

CORPORATE FINANCIAL REPORTING :  
HISTORY, DEVELOPMENT AND  
FUTURE DIRECTIONS

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## CHAPTER 1

### Introduction, Overview and Methodology

There can be little doubt that modern economic systems rely heavily on financial information generated by the corporate reporting function for their efficient operation. Whilst many believe that managers of business enterprises rely very little on published financial statements for their internal decision making, the corporate reporting function as a whole (including reports prepared for the internal use of management) plays a major role in the efficient functioning of an enterprise.

Corporate financial reporting, as we know it today, is a relatively recent phenomenon. Up until the end of the nineteenth century business enterprises were, generally speaking, small entities, with the owners also managing the businesses. As these enterprises grew in size and more funds were needed for development more owners became involved with the contribution of funds, and it was, obviously, impractical for a vast number of owners or shareholders to have a say in the day to day running of these enterprises.

Managers had to be appointed to run the businesses on behalf of all the owners, and this led to the need for these managers to account to the owners on the stewardship of their funds.

In these early days the concepts of honesty and regularity in the financial affairs of the enterprise were the main concerns of the owners, who wished to ensure that their contributions had been adequately safeguarded by the managers.

A balance sheet showing clearly the funds contributed by the owners or shareholders and how these funds had been utilized was considered adequate to satisfy this stewardship function. As an additional safeguard, the balance sheet was audited by an independent person who reported thereon to the owners.

With the growth of business enterprises in the twentieth century into massive corporations with thousands or even millions of shareholders, and with the need for the appointment of specialist managers to ensure the efficient functioning of companies so as to generate maximum profits, the stewardship function began to decrease in importance as compared with the other functions of management, particularly the maximization of shareholders' returns.

This change in approach to the accountability concept led also to the balance sheet becoming less important as a vehicle for corporate reporting, and the income statement emerged as the major element.

This change in emphasis from the balance sheet to the income statement was not a happy one for accountants. The emphasis on profitability led to the problem of the allocation of costs over different periods in the determination of profit for any given period.

Attention was focussed on the bases of calculation of profit and the comparison of profitability ratios of different companies.

Different accounting methods being used in practice dealing with apparently similar transactions or events were highlighted, and accountants were often accused of manipulating the results of companies. This led to criticism of accountants, particularly when

it came to events such as the Great Crash of 1929 or, indeed, any company failures that occurred.

The profession, particularly in the United States, at various points in time made studies of the need to standardise accounting practices, but, on the whole, little action was taken. More recently, accountants have been criticized for failing to disclose the effects of changing prices on profit and asset values, and, thereby, failing to report the "real" profit or net worth of a company, so as to assist investors in their decision making. A major criticism has also been that financial statements do not adequately cater for the needs of other user groups who have a legitimate interest in the affairs of companies. Much debate has taken place with regard to the question of whether user groups other than the shareholders should be catered for in the corporate reporting function. Many eminent accountants are of the opinion that a single set of "multi-purpose" financial statement (prepared on a single basis of accounting) cannot possibly meet the needs of all the different user groups, and have suggested the possibility of preparing multi-columned financial statements, each column depicting the results and net worth of a company using a different accounting basis. In recent years the profession world wide has been producing accounting and auditing standards in an attempt to overcome some of these problems and to modify and adapt the historical cost system of accounting so as to present, in the financial statements, a fairer picture of economic reality.

Accountants have been criticized severely for clinging to the historical cost concept and its related principles in an effort to simplify their auditing task of verification. Accountants have argued that the historical cost system is the most objective of the systems and that the use of a current value based system will result in financial statements becoming unreliable. A counter argument is, however, that, whilst objectivity is an important quality, it should not be strived for at ANY cost, and particularly not at the expense of the more important qualities such as relevance to user needs.

It is important to recognise the risks with which auditors have to contend when reporting on the financial statements of companies. A compromise arrangement may, however, be possible whereby auditors may be able to offer a lesser degree of assurance on current value information as compared with the higher level of assurance associated with the more objective information dealt with in the traditional historical cost financial statements.

Accounting, it must be remembered, is not an end in itself. It should provide the means whereby people's needs for information to make investment and other decisions can be met. If accountants are not to lose much of the credibility they have built up over the years, they will have to think more seriously about satisfying these needs of the users of their product.

The most important criticism, which has come to be accepted by the profession in recent years, is that accounting and, more particularly,

corporate financial reporting lacks a fundamental, underlying objective, or "conceptual framework", as it has become known. One cannot, for example, choose between different accounting principles or practices if one is not sure what it is one is trying to measure.

Preparers of financial statements generally agree that their major objective (apart from giving the shareholders a fair account of their stewardship), is to supply the shareholders (and other users) with a realistic economic picture of the enterprise.

It is in defining "economic reality" that the accountant experiences most of his problems. Different user groups have different ideas of what economic reality means to them.

In preparing this thesis a study was first made of the historical literature in order to determine the environment (particularly in the United Kingdom and the United States) which gave rise to the need for corporate financial reporting. The difficulties experienced by accountants over the years were examined and the reasons for such difficulties sought.

It is clear that a major cause of many of the problems experienced by accountants in the development of the modern approach to corporate financial reporting was the lack of an underlying objective. It is interesting to note how the profession came to realise this in the 1930's and 1940's, but due to the serious and more immediate problems that were facing the profession, a major study of a conceptual frame-

work for accounting had to be shelved until the FASB set about this task in 1973.

These developments in the corporate reporting function, particularly during this century, have been examined by means of a wide-scale study of the literature available. Much emphasis was given to the detailed investigation and study conducted by the FASB in their attempt to formulate a conceptual framework. This project is a long-term one. Having decided on the major objective of corporate financial reporting, namely, decision usefulness; having examined in detail the criteria or qualitative characteristics which make financial information useful; and having defined the elements that are decision useful, the difficult stages have yet to be finalised. These stages are concerned primarily with the problems of RECOGNITION and MEASUREMENT, or, put in another way, with the establishment of a generally accepted definition of profit and the selection of a basis of asset valuation. Although these stages have not yet been finalised, the problems being experienced have, nevertheless, been studied and commented on.

The Canadian Institute of Chartered Accountants also commissioned a study group to examine the possibilities of formulating a conceptual framework for Canada. This study group issued its report, drafted by Professor Edward Stamp, Director of the International Centre for Research in Accounting in the University of Lancaster, entitled "Corporate Reporting : Its Future Evolution" in 1980, which made various recommendations with regard to the formulation of a

conceptual framework for Canada. The basic approach recommended by this report is quite different from that which is emerging from the FASB's Conceptual Framework Project, and these differences in approach are examined to assess the effect they may have on future standards. In Britain and, to a lesser extent, in Australia there has also been some debate on the need for a conceptual framework for accounting, and such literature was examined and related to the events taking place in the United States and Canada. It appears that most countries are waiting to see what finally emerges from the FASB's Conceptual Framework Project. It appears that the FASB has invested so much time, money and expertise in this project that, in order to maintain its credibility, it would need to achieve its aim of producing a conceptual framework which will not only be generally accepted by the profession, at least in the United States, but will also provide solutions to the many problems and criticisms presently facing accountants.

There can be little doubt that when this project of the FASB has been finalised and a "constitution" for accounting formulated, it will have a significant effect on the future directions of corporate financial reporting.

CHAPTER 2

The Origins and Legislative Development of Corporate Financial Reporting in the United Kingdom up to 1948.

The scale of business enterprises up until the seventeenth century was such that one man or small group of partners was able to provide the necessary funds. As a general rule the proprietor or the partners who had an interest in the enterprise supervised the affairs of the business directly to protect their own interests. There were no legal restrictions on such enterprises and the record keeping consisted mainly of the cash movements into and out of the businesses.

The need to provide vast amounts of capital to finance extensive trading and commercial operations led to the formation of companies by joint subscription for shares. Examples of such companies formed in the seventeenth century include the East India Company (in 1600), the Hudson's Bay Company (in 1670) and the Bank of England (in 1694). The companies were formed either by special Act of Parliament or by Royal Charter. They were unlimited liability companies and there was no provision for managerial accountability to the owners of the shares by means of published financial statements. This lack of accountability and control led to large scale fraud and embezzlement and managers often speculated and lost vast sums of money entrusted to them by the shareholders.

In 1719, after the Great South Sea Bubble scandal, the Bubble Act was introduced, limiting any form of partnership to six members in the hope that this would ensure that all the partners could keep track of the affairs of the business and so reduce the incidence of financial

mismanagement. In 1825 the maximum number of partners who could join a partnership was increased to twenty. The Act was not a great success in that it did not provide for adequate measures of control in order to protect the interests of the owners and the creditors.

Increasing pressure was being applied to governments to allow the formation of larger business enterprises with a more widespread ownership so as to generate the increasingly large amounts of capital which were becoming necessary as the industrial revolution got under way. This naturally led to the need to provide adequate protection for the investors. Thus during the period of "railway mania" in the United Kingdom, between 1830 and 1870, the world saw, for the first time, the emergence of multi-million pound enterprises, with large numbers of people becoming shareholders in these companies. This period is generally considered to have been the birth period of the corporate reporting function as we know it today.

Each of these railway companies were incorporated by a separate Act of Parliament, which gave the companies the authority to build the line concerned as well as to raise the necessary funds for their construction. Most of these private Acts required accounting records to be kept, but made no provision for published financial statements or audits. Shareholders were, therefore, not only not provided with financial statements, but were even denied the right to examine the accounting records kept by the companies. Gradually, however, investors' needs were recognised and provision was eventually made for the preparation of half-yearly financial statements which were to be presented to the shareholders at a general meeting. The various enactments were consolidated into the Companies Clauses Consolidation

Act 1845, which provided, inter alia, that:

"On the books being so balanced an exact balance sheet shall be made up, which shall exhibit a true statement of the capital stock, credits and property of every description belonging to the company, and the debts due by the company at the date of making such a balance sheet, and a distinct view of the profit or loss which shall have arisen on the transactions of the company in the course of the preceding half-year".<sup>1</sup>

In addition this Act required that the balance sheet had to be examined by at least three directors and signed by the Chairman or his deputy. There was no provision for the balance sheet to be circulated to all shareholders, although it was necessary to produce it at a general meeting. Whilst there was provision for a compulsory audit, the Act provided that the shareholders were to elect one of their number, not being an officer of the company, to perform the audit. The balance sheet was then required to be sent to the government department dealing with railways.

This was, therefore, the situation which existed in the mid 1840s. The public could purchase shares in these companies and were given some measure of protection in that an audited balance sheet was available for inspection at general meetings. On the face of it, therefore, it appears that the accounting and reporting provisions satisfied the conditions of stewardship laid down by Bird:

"Every steward is held accountable to the person or body which entrusted resources to him, whether the latter is a "superior steward" or the ultimate owner. Accountability places two obligations upon a steward; he must render an "account" of his dealings with the stewardship resources, and then he must submit to an examination (usually known as an "audit") of that account by or on behalf of the person or body to whom he is accountable."<sup>2</sup>

This stewardship-orientated system of accounting must, however, be viewed in relation to the following factors:

- . The financial statements comprised a balance sheet only - there was no provision for an income statement. The profit or loss for the period was calculated as the balance remaining after the inclusion in the balance sheet of the various assets and liabilities of the company, and after adjusting for the shareholders' funds at the beginning of the period.
- . The balance sheet was not sent to the shareholders, but had to be inspected at the registered office of the company or at a general meeting.
- . There was a distinct lack of any generally accepted accounting standards which could be relied upon to ensure that the assets and liabilities included in the balance sheet had been properly measured.
- . Auditing standards were extremely poor as there were very few who were professionally qualified accountants.

The existence of these factors, in particular, meant that the shareholders were not really in any position to protect their interests from unscrupulous directors. By incorrectly valuing the assets of a company, the directors could manipulate profits almost at will. Income could be overstated in bad years and understated in good years, often done in order to justify the payment of certain levels of dividends. However, as Pollins points out:

"....., there is some evidence to suggest that many railway directors, as well as shareholders wished to have regular rather than fluctuating dividends, and the entries in the final accounts may very well have been influenced by the desire for a record of stable earnings and dividends. The fact that many items appearing (or not appearing) in the revenue accounts involved personal judgements, and that there was not yet a generally accepted body of accounting doctrine, made it easy for the preparation of the final accounts of even the most conscientiously conducted company to be influenced by considerations of management policy." <sup>3</sup>

The main accounting issues which were being debated at the time concerned the allocation of expenses, and particularly the question of what expenses should be treated as assets for balance sheet purposes. Manipulation in this regard led, on numerous occasions, to dividend payments being made where the income did not exist to

justify the distributions. The intention often was to attract more investors either to provide funds to the companies so as to alleviate difficulties caused by poor or fraudulent management, or to artificially increase the prices of the shares allowing the management to dispose of their shareholdings at a profit.

