am not, of course, referring to provisions for possible contingencies—reasonable provisions against any catastrophes that may fall through devaluation or accountancy problems or anything of that kind—but to highly prosperous concerns which feel that it is undesirable to disclose the full extent of their earnings, partly because they do not wish to have the pressure from the stockholders to distribute larger dividends and partly, perhaps in occasional cases, for political reasons and possibly because of pressure on the part of labor for increased emoluments. Put it this way: Personally I should be glad if I could get some indication as to the attitude of the American accountants generally to the creation of secret reserves.

May I say how much I appreciate having been privileged to be present at the discussion and to hear the synopsis of the very thoughtful paper which has been the subject of your prize essay, and I look forward to reading it in greater detail when I have the opportunity of having a copy.

CHAIRMAN COUCHMAN: Thank you, Mr. Gordon. Mr. Gordon mentioned one thing which is certainly pertinent, I think—the difficulty of a law being established with regard to an accounting matter without contemplating the various emergencies that may arise later that bring an entirely different set of characteristics which still have to be handled under that antique and really inapplicable law. That is one of the dangers in putting forth any rule or principle by law, affecting a thing as flexible and as constantly changing as accountancy. It is one of the dangers of putting out principles by any body, such as the Institute, until we are quite sure that the rule is one, as I said in my earlier remarks, that will be applicable to all those cases which come under it.

We have just a few minutes left—time for two more people if they will speak.

INSTITUTIONAL AND MUNICIPAL ACCOUNTING

MR. LLOYD MOREY (Urbana, Ill.): I should like to call attention to two undertakings in which we are attempting to develop the principles, terminology, and so forth, in certain segments of the field of accountancy; it may suggest what might be done in the larger field of general accountancy. Perhaps these are relatively not so important in the practice of persons here, and yet they are of some significance. One of them is in the comparatively small field of accounting and reporting for colleges and universities.

A few years ago a committee undertook to work out a standard of procedure in that field and after several studies it was able to arrive at a program which has since proved to be practicable and has been widely accepted.

The other is in the larger and much more difficult and involved field of public accounting or governmental accounting, which is represented in the work of the National Committee on Municipal Accounting. That work is to have discussion at some great length in another round table later on in the convention, and so I merely mention here its general relationship to this question of the development of principles.

Both of these committees proceeded along the lines of endeavoring, first, to set down some of the most important underlying principles that should apply to these fields with respect to accounting and reporting; second, to develop definitions of the accounting terms most commonly used in these fields, as Mr. Kohler has mentioned; and third, supplementary to those, to prepare suggested model forms of statements.

Now, these efforts suggest the possibility of development in the broad field of general accounting practice for private business, and the success that has attended these efforts seems to me to indicate that there can be success in these broader fields if we attain the cooperation that is necessary to reach general agreement on some of these fundamental points and are willing to give a trial at least, to the procedures that may be developed in this way. They should be reasonably authoritative since they would represent a composite of opinion which, generally speaking, is likely to be superior to that of an individual.

I call attention to these possibilities because I believe they do suggest opportunities for us in the broader fields. Thank you!

CHAIRMAN COUCHMAN: Thank you, Professor Morey. Is there one more who can speak within two minutes? There is.

MR. HIRAM SCOVILL (Urbana, Ill.): I hesitate to rise; my good colleague has spoken, but I was just on the verge of rising before him, so I will say what I had in mind anyway.

I cannot but feel, after hearing the discussion this afternoon, that all this indicates that we probably are really in a healthy profession. We probably would be much more stagnant than we are if we did not have all these things discussed and if we felt that all the so-called principles and rules were so well formulated that we could merely pass them on as a pattern and say, "Follow this rule or this principle."

I happen to be in academic work and we recognize the very great necessity of having some of these points brought before us. We do have our difficulties in teaching youngsters what they ought to know. I regret very much the fact that too many of our textbooks put things down as principles and rules which really are not yet, and one of my objects is to disillusion the students on a great many things. We often have questions put to us by the students like this, "What is the difference between a principle and a convention?" I believe most of us here would hesitate to say definitely what a principle or a convention is.

I just happened to think of the story I heard the other day about a professor in physics who was teaching his class. He was of German extraction and he noticed one of the boys in the class was asleep. He called on him and said, "Gates, will you define electricity for us?" The young man roused up just in time to miss the question. "Well, I don't know just now, Professor, I read that last night. I knew it last night, but I just can't think of it now. I've forgotten it." The professor said, "What a shame, what a shame—the only man in the world that ever knew what electricity was, and he has forgotten it!"

CHAIRMAN COUCHMAN: Well, gentlemen, I again want to thank Mr. Simpson for opening this discussion, Mr. Dalglish for coming down and giving us the benefit of his views, and Mr. Byrne for his contribution, and all of those gentlemen who have been good enough to express their views and give us their help in this problem. And now that our time is up and we all know exactly the extent to which accountancy can be reduced to rules and standards, and now that we understand quite definitely the distinction between principles and rules and conventions and standards, and now that we realize how simple it is going to be to set down this list of principles (I imagine some of you will jot them down and have them all worked out before we meet at supper), how easy it is going to be to establish rules that will be agreeable to all of the profession and that will work beautifully in every case! At no time when they are applied will there result any distortion of facts or truth, now that all of that is accomplished. I want to thank you all for your attendance and refer to the fact that there is to be another session—I think it is also round table—on the subject of "To what extent can the joy of the occasion be reduced to dining, wining and dancing," which, I believe, will be in the grand ballroom. Thank you, gentlemen!