The Regulation of Railways Act 1868 attempted to remedy this, especially with regard to the treatment of expenditure. This Act provided for the publication and filing with the Board of Trade of detailed accounting statements, including a balance sheet and, for the first time, a revenue account (an early form of income statement) in prescribed forms. Provision was also made, for the first time, for a distinction to be drawn between depreciable and non-depreciable assets. The concept of depreciation was still in its infancy, but the Act provided that depreciable assets should be maintained in good condition and that the cost of doing so be charged as an expense. This Act, therefore, created an accounting uniformity amongst railway companies which had not existed previously.<sup>4</sup>

Summarizing, therefore, on the example of railway development, it can clearly be seen that the need for investor protection by providing relevant financial information was recognised early on, but the relative lack of acceptable accounting standards, coupled with legal regulations which were inadequate, allowed dishonest and fraudulent managements to abuse the system if they so desired. The result of all this was that by the 1860s there was a clear need for a tightening up of the law as well as the introduction of a consistency and uniformity in railway accounting and reporting practices.

Apart from the development of the railway companies, the effects of the Industrial Revolution had given rise to the ever-increasing need of companies for funds to finance the business ventures being undertaken. These funds were provided only in part from shareholders contributions; a great deal came also from bankers and other creditors.

The Joint Stock Companies Act of 1844 facilitated the formation of companies by providing for their incorporation by registration as distinct from their formation by private Acts of Parliament. Edey and Panitpakdi describe this Act as being relatively modern in its outlook in that it provided, for example,

- . for accounting records to be kept;
- . for the presentation of a balance sheet to each ordinary meeting of shareholders;
- . for the balance sheet to be sent to shareholders before such meetings; and
- . for the audit of the records and the balance sheet.<sup>5</sup>

Unfortunately, the Companies Bill 1844 provision to present half-yearly income statements to the shareholders was not incorporated into the 1844 Act. The form of the balance sheet was not prescribed by this Act, nor was there any provision for incorporating companies with limited liability. The main aim of these provisions was, therefore,

- (a) to provide the creditors and shareholders of companies with statements of assets and liabilities that would give indications of the solvency of the companies, and
- (b) in the case of some classes of companies to prevent actual and potential shareholders or creditors from being misled as the result of dividend distributions made out of capital - which,

in effect, means made at the expense, in some sense, of the future of the company without this fact being known.<sup>6</sup>

The lack of adequate disclosure and auditing provisions in the 1844 Act (for example, auditors were not required to be professionally qualified) was not remedied by the Joint Stock Companies Act of 1855. This latter Act did, however, provide for the formation of limited liability companies.

Limitation of liability introduced a completely new legal concept. Limited companies were endowed with a separate legal entity and a member of the company was given the right to restrict his liability to the amount of his capital contribution. The company remained liable to its creditors to the full extent of its resources and in this sense the position of such a company remained the same as that of an individual or a partnership. The resources of the company were now, however, being limited to those which had been provided by its members together with any profits which it had retained. Unlike an individual or a partnership, the company could not make any further calls upon the private uncommitted resources of its members, who were relieved of any direct responsibility to the creditors. The separate legal existence of this form of company now confirmed and underlined this position.

When this first law along these lines was introduced there was considerable opposition to it because many people feared that it would be used fraudulently. Whilst the law had obvious advantages for investors (shareholders), dangers did exist that the law would

be exploited at the expense of the creditors. No difficulty was anticipated in the case of a company whose business was honestly conducted as the existence of undistributed profits would always provide additions to the assets from which claims could be met. It was this fear that led to the concept, still firmly entrenched today, that dividends may not be distributed out of the capital of a company. This capital fund was seen as providing the creditors with the protection needed and in the event of a winding up, the creditors' claims had to be settled before the shareholders received back any part of their capital. The concept of limited liability was introduced also as a means of warning creditors not to over-extend their credit and lending facilities to companies.

The 1844 and 1855 Acts were consolidated into the Joint Stock Companies Act 1856 with one important amendment: the compulsory reporting and auditing provisions were omitted. Edey and Panitpakdi postulated that this was done because of a feeling that such arrangements should be left to be made at the discretion of the parties involved, i.e. the shareholders and the directors.<sup>7</sup> Table B of the 1856 Act did, however, include a model set of articles of association which contained voluntary reporting and auditing provisions for companies. These included, inter alia,

- . the keeping of proper accounting records (details of these were listed);
- . the presentation to an annual general meeting of an annual income statement (details of the contents were listed);
- . a similar provision for a balance sheet;

- . the communication of these reports to shareholders at least seven days prior to the annual general meeting; and
- . the audit of those published financial statements - they were to be examined and a report was to be given on the balance sheet in particular:

"The auditors shall make a Report to the Shareholders upon the Balance Sheet and Accounts, and in every such Report they shall state whether, in their opinion, the Balance Sheet is a full and fair Balance Sheet, containing the particulars required by these Regulations, and properly drawn up so as to exhibit a true and correct view of the State of the Company's Affairs ....."<sup>8</sup>

Also included in Table B was a standard form of balance sheet to act merely as a guide to directors and accountants. No standard form of income statement was included.

A further consolidation of all company laws took place with the promulgation of the Companies Act 1862. Table A of this Act contained model reporting and auditing provisions similar to those in the 1856 Act. There were several attempts between 1862 and 1900 to reintroduce compulsory reporting provisions, mainly as a consequence of the increasing role being played by companies in business generally and also as a result of the growing market in company shares.<sup>9</sup> The new Companies Act introduced in 1900, however, did not provide for compulsory accounting and reporting measures, but did provide for a compulsory annual audit of the accounting records

and the balance sheet. The reluctance to provide for the compulsory publication of financial statements is summed up by Lee as follows:

"The practices, and resistance to the introduction of compulsory publication of accounts, were sympathetic of the old entrepreneurial attitude - shared by many directors, especially of old-established 'family' firms which had been converted to companies - that a businessman's accounts were his private concern, that outsiders had no right to pry into them, and that availability of information would help his competitors."<sup>10</sup>

It appears, therefore, that the legislature concerning company financial reporting prior to 1900 allowed managements to maintain as much secrecy about the affairs of companies as they considered necessary. The informational needs of the shareholders and other parties such as creditors were not regarded as being of paramount importance. The idea of the balance sheet being the fundamental reporting vehicle to the shareholders emphasizes the belief that existed at the time that the managers' major reporting duty was concerned with their stewardship of the funds which were contributed by the shareholders. The audited balance sheet provided clear evidence to the shareholders that their funds were intact and served, therefore, as a check on the honesty of the management.

The calculation of the profit for the period was not aimed at providing the shareholders with a means of assessing the profitability of the company or of assessing the efficiency of management in their

business operations - instead, it provided proof that dividend payments did not exceed the profits earned, i.e. that dividends were not being paid out of the capital fund. In other words, the main objectives of company financial reporting at the time were:

- . to provide a stewardship report to the shareholders
- . to justify the level of dividends paid to shareholders
- . to provide the creditors with evidence that the company was on a sound footing and was not overdistributing profits to their detriment.

The Companies Act 1907 recognised this particular approach in requiring all companies, with the exception of private companies, to produce an annual audited balance sheet. The Act did not, however, prescribe any particular format, nor did it include any specific requirements with regard to the contents of the balance sheet. There were still no formal arrangements regarding qualifications for auditors.

As pointed out earlier, the lack of any formal accounting principles at the time enabled managements to manipulate the profits and asset values almost at will and, thereby, allowed them to distort the earnings calculations and corresponding dividend distributions. There were, for example, a variety of ways in which the problem of depreciation was viewed. Many companies did not consider it necessary to provide for depreciation because there was no outlay of funds, in years when trading was poor. Other companies regarded it as being unwise to treat all of the increase in net current assets

as profits available for distribution. They recognised the fact that the company was to continue in existence and had to replace its fixed assets as they were used up. Depreciation was considered to be providing for the replacement of the assets, not the revaluation thereof. Many did not regard the depreciation charges as being the spreading of the cost of the asset over a number of years - instead it was often regarded as a reserve for the replacement of the assets. Some companies ignored the periodic depreciation charges and simply treated the full costs of replacement or renewals as an expense in the year in which the replacements took place.

There can be no doubt that in the nineteenth century the wide area of discretion in accounting to shareholders was often exploited by hardpressed or unscrupulous managements. The development of the accounting profession and the publicity given to abuses gradually introduced safeguards in the calculation and reporting of company profits. But this did not mean that a "scientific" profit measurement emerged.

In practice, the exercise of accounting discretion or judgement came to be conditioned by an approved bias towards conservatism. This meant, by and large, that it was better to err on the side of understatement rather than overstatement of profits. Thus assets in the balance sheets were to be under- rather than overvalued, possible losses were to be anticipated rather than deferred, while the recognition of profits was to be deferred until they had been realised.

In this way the creation of secret reserves and their subsequent resurrection to augment profits in years when profits were low, were important features of company accounting in the second half of the nineteenth century and for several decades later. In practice the setting up of such secret reserves often went well beyond the ordinary level of accounting conservatism. It was regarded as appropriate and in the shareholders' own interests that the results be "manipulated" in this manner. The net assets, and hence profits, could be understated in "good" years, for example by depreciating assets faster than was necessary, by treating capital expenditure as current revenue expenditure or by providing excessively for contingencies. In this way smaller profits were reported without the shareholders being made aware of the magnitude of the undisclosed reserves. In the "leaner" years these secret reserves could then be drawn on by balancing out such expenditures and thereby augmenting profits. In this way profits over the years could be evened out and the dividend distributions could be maintained. These practices were widely practised prior to the 1930s and were considered to be in the best interests of the shareholders and the creditors of the company as it created financial stability.

The use of secret reserves in this way was seen by many as representing a victory for the needs of company management over the developing accent on meticulous accounting calculation (an example at the time was the attention being drawn to the need for a careful apportionment of prepaid and accrued expenses). It also reflected an attitude taken by company management towards the shareholders; it was deemed to be in order that, provided they acted in good faith, the management

should decide, within limits, what to tell the shareholders in financial statements prepared for their information. The neglect of shareholders' interests in this respect is illustrated by Hannah<sup>11</sup> in his study of takeover bids prior to 1950. Commenting on the relative lack of takeover bidding in the inter-war period (partly because of the concentration of shareholdings either in private family hands or in large blocks controlled by the company directors), he reveals that bids were normally made through the board of directors without reference to shareholders. He quotes one authority of the day in this respect:

"This was the usual form of merger between two quoted companies and it therefore seemed quite natural for an accountant to insist in 1925 that 'the negotiations must obviously be conducted by the Directors. In order to preserve proper secrecy, it is not possible for the Directors to acquaint the shareholders of the matter'. Almost invariably, the shareholders were passive agents in the decision-making process, and the history of their attempts to thwart the decisions of directors and achieve a better bid price is largely a study of failure."<sup>12</sup>

In addition, as Hannah has pointed out, the quality of reported information was poor when it was made available to the shareholders:

"One tentative explanation of the failure of contested direct bidding to emerge in its modern form is the quality of information available to shareholders and

potential bidders in the inter-war years ... Neither balance sheets nor profit and loss accounts gave adequate indications either of assets and liabilities or of trading profits - for a variety of reasons - commercial secrecy, preservation of credit status, reduction of trade union wage pressure, discouragement of new entry - directors sometimes published figures which understated or overstated the true position of their company. The imperfect state of the law relating to company accounts, and in particular to secret reserves and holding company accounts, allowed common resort to such malpractice." 13

The period following the 1908 Act, therefore, saw only the limited publication of financial information on a compulsory basis. Little advance had, therefore, been made in this respect since the Joint Stock Companies Act of 1844. There was a feeling that shareholders were content if they knew that their capital was being kept intact and that their dividends were being maintained. Shareholders were regarded simply as sleeping partners in companies. In any case, the majority of companies were family businesses, their shares being closely controlled by persons who were also directors. In this regard, Board of Trade statistics reveal that, by 1930, there were 16 262 public companies and 95 598 private companies in existence in Britain.

The Companies Act of 1929, in addition to consolidating all previous Acts, introduced one important change, at least for public companies. It required such companies to present to their shareholders an annual income statement in addition to the balance sheet. No guidance was given as to the contents of these financial statements, nor was the income statement required to be audited. It can, however, be looked upon as a small step in the direction of providing shareholders and other interested parties with more adequate financial information to serve their needs. Such financial needs were, therefore, slowly being viewed with more importance. This aspect of corporate reporting is examined more closely in Chapter 3.

During these inter-war years also, companies were gradually merging into larger entities or groups but there was no legal provision for the publication of consolidated financial statements reflecting the profitability and financial position of the group as a whole. This served to help mask the affairs of companies considerably, as only the results of the holding companies were disclosed.

The 1930s and 1940s saw a considerable increase in the number of companies in Britain, which resulted in a consequential increase in share ownership. In 1939 there were 13 920 public and 146 735 private companies. By 1949 these figures had changed to 12 075 and 231 443 respectively. The government began to recognise the need to review safeguards for company investors and in 1943 the Cohen Committee on Company Law Amendment was formed. The Committee sat for two years and its report was published in 1945. This resulted in the Companies Act 1948 which was to radically change the legal require-

ments for company financial reporting and which forms the basis for present-day company financial statements. The major changes in the 1948 Act were as follows:

- (a) Every company was required to present annually to its shareholders an income statement and a balance sheet, both of which had to be audited.
- (b) The eighth Schedule of the Act contained a list of items of information which every company was required to disclose, where relevant, in its financial statements. In other words, this was the introduction of a legally enforceable minimum disclosure level, although certain companies (for example banks and insurance companies) were exempted from certain of the provisions because of the nature of their businesses.
- (c) Holding companies were required to present to their shareholders consolidated financial statements for the group as a whole. These statements were to be subject to audit and were also subject to the minimum disclosure requirements.
- (d) Company auditors were required to be professionally qualified accountants, except in the case of the small family company, defined as an exempt private company.
- (e) The auditor's rights, duties and powers were clearly laid down in the Act. In particular, the auditor was required to give an opinion on the truth and fairness of the reported information.

This Act, therefore, gave companies the basis with which to provide shareholders and other interested parties with meaningful information about their financial affairs.

While the changes in the legislature that took place in the 1920's and 1930's could be described as evolutionary, the changes recommended by the Cohen Committee and put into effect with the introduction of the 1948 Act could conceivably be described as somewhat revolutionary. For this reason it is considered desirable to examine the causes of significant change in direction in more detail.

Accounting doctrine in 1925

"..... to attempt to prescribe either a statutory form of balance sheet or what a balance sheet must disclose or that there should be in addition a profit and loss account is considered likely to do more harm than good ..... Shareholders have the remedy to a large extent in their own hands ..... the business done by limited companies is, on the whole, transacted by directors and managers who are honest, and if in some cases they disclose in the published accounts less than some people desire, the absence of detail is in most cases wise, and is generally supported by the shareholders ..... It is impossible by legislation to protect fools from their own folly ..... Secret reserves or inner reserves are in certain cases desirable and in many cases essential .....

If businesses carried on by joint stock companies are to be as successful in the future as in the past, too much disclosure should not be insisted on and the greatest possible freedom should be allowed to those responsible."<sup>14</sup>

Accounting doctrine in 1943

"The institute is in favour of the maximum practicable disclosure of information in annual accounts..... The institute has a full recognition of the fact that in a large proportion of cases undisclosed reserves have been carried and used by boards of directors in what they have honestly believed to be the best interests of their shareholders. The institute considers, however, that the existence, use and increase of such reserves where they are of material amount should no longer remain undisclosed..... There has hitherto been an absence of statutory guidance (on the subject of contents of profit and loss accounts) and the institute thinks it desirable that this omission should be rectified."<sup>15</sup>

The course of events 1925 - 1943

The philosophy of accounting and company practice underlying the 1925 evidence of the institute was accepted by the Wilfred Greene Committee, which recommended comparatively minor amendments of the existing company law with respect to accounting matters. "The matter of accounts", the Committee said, "is one in which we are satisfied upon the evidence before us that within reasonable limits companies should be left a free hand."<sup>16</sup>

A fundamentally different philosophy was expounded by the institute in 1943 and this new philosophy was adopted by the Cohen Committee. The change was not due to any belief that the system of limited liability companies was being abused in 1943 any more than it was in 1925. Indeed, both committees expressed, in identical words, their conviction that "the great majority of limited companies, both public and private, are honestly and conscientiously managed."<sup>17</sup>

Each committee recognised that opportunities for abuse existed, but were satisfied that cases of fraud or improper dealings were few and inevitable. The Wilfred Greene Committee thought that the unfavourable public comments on the activities of limited companies were largely due to the abnormal conditions prevailing during and since World War 1, and that the "return to more normal conditions" would tend to eliminate certain unsatisfactory features which had shown themselves in recent years. The Cohen Committee, on the other hand, thought that the fullest practicable disclosure of information concerning the activities of companies would lessen opportunities for

abuse and accord with a wakening social consciousness.

Unfortunately for the expectations of the Wilfred Greene Committee, the return of more normal conditions after 1925 was indefinitely postponed! The presses on which the 1929 Companies Act were printed had scarcely ceased revolving when a series of "abnormal" storms broke over the heads of the investing public. The financial crisis of the early 1930s and the subsequent lingering depression produced many company failures, some of them of spectacular proportions and involving men who had occupied positions of prominence in business and accounting circles.

In the discussions which ensued there was a renewal and re-emphasis of the demands which, even before 1925, had been made for greater protection of investors against loss, not caused only by isolated instances of deliberate and wilful distortion of accounts, but also by the obscurities in accounts accepted as usual practice and actuated by the highest motives. As one shock followed another, it came to be realised that there were inherent weaknesses in a policy which sought to benefit investors by keeping them in the dark; that control of many companies by shareholders was in many cases theoretical only, because of the paucity of the information given to them and of the difficulty of organising concerted action by a large number of small individual shareholders; and further, that the advantages of companies creating secret reserves in good times and using them in bad times did not necessarily depend upon the creation or the use of the reserves being kept secret. The reactions on accountancy thought of the revelations in several cases in which

apparently sound structure suddenly collapsed were not immediate. For instance, the council of the Institute of Chartered Accountants in England and Wales considered the question of communicating with the members of the institute certain matters arising out of the Royal Mail Steam Packet Co. case (Rex v. Kysant and Morland - see p. 36), but decided instead to circulate a copy of an opinion given by learned counsel. The opinion of counsel expressed the view that no pronouncement by the council for the guidance of members on the questions and matters discussed in the case was "really feasible".<sup>18</sup> The opinion went on to say that it would be difficult to found upon extracts from the Judge's summing-up in the case "any principles either of general or of particular application which would both afford a clear guide to a practitioner and be certainly consonant with the law and with the Judge's views".<sup>19</sup>

The Accountant, the recognised weekly organ of the institute, expressed disappointment with the passive attitude of the council, and repeated the opinion, which it had been expressing for some months, that "it was time definite steps were taken to bring profit and loss accounts into line with the current, and very reasonable, demand that accounts should not conceal but reveal".<sup>20</sup> There were critics who put it even more forthrightly. George O. May, in a letter from the United States to the president of the institute, maintained that the institute was "obviously face to face with one of the greatest problems and one of the greatest opportunities presented to it in the course of its existence". His view was that "upon the accounts charges in that case it was a system, rather than individuals, that was on trial", and that "the general conclusion

had been that, though the individuals were clearly entitled to acquittal, the system must be condemned and must be changed".<sup>21</sup> That Mr May was not alone in expressing these opinions became increasingly clear within the next few years. The War years that followed produced new practical problems for accounting, but its effects on accounting thought were even more penetrating, and probably more permanent, than its effects on accounting methods. The state of affairs in which "the greatest possible freedom" was allowed to companies was soon to be forgotten and with it the illusion of "normal times".

Various factors such as price control, high taxation and cost-plus contracts materially modified the conception of the limits within which companies should be allowed a free hand. Scrutiny and investigation of private business affairs rapidly came to be accepted as part of the normal course of events.

Against this background, it is easy to accept the view of the Cohen Committee that the fullest practicable disclosure of information concerning the activities of companies accords with a wakening social consciousness. It is significant also that the Committee included in its recommendations "a number of proposals to ensure that as much information as is reasonably required shall be made available both to the shareholders and creditors of the companies concerned as well as to the general public". It should also be mentioned that the Committee believed that the result of insistence upon greater disclosure and of making it easier for shareholders to exercise a more effective general control over the management of their companies

would be "to strengthen the already high credit and reputation of British companies".<sup>22</sup>

It may be thought that the gradual extension of the accounts provisions of the English Companies Act was an evolutionary process which had its beginnings in the days when joint stock companies were first formed. The evolution was, however, clearly accelerated significantly in the years 1925 to 1950, and this acceleration had been the result of a reversal of accounting thought, so rapid and so violent as to excuse, if not justify, its description as a revolution. The new accounting doctrine reflected in the accounts provisions of the 1948 Act, was the doctrine of disclosure in published financial statements - the tenet that good standards of presentation of accounting statements involve, in the words of the Institute of Chartered Accountants in England and Wales, the "maximum practicable disclosure" of information in the annual accounts.

#### The effect of case law on the development of Corporate Financial Reporting.

It was pointed out above on numerous occasions that one of the major problems facing accountants during the early years was the lack of any generally accepted accounting standards on which to base the measurements of profits and assets in the financial statements. This resulted in managements having a relatively free hand in deciding upon what information should be disclosed to the shareholders. Dishonest and unscrupulous managements naturally took

advantage of this position and it is not surprising, therefore, that during this period courts of law were often called upon to take action in this regard. This resulted in case law playing an important role in the development of accounting principles and corporate financial reporting during these years.

Arguably, some of the most significant developments in company accounting took place in courts of law, particularly during the period from about 1890 to 1930. These cases generally dealt with the measurement and reporting of periodic income and especially its relationship to the payment of dividends.

Relatively early on in the history of the limited company the principle was established that dividends should not be paid out of subscribed capital (e.g. Flitcrofts case (1882)), that is, that dividends should only be paid out of profits over and above the share capital subscribed to the company. With that principle established, there still remained the problem of putting it into practice, particularly as far as the calculation of distributable income was concerned.

The following cases are considered to be some of the most significant cases concerning accounting practice that were decided during these years.

In *Lee v. Neuchatel Asphalte Co., Ltd* (1889) 41 Ch. 1, it was held that a company, empowered to do so by its articles of association, may distribute dividends without providing for depreciation of its wasting

assets, (for example one which is being depleted through extraction as in the case of mines or quarries). In other words, distributable income could be calculated before deducting such depreciation. The judge, in fact, stated: "There is nothing in any of the Companies Acts prohibiting anything of the kind..... It has been judicially and properly left to the commercial world to settle how the accounts would be kept."

In *Bolton v. Natal Land and Colonisation Co., Ltd* (1892) 2 Ch. 124, it was held that a company can declare a dividend out of current income without providing for losses caused by exceptional reductions in the value of assets such as land. In other words, it was proper to pay dividends out of trading income before providing for infrequent reductions in the values of such assets.

In *Lubbock v. The British Bank of South America* (1892) 2 Ch. 198, it was held that a gain made on the sale of part of a company can be distributed as a dividend, if the articles of association do not prohibit it. Thus an element of non-trading income was held to be distributable to the shareholders.

In *Verner v. General and Commercial Investment Trust Ltd* (1894) 2 Ch. 239, it was held that, as in the Bolton case, an investment trust company can distribute income before providing for decreases in certain asset values.

In *Wilmer v. McNamara and Co., Ltd* (1895) 2 Ch. 245, it was held that a company can declare a dividend out of current income without

providing for the depreciation of fixed assets. This case hinged on whether depreciation of goodwill and leased property was to be regarded as expenditure which should be deducted from sales revenue in determining distributable income. It was held not to be.

In *Foster v. The New Trinidad Lake Asphalt Co., Ltd* (1901) 1 Ch. 208, it was held that a realised gain on an asset taken over by a company at its formation is not distributable income, unless such a surplus remains after a revaluation of all other company assets. This decision seems to be contrary to the previous judgement in the *Lubbock* case.

In *Bond v. Barrow Haematite Steel Co., Ltd* (1902) 1 Ch. 353, it was held that preference shareholders cannot compel directors to pay a dividend without retaining income in the company when the articles of association demand that such retentions be made.

In *Ammonia Soda Co. v. Chamberlains* (1918) 1 Ch. 266, it was held that it is not necessarily illegal for the directors of a company to pay dividends out of current income without taking cognisance of past aggregate losses. In other words, if the value of the shareholders' equity in the balance sheet is less than that originally subscribed because of cumulative losses, it is still proper to pay dividends out of current income rather than out of any surplus left after deducting past losses from current income. In this case the judge stated:  
"In my opinion this alleged restriction has no foundation in law ....  
I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss; the nature

of the business and the amount of the loss may be such that no honest and reasonable man of business would think of paying dividends without providing for it."

In *Stapley v. Read Bros., Ltd* (1924) 40 T.L.R. 442, it was held that a company can pay a dividend out of current income where accumulated previous losses have been written off by the revaluation of goodwill. This rather follows the previous judgement given in the *Ammodia Soda* case.

In *Rex v. Kysant and Morland* (1932) 1 K.B. 442, the chairman of the Royal Mail Steam Packet Co., Ltd was found guilty of presenting false financial statements to shareholders with an intent to deceive them. In particular, this involved the manipulation of accounting data through undisclosed secret reserve movements, for example by undervaluing an asset in one period and revaluing it in the next. In this case the company was incurring losses of the order, in 1926, of £300 000, but, by transferring funds from reserves set up in the years of high profits in the first World War, they reported profits for 1926 of £439 000. The justification of this practice was that if the true state of affairs were revealed it would upset the orderly marketing of the company's securities allegedly to the detriment of unsophisticated shareholders and investors. The judge had this to say of secret reserve accounting: "We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt by many concerns, of the highest

standing. On the other hand, it may be the subject of almost intolerable abuse. It is said to be a matter of domestic concern between the company and the shareholders, but if the shareholders do not know and cannot know what the position is, how can they form any view about it at all?"

The answer to this question came soon after the Kyslant case when, owing to the nature of its findings and judgements, the practice of secret reserve accounting began to disappear from the scene. It is clear then, that the courts of law had a considerable influence on the accounting practices concerned with the measurement of income and asset values. The particular concern appears to have been with the determination of income figures with which to justify dividend distributions rather than with figures required for reporting purposes. However, as the reported income statement of these times appears to have been used to justify dividend payments, it is clear that such measurement practices would also be used for reporting purposes.

CHAPTER 2

Footnotes

1. H.G. Pollins, 'Aspects of Railway Accounting before 1868' (eds. A.C. Littleton and B.S. Yamey), In: *Studies in the History of Accounting*, (London, 1956), p. 338.
2. Peter Bird, *Accountability : Standards for Financial Reporting*, (London, 1973), p.2.
3. Pollins, *op. cit.*, p. 354.
4. *ibid.*, p. 332.
5. H.C. Edey and P. Panitpakdi, 'British Company Accounting and the Law: 1844 - 1900', (eds. A.C. Littleton and B.S. Yamey), In: *Studies in the History of Accounting*, (London, 1956), pp. 356-7.
6. *ibid.*, p. 354.
7. *ibid.*, p. 361.
8. *ibid.*, p. 364.
9. *ibid.*, pp. 368 - 71.
10. T.A. Lee, *The Concept of Profit in British Accounting 1760 - 1800*, (Nottingham, 1974), p. 26.
11. L. Hannah 'Takeover Bids in Britain Before 1950 : an exercise in business "pre history" ', *Business History*, (January 1974), pp. 65 - 67.
12. *ibid.*, p. 68.
13. *ibid.*, p. 69.
14. A.A. Fitzgerald, *Current Accounting Trends*, (Sydney, 1952) p. 124.
15. *ibid.*, p. 124.
16. *ibid.*, p. 124.
17. *ibid.*, p. 125.
18. *The Accountant*, (19 December 1931), p. 804.
19. *ibid.*, p. 804.
20. *The Accountant*, (9 January 1932), p. 30.
21. G.O. May, *Twenty-five Years of Accounting Responsibility*, (Lawrence, Kansas, 1936), Vol. I, p. 76.
22. *Cohen Commission's Report on Auditors' Responsibilities*, (New York, 1978), p.8.

CHAPTER 3

The Development of Corporate Financial Reporting in  
the United States.<sup>1</sup>

After the first World War the United States experienced a wave of prosperity, which, except for a brief recession in 1920, mounted steadily until the stock market collapsed in 1929. During the Harding, Coolidge and Hoover Administrations big business had a relatively free hand as a result of the laissez-faire approach adopted by these governments. The country was enjoying a period of unparalleled economic growth. New industries like motor and aviation developed rapidly, bringing with them other developments such as the construction of highways and airports. There were increasing demands for capital and new share issues were taking place on an unprecedented scale. This climate of prosperity as well as the lack of any regulation of the securities markets provided the stimulus for many dishonest businessmen to seek ways of abusing the system for their own gain. This period is described by Samuel Eliot Morison as "the greatest orgy of speculation and overoptimism since the South Sea Bubble of 1720".<sup>2</sup> Such speculation in the share markets pushed prices to fantastic levels. There existed a general feeling that a new era had dawned which would continue forever.

Thoughtful members of the accounting profession were aware that financial reporting practices were not what they should be and that the responsibilities of independent auditors had not been clearly defined. There were no generally accepted accounting principles, nor any well-defined standards of disclosure.

Accountants and even teachers of accounting had taken it for granted that there was a body of accounting theory which might properly be called accounting theory. There had been no attempt to prepare a comprehensive list of these principles, nor even to discuss the logical basis upon which they might be founded. Even textbooks on accounting principles did not pretend to expound a complete philosophy of accounting. What were tacitly accepted as principles were, in fact, mainly rules of practice, acceptance of which was claimed on grounds of proved usefulness rather than logic.

As Stephen Gilman pointed out, this supposed body of accounting principles, based on experience and precedent, was to accountants, analogous to what the English common law was to lawyers.<sup>3</sup> But, though everyone believed there were principles of accounting, scarcely anyone had been interested in trying to state those principles; there were obvious conflicts among the rules of practice; there were noticeable differences among standard textbooks as to the proper application of certain rules; and there was no final arbiter to whom the accountant, the teacher or the student could appeal for decision upon controversial points.

The American Institute of Accountants (now the AICPA), on its own initiative, made sporadic efforts to plug some of the gaps.

The New York Exchange as early as 1922 showed uneasiness about some prevalent financial practices. The president of the exchange, Seymour L. Cromwell, made a speech in that year advocating full publicity in connection with the issuance of securities, and full

information about the status of issuing companies, in line with the English practice. He proposed a requirement that "sworn statements" be filed prior to the issuance of securities, and semi-annually thereafter, including adequate information on the financial position of the issuing companies, as well as their operations and earnings.

Apparently there had been some talk about the possibility of new legislation to regulate the issuance of securities. In commenting on the Cromwell speech, The Journal of Accountancy said: "What can and should be done by legislation and effective public administration is to throw a light of publicity upon the issuance of securities that will enable investors to judge for themselves whether a given security is sound and to what extent it is speculative".<sup>4</sup> The editor further advocated provisions similar to those of the English Companies Act, including independent audits of financial statements - a point which Mr Cromwell had apparently overlooked. This took place eleven years before the Truth in Securities Act was introduced in 1933, which Act might have been unnecessary if the business and financial community had disciplined itself in time. But no action was taken in response to these and many other criticisms. The stock exchange was rising, corporations were merging and holding companies in the utility field were developing vast empires, financed by issue after issue of common stock.

Perceptive critics soon began to emerge in print. Professor William Z. Ripley of Harvard University began to make speeches and write articles sharply criticizing current financial practice, including financial reporting. His writings were brought together in 1927 in

a book entitled "Main Street and Wall Street", which attracted wide public attention. He wrote of "the docility of corporate shareholders permitting themselves to be honeyfuggled", and about the "hoodwinking of the shareholders" in the field of public utilities - much of his criticism supported by references to specific situations involving specific companies. "The Accountants", he wrote, "are enabled to play ball with figures to an astounding degree".<sup>5</sup>

Referring to Institute proposals for independent audits in accordance with British practice, he said, quite inaccurately, that the accounting profession in Great Britain was standardized by Statute which prescribed qualifications and performance, while in the United States, "with the credentials of competence emanating from 48 conflicting and competing state legislatures, sheer independent audit would be no better than management audit as we have it at the present time".<sup>6</sup> However, Professor Ripley advocated full publicity about corporate affairs and turned his wrath on many current financial reporting practices. State legislation, he concluded, held out little promise. He expressed the belief that under existing legislation the Federal Trade Commission had the power to deal with the problem and implied that this power should be exercised.

One of the early Ripley articles appeared in The Atlantic Monthly of September 1926. The annual meeting of the American Institute was held in Atlantic City later that month, and George O. May took the opportunity to reply. While expressing disagreement with the professor on many points, Mr May said:

"I would rather express my gratification at the success with which he has attracted the attention of the public to the subject, and consider what we, as accountants, can do to bring about that improvement in the information furnished to stockholders and potential stockholders of corporations for which his article is a plea..... I am not sure that auditors have done their full duty in this respect in the past ..... I think the time has come when auditors should assume larger responsibilities, and their position be clearly defined".<sup>7</sup>

Mr May said that ninety per cent or more of industrial companies listed on the New York Stock Exchange were independently audited; that the powers and duties prescribed for auditors under the English Companies Acts had resulted in a fully satisfactory situation; and that similar results might be achieved in the United States through co-operation with the accounting profession on the part of the stock exchanges, the investment bankers and the commercial banks. Through agreements among these groups, he said, standards might be established for balance sheets and income statements, and he discussed in general terms the possible nature of such standards. He urged the Institute to take the initiative in such a co-operative effort.<sup>8</sup>

During the next few years Mr May proceeded to follow his own suggestion. In November 1926, a few months after making this speech, he relinquished his administrative duties as senior partner of Price Waterhouse in order to devote more time to economic studies and to the broader problems of financial and business affairs. This freedom of time allowed him to lead the profession during the following years in some urgently needed reforms.

Early in 1927 an effort was made by the Institute to follow Mr May's suggestion that co-operative relations with the New York Stock Exchange be established to consider requirements for more comprehensive financial reports from listed companies. However, the Institute's secretary reported to Council that efforts to assist the stock exchanges "had not yet borne fruit" - though the secretary hoped confidently that in the near future "there would be greater inclination on the part of the exchange authorities to assist accountants in their attempts to insist upon full and frank disclosures of financial facts".<sup>9</sup> This was somewhat overoptimistic. In fact, an offer from the president of the Institute, William H. West to the president of the New York Stock Exchange to initiate co-operative efforts to improve financial reporting had been flatly rejected. Disappointed and somewhat resentful of the brush-off, Mr May approached the problem from another direction.

In 1926 J.M.B. Hoxsey had been named executive assistant to the Committee on Stock List of the New York Stock Exchange, a full-time salaried position which did not carry much authority but did provide

direct access to the Committee. While not a CPA, Hoxsey had some knowledge of accounting, and May cultivated his acquaintance. Hoxsey was wholly in accord with May's objective to make financial statements of listed companies as informative and reliable as possible, and consulted May informally on technical questions.

When the president of the exchange rejected the Institute's offer of co-operation, Hoxsey inquired of May whether Price Waterhouse would accept a retainer as consulting accountants to the exchange. As an alternative May suggested a committee of the Institute to co-operate with the exchange. However, the Stock List Committee preferred to have its own advisers, and the firm, therefore, accepted the appointment. This gave May direct access to the Committee and he constantly urged improved financial reporting, clearly perceiving that the speculative boom, if not checked, would collapse.

The stock market crash in 1929 was a catastrophe beyond the worst predictions of the most pessimistic observers. The financial community was in a state of shock. Thirty billion dollars of quoted value of securities vanished in less than a month. Banks failed and, in some states closed. Financial paralysis gripped the country. Public reaction was bitter and a critical review of the process of the financial market, including financial reporting practices, became an obvious political necessity.

The stock exchange suddenly showed an eager interest in reform and a desire to co-operate with the Institute in improving financial reporting. Hoxsey was dispatched to the annual meeting of the Institute

at Colorado Springs in September 1930 to make his famous speech, "Accounting for Investors". He recited some of the important areas of financial reporting in which there were variations in practice that needed attention - depreciation, consolidated statements, disclosure of sales, distinction between operating income and other income, surplus, stock dividends, overconservatism in accounting... In conclusion he said that the stock exchange would welcome the appointment of an Institute committee to co-operate with the exchange for consideration of all such problems. The invitation was promptly accepted.

A special committee on co-operation with stock exchanges was appointed and George O. May was made chairman. The committee went to work promptly and was able to report progress a year later. The committee said that it had had discussions and correspondence with the exchange and that the officers of the exchange recognised their obligation to see that companies whose securities were listed made reasonable disclosures to the public. The exchange desired the co-operation of auditors in this venture. The exchange had also expressed the view that there was considerable uncertainty regarding the extent of the responsibilities assumed by auditors in the ordinary audit of accounts for publication in companies' annual reports, and suggested the advisability of defining and possibly adding to those responsibilities. No details were suggested in 1931.

Meanwhile pressure was generally mounting for accounting reform. A statement published by the American Management Association in 1932 advocated "such action as may be necessary to secure the appointment,

by the leading professional accounting societies, of a joint committee on accounting standards, which committee shall be charged with the formulation and periodical revision of the accounting rules necessary to safeguard against recognised errors and misrepresentations in corporate reports and statements". This declaration was submitted to the New York Stock Exchange. The Committee on Stock List requested an opinion from the Institute's Co-operating Committee as to the lines along which the policies of the exchange should be developed in relation to the accounts of listed Corporations. The Institute committee submitted a memorandum in response, but did not believe it proper to make it public at the time.

The Committee reported, however, that it believed the prescription of complete standard accounting rules for corporations would be impracticable and undesirable. It recommended that any formulation of rules which might be attempted should be restricted to a statement of a relatively small number of established principles upon which there was no substantial difference between reputable accountants and corporations. This committee suggested further that in regard to other matters such as inventory valuation, on which legitimate differences of opinion and practice existed, it was preferable to recognise the right of corporations to use those methods best adapted to their requirements so long as the methods were reasonable and were properly disclosed.

As one step in the direction of reform, the exchange in 1932 adopted a policy under which corporations applying for listings were asked to sign an agreement stipulating that their financial statements would

bear the certificate of accountants "qualified under the laws of some state or country". The Institute's committee on co-operation with stock exchanges pointed out that these developments require auditors to accept a larger responsibility to stockholders, and "to display courage and independence when their approval is sought for accounts which are either clearly inadequate or misleading, even if technically accurate. The committee believes that a full acceptance of this responsibility in the difficult times through which we are passing will do much to enhance the position of the profession for the future."<sup>10</sup>

The pressure for legislation to protect investors was heightened in 1932 by the publication of "The Modern Corporation and Private Property" by Adolf A. Berle, Jr. and Gardiner C. Means. Berle was a professor of law at Columbia University and was soon to become a member of President Franklin D. Roosevelt's "brains trust" - a group of young liberals assembled to advise the President on how to recover from the depression and how to prevent a recurrence. The authors analysed the "concentration of economic power" in a relatively small number of large corporations. The book showed how the dispersion of stock ownership enabled management to control corporate finances, including the distribution of earnings. They criticized the inadequacy of information given to investors. Berle and Means went on to point out methods of "accounting manipulation" which could be used to show abnormal profits, through inventory valuations, depreciation, issue of bonds with stock or stock warrants (resulting in lower than normal interest charges against income), overvaluation of assets, charges to surplus that should go against income, elimination of

"nonrecurring expenses" from income accounts and crowding of sales into the last period. "Capable accountants of a high degree of integrity will catch these situations as they arise", said the authors, "and will usually make the necessary corrections before permitting the use of their name..... The integrity of the accountant and the soundness of his method are the greatest single safeguard to the public investor.... . But rules of accounting are not as yet fully recognised rules of law..... In fact, the failure of the law to recognise accounting standards is probably due to the lack of agreement among accountants ....."<sup>11</sup>

This 382 page book had great influence. Prepared under the auspices of the Columbia University Council for Research in the Social Sciences, acting on behalf of the Social Science Research Council of America, it was the first scholarly and authoritative analysis of the modern corporation, its position in society and its relation to stockholders and investors.

Soon after his election as president of the Institute in 1932, John B. Forbes appointed a new special committee on development of accounting principles with George O. May as chairman. May also continued as chairman of the committee on co-operation with stock exchanges. The latter committee had been cautious in reporting the results of its work, pending final decisions on a number of matters by the New York Stock Exchange itself. However, in 1933 the committee reported that the passage of the Securities Act, in its opinion, seemed to make a clearer definition of the responsibilities of auditors more imperatively necessary. This conclusion was reinforced by a paper

on "Public Interest in Accountancy" by the same A.A. Berle Jr. who had co-authored "The Modern Corporation and Private Property". His paper was presented at the 1933 annual meeting of the Institute, approximately four months after the enactment of the Securities Act of 1933. While Mr Berle had accepted an invitation to speak at the annual meeting, other commitments had forced him to forego a personal appearance at the last minute and his paper was read by Walter A. Staub of New York. The paper emphasized the growing importance of accounting in the economy and Berle said that accounting was rapidly ceasing to be a private matter.

He raised questions about several accounting practices - the cost - or - market method of valuing inventories in certain circumstances; the inclusion of nonrecurring credits or charges in the income statements; changes in accounting methods between years - which might distort comparisons. He stressed the desirability of comparisons of the results of one company with others in the same industry. He continued, "How then should we handle the consistent development of principles of accounting, bearing in mind that these are likely to be subjected to the test of public opinion and public desirability as well as to their effectiveness in specified private transactions? For accountancy is now coming of age; there is no mistake about it".<sup>12</sup>

Mr Berle suggested that the first approach must be made by accountants themselves, acting through such organisations as the American Institute. But he questioned whether the job could be done by accountants alone - whether individual accountants could maintain completely impartial minds when under the instructions of a client. He predicted that a

bureau would be set up, presumably in the Department of Commerce, to standardize accounting practices in various industries.

The speech was something of a shock to the Institute audience. Mr Staub, who had read the paper, also led the discussion. He contended that the accounting practices which Berle questioned had already been generally eliminated, either through the efforts of the accounting profession itself or the stock exchange, or were in the process of elimination through the co-operative efforts of the Institute and the stock exchange, the results of which were to be published in the near future.

Objecting to the proposal that accounting practices be standardised by a government agency, Mr Staub alluded to the unsatisfactory experiences with government control of accounting under the Interstate Commerce Commission in the utility field and under the bank regulatory agencies. He also challenged Mr Berle's doubts about the independence and impartiality of public accountants.

Other members, however, urged the Institute to take affirmative action. One of these was Frederick B. Andrews of Chicago, who was head of his own local firm, highly articulate, idealistic and an independent thinker. Mr Andrews suggested, "..... unless the profession works out for itself something along the line that is suggested in Professor Berle's paper, the government may, and probably will". He urged official pronouncements by the Institute on the many phases of accounting procedure which were not yet crystallised "because different views are expressed by different accountants of equal

standing ..... and there is no place where those views are finally reconciled..... I hope..... there may come to be a body of officially recognised promulgated views on what constitutes proper accounting procedures in certain directions."<sup>13</sup>

Earlier, in September 1932, George O. May, as chairman of the special committee on development of accounting principles, wrote to the committee on Stock List of the New York Stock Exchange, intimating that his committee believed that there was an urgent need to educate the public regarding the significance, value and limitations of accounts, and to make accounts published by corporations more informative and authoritative.

The letter<sup>14</sup> said that there was general misunderstanding, even among writers on financial and accounting subjects, of the nature of balance sheets and income statements. The importance of the earning capacity of an enterprise as contrasted with the valuation of assets was discussed as was the importance of the income account as contrasted with the balance sheet. It is explained that these accounting statements were "largely the reflection of individual judgements, and that their value is, therefore, to a large extent dependent on the competence and honesty of the persons exercising the necessary judgement". It emphasized the importance of method and, particularly, of consistency of method from year to year, in the preparation of statements, and it claimed that there existed fairly general agreement on certain broad principles which should be followed in the formulation of conventional methods of accounting, though there was room for differences in the application of these principles.

There followed a discussion of accepted alternative methods of accounting for depreciation and inventories, as examples.

Alternative ways of improving the situation were considered:

- (a) selection by a competent authority, from presently accepted methods, of a detailed set of rules binding on all corporations of a given class; or
- (b) permission to corporations to choose their own methods within reasonable limits, but with disclosure of such methods and with consistency in their application from year to year.

The arguments against the first alternative were considered overwhelming. The second was strongly advocated. Finally, a change in the form of audit certificate was recommended, so that auditors would specifically report whether the accounts were prepared in accordance with the methods of accounting regularly employed by the company, as filed with the exchange and available to the public.

In an exhibit accompanying this letter five broad principles of accounting were proposed, as follows:

1. Unrealised profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts that would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be

made in respect of inventories in industries (such as the packinghouse industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there against. This rule might be subject to the exception that where, upon re-organisation, a reorganised company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganisation provided the facts were as fully revealed to and the action as formally approved by the subsidiaries as in reorganisation.
3. Earned surplus of a subsidiary company created prior to acquisition does not form part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.
4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.
5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

A further exhibit illustrated the nature of the statement which a corporation would file with the exchange, disclosing the accounting methods it followed.

The Institute Committee's recommendations were in general approved by the Stock Exchange and put into effect in 1933 - with one important exception. Listed companies were not required to disclose the accounting methods they followed. Instead, the exchange took two steps in January 1933. It required independently audited financial statements to be filed with listing applications and to be published annually thereafter. The exchange also asked listed companies to secure from their auditors and furnish to the exchange information as to the scope of their audit; whether the form of the financial statements was such as fairly to present the financial position and results of operations; whether the accounts reflected consistent application of the company's regular accounting system; and whether such system conformed to accepted accounting practices and was not inconsistent with the five broad principles proposed by the Institute Committee.

Nine large accounting firms responded jointly on 24 February 1933 to the enquiries on these six points, with the objective of further clarifying the responsibilities of the auditor. In this letter special reference was made to reliance on internal check and control, the primary responsibility of management for accounting judgements and the concept of materiality. In October 1933 the Committee on Stock List addressed a formal letter to the Governing Committee of the exchange, enclosing the communication from the nine accounting

firms. The letter recommended that the "five broad principles" of accounting be regarded as so generally accepted that they should be followed by all listed companies. The letter then discussed further appropriate scope of an independent audit, and suggested the development of a form of audit report or certificate more informative than those currently in use. The governing committee immediately approved these recommendations.

Throughout this correspondence were references, with general approval, to the revised Federal Reserve Board bulletin, published in 1929 under the title "Verification of Financial Statements". The accountants pointed out that this bulletin was "framed to fit the case of borrowers engaged in business on a relatively small or medium-sized scale", and that in larger corporations, with effective systems of accounting and internal control, less extensive detailed checking was required by the independent auditor.

In a letter<sup>15</sup> to the exchange dated 21 December 1933 the Institute's committee stated that if "a defalcation should occur and escape detection, the accountants cannot be expected to accept any financial responsibility, but only to accept such blame as may attach to a possible error of judgement on their part with respect to their review of the methods and extent of the internal check and control. The effect on the reputation of a public accountant, arising from such an error of judgement, is serious and quite sufficient to ensure care on his part."

The Institute committee agreed with the exchange, however, that the auditor should "accept the burden of seeing that the income received and the expenditures made are properly classified insofar as the facts are known to them or are ascertainable by reasonable inquiry".

A standard form of "accounting report" was then suggested by the Institute Committee on co-operation with stock exchanges, which after modification was approved by the Controllers Institute of America and the Committee on Stock List. It read as follows:<sup>16</sup>

"To the XYZ Company:

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

In our opinion, based on such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the

year under review, its position at December 31, 1933 and the results of its operations for the year.

Notes:

1. It is contemplated that before signing a report of the type suggested, the accountant should have at least made an examination of the character outlined in the bulletin, "Verification of Financial Statements", as interpreted in the communication of the Committee on Stock List to the Governing Committee dated October 24, 1933.
2. The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.
3. The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.
4. In the second sentence, any special forms of confirmation could be mentioned: e.g. 'including confirmation of cash and securities by inspection or certificates from depositories'.
5. This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.
6. It is contemplated that the form of report would be modified when and as necessary to embody any qualifications, reservations or supplementary explanations."

Soon after the 1933 annual meeting of the Institute at which the Berle paper and the following discussion caused somewhat of a shock amongst accountants, came a breakthrough of historic significance. In 1934 Mr May reported on behalf of both the special committees on co-operation with stock exchanges and development of accounting principles. The long negotiations with the stock exchange had been completed. On 21 January 1934 the Institute published a pamphlet entitled "Audits of Corporate Accounts" containing all the correspondence between the Institute's committee and the Committee on Stock List of the exchange described above, with supplementary material. This document was circulated to all members of the Institute and given a wide general distribution. It marked a big step forward in the development of accounting principles and clarification of auditors' responsibilities.

The Securities Act 1933, the Securities Exchange Act 1934 and the formation of the Securities and Exchange Commission.

Despite Ripley, despite Berle and Means, despite the growing criticism of the profession and despite public demand for reform of the securities markets after the stock market crash of 1929, the Institute was not prepared with legislation directed to that end. When bills were introduced in both Houses of Congress only a few months before final enactment of the Securities Act of 1933 on 27 May 1933, they came as something of a surprise to the profession. No

policy positions, no strategy for dealing with such legislation, no constructive proposals for inclusion in such legislation had been worked out - the correspondence with the New York Stock Exchange was only in midstream. Consequently, instead of having a hand in the drafting of the Securities Act, the profession had to react to drafts prepared by others.

When word came that legislation was expected, the Institute immediately created a committee to deal with it. The Institute did not appear formally at the hearings on the securities legislation - after all, the profession's record in developing standards of financial reporting was not impressive. Even the basic philosophy outlined in the stock exchange correspondence was not yet available for public reference. If official representatives of the Institute had testified at the hearings, they might have been subjected to hostile questioning. This could have resulted in further adverse publicity, and possibly even more punitive legislation than that proposed.

The Institute's committee did study, carefully, the various drafts of the bill, exchanged correspondence among its members and held several meetings. The committee reported that it had transmitted certain recommendations through various channels to persons influential in the Administration and in Congress.

The first draft of the bill contained only one reference to examinations by independent accountants. These were provided for only in case the Federal Trade Commission (which was originally designated

to administer the legislation) desired to initiate an investigation of the affairs of any company about whose eligibility for registration there appeared to be any doubt upon the basis of the statements submitted with the application. The Institute dispatched a letter to the appropriate Congressional Committee suggesting that it might be desirable to extend the provision for independent audit to all financial statements filed for purposes of registration. The letter explained that many reputable issuers of securities were already subjected to independent audits, either voluntarily or through stock exchange requirements, and that the omission of such a provision from the Truth in Securities bill might be an advantage to less reputable issuers, over whom the government evidently desired particularly to exercise supervision. This letter apparently made an impression on the House Committee on Interstate Commerce, since its bill was amended to include the audit provisions.

The House bill, which was finally passed into law, also contained at least two provisions which were of special concern to accountants. The first of these was the provision which authorized the Federal Trade Commission to prescribe accounting rules to be followed by listed corporations. Most alarming of all were the liability provisions. The provisions, it must be remembered, were enacted in a punitive atmosphere. They were a cause of grave concern to the profession for several reasons : first, they put the burden of proof on the defendant-accountant rather than on the plaintiff investor; second, the plaintiff need not prove reliance on the statements alleged to be false and misleading; and third, no limitation is placed on the amount of damages for which a defendant-accountant might be held liable.

Following enactment of the 1933 Act, close co-operative relations were established by the Institute with the Federal Trade Commission, which initially had responsibility for administration of the law. The Commission was pleased to have the help of experienced accountants in dealing with some of the technical problems confronting it, and the Institute had considerable influence on the regulations dealing with the form of financial statements, the form of accountants' certificates and related matters.

A little more than a year after the 1933 Act became law, the Securities Exchange Act of 1934 was approved. It created the Securities and Exchange Commission, which was charged with the administration of both Acts.

When the 1934 Act was under consideration by Congress, the Institute submitted a memorandum brief for incorporation in the record of the hearings. The memorandum objected to the liability provisions of the proposed legislation, particularly the "immeasurable liability" to which an accountant would be exposed. The memorandum also challenged a provision giving the Commission power to prescribe uniform accounting for industry, pointing out that attempted uniformity in the accounting of public utilities and railroads had not resulted in more dependable financial statements in those industries; on the contrary there had been greater advance in the accounting of unregulated companies.

In the law as enacted, the liability provisions were somewhat less harsh than those of the 1933 Act. However, the power of the Commission to prescribe accounting methods was retained.

Relations between the Securities and Exchange Commission and the Institute.

The Institute immediately appointed a special committee on co-operation with the new Securities and Exchange Commission, whereupon the Commission's offer of co-operation was received.

In the first years, the administrators of the two Acts were pre-occupied with organisational problems, the development of rules, forms and procedures, prosecution of flagrant violators of the law, and encouragement of public acceptance of the new state of affairs. Institute members had long sessions with the SEC staff, working on regulations, forms and procedures. Speeches by SEC spokesmen were conciliatory. Although in some quarters there was a disposition to exercise the Commission's authority by prescribing accounting principles and methods, it was finally decided - partly due to the persuasiveness of Institute representatives - not to do so. Rather the Commission adopted a policy of gradual improvement, leaving to the accounting profession the initiative in proposing accounting principles to the extent to which it was able and willing to do so.

Numerous questions arose during the early years of the two Acts requiring interpretation of their provisions and related regulations. Since many of these involved accounting questions, the Commission decided to appoint Carmen G. Blough to the newly created office of Chief Accountant. Blough had previously served in the SEC as a security analyst, he had practised as an accountant, and had served

as head of the accounting department at the University of North Dakota for four years, amongst other things. Blough urged the accounting profession to narrow the range of diversity in accounting principles and was destined to play a great role in the development of technical standards in the profession.

In the years ahead, SEC spokesmen alternated between praise of the profession's substantive contributions to improvement of corporate reporting, and frank criticism of the profession's failures of omission or commission. The criticism was sometimes mingled with thinly veiled threats that the Commission might exercise its latent powers to prescribe accounting principles and methods if the profession did not move forward more rapidly.

The influence of the SEC on accounting and auditing standards and practice was tremendous. The Securities Acts, without doubt, strengthened the position of independent auditors in insisting that clients follow sound principles and make adequate disclosures. The Commission's requirements also greatly increased the volume of auditing engagements.

As mentioned earlier, at the 1934 annual meeting of the Institute, Mr May reported not only for the committee on co-operation with stock exchanges, but also as chairman of the special committee on development of accounting principles. In the latter report the Committee made the following six points:<sup>17</sup>

1. Principles of Accounting cannot be arrived at by pure reasoning, but must find their justification in practical wisdom.
2. The institute should proceed with caution in selecting from among various commonly employed methods those which should be accorded the standing of principles or rules of accounting.
3. It was desirable to secure the acceptance of any rules or principles laid down by the Institute, also by the courts or by independent bodies having some regulatory powers or authority.
4. The concurrence of the Federal Reserve Board and the Federal Trade Commission in the definition of the scope of a balance sheet or financial audit and the agreement on principles reached in the correspondence between the Institute and the New York Stock Exchange constituted precedents which the committee proposed to follow as far as possible.
5. Under the Securities Act, the SEC had wide powers to prescribe methods of accounting, and close co-operation between the Institute and that Commission was desirable.
6. The stock exchange had approved the five general principles submitted by the Institute's committee on co-operation with that body, and these "rules" or "principles" should be adopted by the Institute. (The Council of the Institute formally approved these principles, and the members approved all acts of the Council at the 1934 annual meeting).

### The Development of Accounting Standards

Given the need for clear and authoritative enunciation of accounting standards, and given the willingness of the profession to accept this responsibility, the next question was how standards were most effectively to be developed and established. The alternatives were persuasion or compulsion, self-imposed discipline or regimentation, voluntary acceptance or legislative sanction.

In the United States the first approach to the problem was through persuasion. The memorandum by the Institute on balance sheet audits, contained in the Federal Reserve Board bulletin in 1917, was given provisional or tentative endorsement by the Federal Reserve Board after conferences with representatives of the Federal Trade Commission and the Institute. This persuasive approach was used in preference to the adoption of proposals which were then being made for prescription of a uniform system of accounting and auditing for all circumstances and businesses.<sup>18</sup>

After more than ten years of trial of the recommendations contained in the memorandum, the Institute appointed a special committee to deal with criticism and suggestions for changes. The report of this committee was a revision of the old memorandum, voluntarily undertaken by the Institute in furtherance of a movement initiated by government agencies. It was greeted as meeting "the constantly growing need for an official utterance on the modern practice of accountancy", and as "the most representative pronouncement upon the vital question of accounting procedure which has been made in this country".<sup>19</sup>

The next revision of the manual, in which attention was for the first time given to accounting standards as distinct from accounting practices, was published in January 1936 by the Institute itself, under the title "Examination of Financial Statements by Independent Public Accountants". In the preface to this bulletin it was stated that developments of accounting practice during the recent years had been accelerated by the prominence given to disclosure and consistency in accounting statements by regulations of the Securities and Exchange Commission and by the correspondence during 1932 - 4 between the Institute and the New York Stock Exchange. Thus, the regulations of the Securities and Exchange Commission, compulsive within the field of practice before the commission, spurred the persuasive activities of the institute.

Demand from within the profession for continuous research into accounting problems, not necessarily activated by outside pressure, had meanwhile been shown by the 1929 report of the committee on technical affairs of the American Society of Certified Public Accountants. This report had urged that the need for scientific reconstruction of accounting theory and practice was not being adequately met by the work of disconnected committees of busy practitioners and had recommended a more permanent agency to encourage and co-ordinate research.<sup>20</sup>

This urge from within the profession was evidenced also by the publication in July 1936, by the committee of the American Accounting Association of a "Tentative Statement of Accounting Principles Underlying Corporate Financial Reports"<sup>21</sup> and by the publication in 1938,

by the Institute, of "A Statement of Accounting Principles", prepared by Professors T.H. Sanders, H.R. Hatfield and Underhill Moore on the invitation of the Haskins and Sells Foundation. It was further shown in 1939 by the establishment by the Institute of a research department with Thomas H. Sanders, of Harvard, as Director of Research, and by the establishment of a Committee on Accounting Procedure of twenty-two members, including prominent teachers as well as practitioners.

In its first bulletin, issued in September 1939, the committee said that it regarded the representative character and general acceptability of its pronouncements as of the highest importance, and to that end had adopted certain rules for its own procedure. These rules provided that no opinion should be issued by the committee unless it had first received formal approval of two-thirds of the committee, and dissentient members were to be entitled to have their dissent recorded in the document in which the opinion was expressed. This first bulletin also stated that, "The committee recognises that its general rules may be subject to exception and that in extraordinary cases truthful presentation and justice to all parties at interest may require exceptional treatment. But the burden of proof is upon the accountant clearly to bring out the exceptional procedure and the circumstances which render it necessary." This bears a striking similarity to Paton and Littleton's concept of standards as "gauges by which to measure departures, when and if departure is necessary and clearly justifiable."<sup>22</sup>

The bulletin included a list of topics which the committee was currently examining; it invited expressions of opinions from members

on these topics, and renewed an invitation to members to submit other questions upon which they would like to have pronouncements made.

The Institute, recognising the need for more effective research, appointed Blough as the first full-time Director of Research in 1944. Shortly after this appointment the research department began circulating exposure drafts of proposed Accounting Research Bulletins to various interested parties.

So far as the relationship between the bulletins and the rules of the Securities and Exchange Commission was concerned the Institute and the Commission adopted a co-operative attitude. The fourteenth annual report of the Commission<sup>23</sup> specifically referred to the "practice of co-operating with various accounting groups in the development of accounting and auditing standards of practice". The Commission referred proposed changes in its rules to the several accounting organisations and others interested and, in return, the organisations referred proposed public announcements to the Commission's accounting staff for comment.

Even in those respects in which the Commission and the Institute did not see eye-to-eye, a spirit of co-operation could still be evidenced. A classic example was Research Bulletin No. 32. This dealt with the form and content of income statements and, inter alia, expressed the committee's opinion that there should be a general presumption that all items of profit and loss recognised during a period are to be used in determining the figures reported as net income for that period. "The only possible exception to this presumption, in any case, would be with respect to items which, in the aggregate, are materially

significant in relation to the company's net income and are clearly not identifiable with, or do not result from, the usual or typical business operations of the period".

The Commission took the view that these exceptions to the general presumption could best be served by proper presentation in an "all-inclusive" income statement, and authorized its staff to object to financial statements which appeared to be misleading, even though they reflected the application of the bulletin. It also authorized the chief accountant to write to the Institute's director of research, expressing the view that the procedures recommended in the bulletin seemed to be susceptible to abuse, and might result in misleading statements in conflict with published rules and opinions of the Commission.

The Commission acknowledged the courtesy of the Institute's director of research and of the editor of the Journal of Accountancy in publishing the chief accountant's letter in the journal immediately following the pages on which the bulletin was reproduced.

Prior to the establishment of the Committee on Accounting Procedure, a different method of issuing pronouncements had been used. This was to submit to meetings of the members of the Institute for adoption "rules or principles" recommended by the Special Committee on Development of Accounting Principles. Six rules were so adopted by the Institute as a whole, including the five recommended to the New York Stock Exchange in 1933. Abandonment of this practice after 1934 was obviously a change from compulsion to persuasion, and the

changed approach was emphasized by a note appended to all bulletins from No. 5 onwards, which stated that "except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions" reached by the committee's rules.

The evolutionary nature of the research bulletins has been shown in several ways: by repeated invitations to members to express opinions on the topics discussed, by statement of differing views on controversial points, by publication of the names of dissenting members of the committee and their reasons for dissenting, by explicit disavowal of authority other than general acceptability of the opinions expressed, by specific recognition of the possible justification of departure from standards in special circumstances, and by the readiness of the committee to modify previously expressed opinions in the light of further consideration or criticism.

The development of accounting standards had now been entrusted by the Institute to the Committee on Accounting Procedure. By the time this Committee was replaced by the Accounting Principles Board in 1959, it had issued 51 Accounting Research Bulletins. As was mentioned above, these bulletins were merely advisory in nature and helped to add to the number of available practices in certain defined areas of accounting. This flexibility, coupled with the lack of a mechanism for the abandonment of bad or obsolete practices through time, resulted in criticism of accounting and reporting practices, particularly when it was realised by the financial and investment communities that it was possible for a company to produce a number of

alternative income statements and balance sheets, each based on the same transactions, but each different because of the various accounting practices applied.<sup>24</sup>

Such criticism eventually led to the formation of the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA). The APB was supported by a research division which published several Accounting Research Studies concerning the fundamental truths and ideas in accounting. In other words, the initial approach was to pronounce on what should be rather than what is being accounted for. This produced such radically different forms of accounting that the APB was later forced into a system of ad hoc problem solving.

The recommendations of the APB were issued in the form of "Opinions". These Opinions were made mandatory on members of the AICPA in 1964. The SEC generally followed the practice of endorsing these opinions requiring its members to comply. This system of setting standards created even more public criticism of accountants and their practices. Many critics of the APB charged that the Board moved too slowly and that repeatedly major problems were not studied and opinions publicized until years after the accounting problems began to appear.

Much of the lack of progress on the part of the APB may, perhaps, be attributed to the "quasi-independent" nature of the Board and reliance upon others for implementation of its opinions. Each member of the APB was part-time and, as such, carried a dual responsibility as a member of his own firm or organisation as well as a member of

the APB. Pressures might have arisen in which the Board members' responsibility for the public interest conflicted with his firm and client responsibilities. Quite often perhaps, the part-time Board member with dual responsibilities caused a lack of timeliness and/or tends to promote compromise of position - the end result of which is described by Mr Philip K. Defliese, Chairman of the APB, in testimony before the Wheat Committee, as a "..... 'damned if you do and damned if you don't attitude' ....." by persons to whom the APB is responsible.

Perhaps the demise of the APB was accelerated in the late 1960's when the basic question of "fairness" and "generally accepted accounting principles" was cited in the Continental Vending decision. In this case Judge Henry J. Friendly took the position that the first responsibility of the independent accountant was to be "fair" and that this meant more than merely "fair within generally accepted accounting principles". A very stimulating part of Judge Friendly's benchmark decision reads:

"The first law for accountants was not compliance with generally accepted accounting principles but, rather, full and fair disclosure, fair presentation and, if principles did not produce this brand of disclosure, accountants could not hide behind the principles but had to go behind them and make whatever disclosures were necessary for full

disclosure. In a word, fairly present was a concept separate from generally accepted accounting principles, and the latter did not necessarily result in the former".

Other critics pointed out that if compliance with accounting principles must result in fair presentation to all of the various segments of society, then there existed an urgent need to incorporate the views of as many of the various segments of society as is possible in their development.

In this connection Professor Abraham Briloff, an eminent academic, joined the growing band of critics when, in his books "Unaccountable Accounting" and "More Debits than Credits" he attacked the manner in which accounting standards were being set and, more particularly, he questioned the morals of the "Big Eight" auditing firms in dominating the setting of the standards. He was of the opinion that these firms were loathe to displease their clients, the large corporations, and so manipulated the accounting standards setting process in the interests of their clients. He exposed several instances of questionable financial reporting by these large corporations with the full, alleged, co-operation of their "Big Eight" auditors. Responding to this criticism from both inside and outside the profession, the AICPA commissioned two major studies in 1971. One was to deal with the process by which accounting principles should be established and was chaired by former SEC Commissioner, Francis M. Wheat, and the

second was to deal with the objectives of financial statements and was chaired by former AICPA President Robert M. Trueblood.

In 1972 the Wheat Study recommended, amongst other things, that a seven-man, full-time Financial Accounting Standards Board (FASB) be established under the auspices of a Financial Accounting Foundation (an independent trust). The entire recommendation received the support of the overwhelming majority of the AICPA's Board of Directors and Council and several of the "Big Eight" firms promised donations of \$1 million to set up the trust. The APB was formally replaced by the FASB on 1 July 1973 and the AICPA declared that the FASB had supplanted the APB as the authoritative source of future "generally accepted accounting principles". This was an important milestone as the task of formulating "generally accepted accounting principles" had been handed over to a body independent of the AICPA. As a result of this the AICPA created the Accounting Standards Executive Committee (AcSEC) as its senior technical committee authorized to speak for the AICPA on matters of financial and cost accounting. In 1974 AcSEC began issuing Statements of Position (SOPs) on "emerging problems" to serve as the subjects of possible future Statements by the FASB. SOPs were not to be regarded as constituting "generally accepted accounting principles", but were nonetheless influential. In December 1973 the SEC declared that

"standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support,

and those contrary to such FASB promulgations will be considered to have no such support".<sup>25</sup>

The AICPA study, chaired by Trueblood, produced their report "Objectives of Financial Statements", which was published by the AICPA in October 1973. This report (generally referred to as "The Trueblood Report") made various proposals which provided the blueprint for the conceptual framework project commenced by the FASB in 1976 and which is examined in more detail in Chapter 7.

CHAPTER 3

Footnotes

1. Much of the factual information in this chapter has been drawn from the following sources:
  - (a) John L. Carey, 'The Origins of Modern Financial Reporting', in T.A. Lee and R.H. Parker, *The Evolution of Modern Financial Reporting*, (Melbourne, 1979), pp. 241 - 264.
  - (b) George O. May, *Twenty-Five Years of Accounting Responsibility*, Vol. I, (Lawrence, Kansas, 1936).
  - (c) A.A. Fitzgerald, *Current Accounting Trends*, (Sydney, 1952).

I wish to acknowledge this assistance.

2. Quoted from John L. Carey, *op. cit.*, p. 241.
3. S. Gilman, *Accounting Concepts of Profit*, (New York, 1939), chap. 12.
4. John L. Carey, *op. cit.*, p. 243.
5. *ibid.*, p. 243.
6. *ibid.*, p. 244.
7. George O. May, *op. cit.*, pp. 53 - 54.
8. *ibid.*, p. 54 - 59.
9. John L. Carey, *op. cit.*, p. 245.
10. *ibid.*, p. 248.
11. *ibid.*, p. 249.
12. *ibid.*, p. 250.
13. *ibid.*, p. 250.
14. George O. May, *op. cit.*, pp. 112 - 120.
15. John L. Carey, *op. cit.*, p. 253.
16. *ibid.*, pp. 253 - 4.
17. *ibid.*, p. 263.
18. A.A. Fitzgerald, *op. cit.*, p. 154.
19. *ibid.*, p. 356.

20. William A Paton and A.C. Littleton, *An Introduction to Corporate Accounting Standards*, (Sarasota, Fla., 1940), p. 143.
21. A.A. Fitzgerald, *op. cit.*, p. 155.
22. Paton and Littleton, *op. cit.*, p. 6.
23. A.A. Fitzgerald, *op. cit.*, p. 155.
24. E. Stamp and C. Marley, *Accounting Principles and the City Code : the Case for Reform*, (London, 1970), pp. 65 - 154.
25. SEC, *Accounting Series Release No 150*.

CHAPTER 4

The Development of Accounting Standards in the United Kingdom  
and South Africa

United Kingdom

The interest in and development of accounting standards in the United Kingdom appears to have taken place at a much slower rate than was the case in the United States.

In September 1931, Sir Arthur Lowes Dickinson, in a speech in the United States, expressed misgivings as to the rate of progress to higher accounting standards in England in comparison with that in the United States. "One reason for that", he said, "is that England has been, to a certain extent, hampered by the fact that there have always been laws and principles on accountancy, whereas in this country you have been able to develop the profession with very little regard, or necessity of regard, for the law, owing to the fact that there has been no law".<sup>1</sup>

This view was supported by George O. May when, in testifying before a Senate Subcommittee in 1933 with regard to the Kreuger and Toll case, he said, in answer to a question concerning the relative development of accountancy in England and in the United States:

".... I think there is a strong feeling to the same effect in England that information is inadequate in England. And the reason has largely been that the regulation in England

is statutory. And, of course, statutes can lay down only what I call minimum standards, failure to comply with which subjects them to penalty. What we want is much higher standards than that. And the result of these standards laid down by law in England has been that company officials who were reluctant to give information have said, 'Well, that is all the law requires, and you have got no right to ask us to give more'. And some auditors have accepted that position. Whereas here I think the profession has taken the position that what is due to shareholders is a matter of good conscience and good business practice. And there are no legal limitations on it. So they must use their own judgements when they consider that the directors are giving a reasonable amount of information to the shareholders. That, I think, is the history of the development."<sup>2</sup>

The major change in the philosophy of accounting and disclosure of the profession in the United Kingdom between the years 1925 and 1943 has already been discussed in Chapter 2. It has also been mentioned that the Royal Mail Case had a lot to do with this change in philosophy. This case was described by De Paula as "an atomic bomb that shattered our self-complacency and startled and shocked the public".<sup>3</sup>

Such an event might have been expected to have had immediate and far-reaching consequences in the overhaul of accounting standards relating to presentation of financial statements of companies. In due course, there were far-reaching consequences, but they were not immediate. In a letter from the United States to the President of the Institute of Chartered Accountants in England and Wales (ICA) in 1931, George O. May had expressed surprise to find that the practice with regard to disclosure in published accounts was so much better in the United States than in England. He was "in no way oblivious of the impossibility of establishing fixed standards of accounting, nor of the necessity of leaving the control of company matters generally in the hands of directors". Yet he thought that the ICA and the leading firms had an opportunity, by a display of courage and independence, to effect a great reform, and were assured of public support in doing so.<sup>4</sup>

As has already been mentioned the Council of the ICA considered the question of making a communication with members on matters arising out of the case, but in the end elected to forward only a copy of Counsel's opinion to its members, and not to make any pronouncement itself. At first it appeared that, after all the excitement in the profession and elsewhere which the case had engendered, this action of the Council was an anti-climax, and it was received with many expressions of disappointment.<sup>5</sup>

Henry Morgan, President of the Society of Incorporated Accountants and Auditors did not agree with Sir Arthur Lowes Dickinson's views.

Morgan urged reform of the company law to prevent the undisclosed use of secret reserves and to emphasize the importance of the profit and loss statement.<sup>6</sup> Thomas Greenwood also advocated similar reforms.<sup>7</sup>

Apparently, while Sir Arthur Lowes Dickinson believed that freedom from legal limitations facilitated development of accounting standards, Mr Morgan and Mr Greenwood looked to the law to support and strengthen standards established by long usage. Mr H.L.H. Hill, President of the ICA, soon made it clear that the memorandum which the Council had circulated to members was not the last word on the implications of the Royal Mail Case. He said:

"There is always a lag, and legislation with which we are concerned is always framed upon the best accounting practice. We must, therefore, take the lead so that, if and when fresh legislation is enacted, there may be by that time an established practice in accountancy in advance of the requirements of present-day legislation, and established practice that will assist and direct those who frame the laws to institute further safeguards for investors and the public."<sup>8</sup>

The Council of the Society of Incorporated Accountants and Auditors appointed a committee to report whether "any amendment of the company law is deemed necessary, and/or what, if any, alterations of a voluntary character may be considered desirable in the compilation

of company accounts or their certification by professional auditors". The Committee's report, which was adopted by the Council of the Society in April 1932, was to the effect that company-law amendments relating to profit and loss accounts, disclosure of reserves, and holding companies' accounts were desirable; and that it was "not desirable to make any recommendations for alterations of a voluntary character in the compilation or certification of company accounts, since in dealing with such alterations, auditors might be placed in a difficult position in regard to the law as it now stands". The report concluded with the positive opinion that "the only effective action must be by amending legislation".<sup>9</sup>

Interest in accounting standards, however, continued to increase and in 1942 the Council of the ICA began the issue of Recommendations on Accounting Principles. The procedure followed by the Council of the ICA in preparing and issuing its "Recommendations" to members was similar in some respects to that adopted by the American Institute, and different in other respects. The recommendations were prepared by the Taxation and Financial Relations Committee of the ICA and its Regional Committees for consideration by the Council. They were, however, issued by the Council itself, with no suggestion that they were not unanimous.

Like the United States bulletins, the recommendations were persuasive in tone and were put forward as indications of what was regarded as the best practice. The President's foreword to the booklet in which the recommendations were reproduced in 1944 made the comment that "accounting development can never be regarded as complete, and

there is every reason to encourage flexibility of form to meet new circumstances as they arise".

When they were originally issued, the recommendations were apparently received in this spirit. A leading article in "The Accountant"<sup>10</sup> on the occasion of the issue of the first recommendation emphasized that they were recommendations only, and not hard and fast rules. The leading article in the same journal<sup>11</sup> on the issue of recommendations III - V pointed out that "the Council does not claim for its recommendations the authority of a mandatory injunction". The pronouncements were no more than a considered statement of the Council's opinion as to what may be regarded as the best practice, and "no statements now made by the Council are to be regarded as derogating from the freedom of auditors in forming that personal opinion on particular circumstances which is the very basis of their reports under the statute".

The recommendations were discussed fairly freely in accountancy journals in the United Kingdom, though not with the same intensity, nor with the same philosophic detachment, as characterized by many of the discussions in the United States. Possibly the reason for this was that, within a year or two after the recommendations were issued, accountancy thought was concentrated on proposals for drastic changes in the accounts provisions of company law, which proposals culminated in the report of the Cohen Committee (based largely on evidence given by the ICA) and the Companies Act 1947.

Although the recommendations were not mandatory, the Council of the ICA seems to have been satisfied that the recommendations quickly received general acceptance. The foreword to the booklet containing the recommendations referred to "the number of companies which have adopted the recommendations in whole or in part, and the general approval which they have received". Also, the foreword by Gilbert D. Shepherd, then President of the ICA, to a booklet on the Companies Act 1947, issued by the Institute in May 1948, opened in these terms:

"To a considerable extent those provisions of the Companies Act 1947 which relate to accounts do no more than give statutory force to what had already been accepted as the best practice..... It is indeed a matter of satisfaction and encouragement to the Council to know that the principles recommended have earned statutory recognition in so short a time."

The position was not entirely satisfactory, however. The various accounting bodies produced their individual research reports and recommendations, each of which failed to carry any mandatory provisions. Public criticism began to emerge over the flexibility of accounting and reporting practices being adopted in practice. A spate of events in the late 1960's resulted in severe criticism of the profession.

The quality of the accounting information presented to the shareholders was called into question in 1966 during the investigation into the difficulties experienced by Pye. A commentator in "Accountancy" observed that "all told the total amount lost or written off by the Group to 31 March 1966 came to over £9 million. The accounts do not show this total; it is necessary to look in six or more places to make up the figure".<sup>12</sup>

There were growing signs that leading members of the business community were getting fed up with the apparently haphazard approach of British accountants. In June 1968 a good deal of publicity was given to a statement by Sir Frank Kearton, F.R.S. saying that he had written to the President of the English Institute to complain about the plethora of generally accepted accounting principles. Sir Frank was very concerned about the difficulties this caused in trying to reconcile pre- and post-acquisition "principles" in take-overs. The complaint was quietly smothered by the Institute, and nothing was done to cure the problem.<sup>13</sup>

The following month the same problem erupted elsewhere. The A.E.I. directors, who had been fighting a take-over bid from G.E.C. in October 1967, had announced that their profit forecast for 1967 was £10 million (before tax). A major accounting firm reviewed the forecasts on behalf of Baring Brothers (the financial advisers to A.E.I.) and declared that on the basis of enquiries they had made the forecasts for 1967, 1968 and 1969 had in their view "been prepared on a fair and reasonable basis and in a manner consistent

with the principles followed (by A.E.I.) in preparing recent published annual accounts". G.E.C. were successful in their take-over bid, and in July 1968 it was announced that A.E.I. had suffered a loss of £4,5 million in 1967. Of the shortfall of £14,5 million it was stated that £5 million was attributed "to matters substantially of fact" whilst the remaining £9,5 million was due to "adjustments which remain matters substantially of judgement". One of the most unsatisfactory features of the whole affair was the fact that not even the former directors of A.E.I. were able to get full disclosure of what the differences were all about.<sup>14</sup>

This was followed by the Pergamon affair which resulted in even greater criticism and finally stirred the British Accounting Profession into action. In 1969, in connection with a take-over offer that subsequently proved abortive, Pergamon Press asked Price Waterhouse to report on adjustments to the audited accounts for 1968, which accounts had been reported on by another firm of auditors. Price Waterhouse reported in March 1970 that the accounting principles used were sound, but that adjustments were necessary in the way they were being applied. In their opinion pre-tax profits, previously reported as £2 104 000 should be adjusted down to £495 000. In other words, this amounted to a public acknowledgement that two reputable firms of accountants were totally unable to agree as to what represented a true and fair figure for profit for the company.

The Economist, in its issue of 30 August 1969, commented on the accounting implications of the Pergamon affair. They observed that:

"Accountants do not have, nor do they believe in, written rules. Apart from the information and method of presentation required by the Companies Act, they rely on integrity and common sense, guided by occasional statements issued by the various professional institutions. These carry none of the legal weight that similar recommendations from institutions of American accountants do. They merely represent the evolving concept of what constitutes 'best practice', and the need to define this only arises when accountants find themselves increasingly meeting situations that defeat their common sense."

The Economist concluded its article:

"A blow up on this scale is mercifully rare. But when it happens it reveals dangerously hit-and-miss methods by which the company accounts get audited by accountants who are often understaffed, working against pressure of time, facing possible hostile and strong-minded directors and with too much left to individual discretion. Playing the game is all very well and most accountants do. But the system which has been exposed so lamentably this week in the City's handling of this mess-up simply is not good enough".

Another article which added to the debate at the time was written by Professor Edward Stamp and appeared in the 11 September 1969 issue of "The Times". Professor Stamp referred, amongst other things, to the multiplicity of different true and fair views which were based on the same facts and which would be acceptable to different accountants. He went on to say that this approach to prescribing principles may be satisfactory for the plumbing, wallpapering or for carpentry trades, but it surely was not good enough for a profession which believed itself to be the intellectual equal of the legal and medical professions. He referred to the ad-hoc manner in which the "rules" were devised and to the need to formulate a theoretical framework on which to base accounting standards.

On 20 November 1969 Lord Shawcross (Chairman of the City Panel on Take-overs and Mergers) expressed his concern also, when he commented on the fact that so many different accounting judgements of the same situation seemed possible. This, he said, could lead to different figures being put forward by the accountants acting for one company from those put forward by accountants acting for another. It could cause "confusion, adverse comment and anxiety". Lord Shawcross suggested it might be as well "if the (English) Institute were perhaps to define more clearly what was the correct practice which had to be followed by all accountants in matters of this kind".<sup>15</sup>

Thus by December 1969 it had become clear to the English Institute that something had to be done to meet the criticisms being so widely voiced. On 11 December the Institute called a press conference to

announce their "Statement of Intent on Accounting Standards in the 1970's". Its main aims were to attempt to narrow the areas of difference and variety in accounting practice, to recommend disclosure of departures from established definitive accounting standards and to provide a wider exposure for major new proposals on accounting standards. It was later revealed that if the ICA had not acted, the initiative might have been taken away from it by the Board of Trade. In the light of this the Accounting Standards Steering Committee was formed in 1970 with members from all the major accountancy bodies in the United Kingdom. Since then the Committee has initiated research in certain key areas, published Exposure Drafts of proposed accounting standards for public discussion and comment, and in 1971 commenced issuing Statements of Standard Accounting Practice (SSAPs), the contents of which are required to be implemented by members of the major professional bodies responsible for the production or auditing of company financial statements in the United Kingdom. If individual circumstances dictate that implementation of a particular standard is not appropriate, then the reasons for this must be fully explained to the shareholders in the relevant financial statements.

The present system of financial reporting by companies in Britain is still primarily a legally based one, that base being the Companies Act 1948. In addition, it is being supported by a series of mandatory professional provisions which have the strength of the major professional accounting bodies behind them (though they do not have the same legal status of the Act.)

The Companies Act 1948 was amended significantly by the Companies Acts of 1967, 1976 and 1981, particularly with regard to increased disclosure requirements and the strengthening of the powers of auditors.

### South Africa

The development of the accounting profession and of accounting standards in South Africa has, since the nineteenth century, been very closely associated with that of the United Kingdom.

The corporate reporting requirements of the Companies Act as well as the accounting standards set out in the statements issued by the Accounting Practices Committee of the Institute of Chartered Accountants in South Africa are both of very recent origin.

It has already been mentioned in Chapter 2 that in December 1942 the Institute of Chartered Accountants in England and Wales commenced issuing the series of "Recommendations on Accounting Principles". These Recommendations, with the exception of the few that were not really applicable to South African law or conditions, were also followed by South African accountants. Recommendation VIII, which dealt with the "form of balance sheet and profit and loss account", was published in July 1944 and dealt in general terms with what it was considered desirable should be contained in the published accounts of all companies so that a true and fair view of the state of affairs and of the results of operations of the companies could be disclosed.

Much of what was advocated in the first eight Recommendations of the English Institute was eventually incorporated into the Eighth Schedule of the (English) Companies Act of 1948. In this way, that which was hitherto regarded merely as sound advice on what was considered the best practice, acquired the force of law and it became compulsory for all companies to give at least the stipulated minimum of information about certain matters in their annual financial statements.

Chapter 2 dealt with the formation of the Cohen Committee in the United Kingdom in 1943 and with its report which was published in 1945. The use of the phrase "true and fair" has its origin in this report and, presumably in the submissions made to that Committee.

A short time later, in 1947, a commission was appointed in the Union of South Africa, under the chairmanship of Mr Justice Millin, to consider and report on amendments to the Company Law of the Union, and a memorandum was submitted to the Commission in December 1947 by the Joint Council of Societies of Chartered Accountants of South Africa. In paragraph 69 of that memorandum there appears a recommendation that the law should be amended "to require every profit and loss account ... to show ... a true and fair view of the profit or loss for the period it covers", and paragraph 71 uses the same phrase in a complementary recommendation in respect of the balance sheet. The memorandum then sets out details of the Joint Council's recommendations as to the contents of the balance sheet and of the profit and loss account, which follow very closely the recommendations of the Cohen Committee, and these recommendations find themselves in substantially their original form in the report of the Millin Commission, and in turn in

the Companies Act 1926, particularly in the Eighth Schedule to the Act, which became effective on 1 January 1953.

Writing in the South African Accountant of March 1959,<sup>16</sup> Professor W.J. Fairbairn states that it was never the intention that the Eighth Schedule should place restrictions or impose limits on the volume or nature of the information to be disclosed in the annual financial statements of companies. The underlying requirement regarding such disclosure was contained in the Act itself, and not in the Eighth Schedule - that is, the requirement that the financial statements should give a true and fair view... . All other considerations, including the details called for by the Eighth Schedule, were to be regarded as subordinate to that primary requirement of a true and fair view. In other words, the Eighth Schedule was to be considered as a minimum guide only and not as the maximum disclosure necessary in all cases.

A further step in the development of accounting standards took place in 1962 with the appointment by Joint Council of the Accounting and Auditing Standards and Procedures Standing Committee. The purpose of this standing committee was to prepare statements on auditing and accounting for issue, on approval by Joint Council, to members of the four Societies, for their general assistance and guidance. On the whole, these statements were not altogether satisfactory in that they were not generally acceptable and they did not derive from a broadly-based body. A further problem was that the accounting standards were not enforceable.

In February 1971 the National Council of Chartered Accountants (S.A.) (formerly Joint Council of Societies of Chartered Accountants of South Africa) established the Accounting Principles Committee (APC), consisting of sixteen members, who together with numerous task committees were to be responsible for future technical statements. National Council anticipated that "the collection of statements as a whole will represent the body of sound accounting principles on which will be founded the whole system of financial reporting in this country".<sup>17</sup> It was anticipated further that certain of these statements would be made mandatory if this were considered beneficial.

The system provided for these proposed statements, after they had been drafted by the APC, to be circulated to all Chartered Accountants (S.A.) so that a full expression of their comments may be given, and in so doing, to collect expertise from as large a source as possible. National Council was, however, concerned that the statements could become dangerously inbred and, to avoid this, proposed to invite comment from other representative bodies and individuals in the country, such as the Stock Exchange and other such users.

National Council was aware of the complexities that would be involved in this major task.

"In undertaking this important project, National Council is under no illusions as to the difficulties it will face. The search for a definitive set of accounting principles elsewhere in the world has not

met with unequivocal success, and it is clear that there will be sharply divided views on some issues... .

The aim is not to produce rigid uniformity in accounting principle and presentation, but to introduce a unity of thought for preparers and users of accounts alike. In this way the country's financial reporting system can become a very much more effective channel of communication".<sup>18</sup>

During the late 1960's several leading overseas accounting bodies were pressing ahead as quickly as possible with the production of statements on accounting principles. Much of the work of the APC consisted, therefore, of studying these overseas statements and adapting them for South African use.

With a view to making certain of the statements mandatory, National Council approached the Public Accountants' and Auditors' Board to consider ways and means of implementing this. In November 1971 the Executive Committee of National Council decided, at the request of the APC, to recommend that Exposure Draft No. 1 on the Disclosure of Accounting Policies should be given mandatory status as it felt that without this statement being mandatory the effect of the whole series would be weakened.

The Company Law Committee of National Council was instrumental in having the new draft Companies Act include a requirement that annual

financial statements of all companies should be prepared in accordance with generally accepted accounting principles.

In May 1972 National Council announced that the name of the Accounting Principles Committee had been changed to the Accounting Standards Committee (ASC) and, further, that it intended taking steps to have the reference in the new Companies Act to generally accepted accounting principles changed to generally accepted accounting practice. Difficulties were being experienced with the connotations being attached to the word "principles" and in the United States and the United Kingdom the corresponding committees were in future to be known as the Financial Accounting Standards Board in the U S and the Accounting Standards Steering Committee in the U K. National Council also decided to take up the British suggestion by using the term "accounting bases" thenceforth rather than "accounting principles".

In 1972, in proposing the formation of the Accounting Practices Board, National Council took into account that the new Companies Act charged the directors with the responsibility for causing annual financial statements to be made out which were to be in accordance with generally accepted accounting practice, and charged auditors with the responsibility of satisfying themselves that the financial statements had been so prepared. The responsibility was, therefore, shared between the preparers and the auditors, but, in addition, National Council recognised the third group of persons vitally interested in the application of accounting standards, these being the users of financial statements. The proposal was, therefore, to make the Accounting Practices Board as widely representative as possible of all

three classes. The APB was formed with the constituent bodies being National Council, the Public Accountants' and Auditors' Board, the Johannesburg Stock Exchange, ASSOCOM, Die Afrikaanse Handelsinstituut, the FCI, SEIFSA, the Chamber of Mines, the Chartered Institute of Secretaries and the Institute of Cost and Management Accountants.

National Council (now The South African Institute of Chartered Accountants), through its Accounting Practices Committee (formerly the Accounting Standards Committee), is responsible for developing and preparing exposure drafts (or proposed statements). Once those have been critically examined by all interested parties (the Exposure Drafts are widely circulated to all registered Chartered Accountants, all constituent bodies of the APB, all Universities, all listed companies and other interested parties), they are submitted to the APB itself for their consideration and sanction.

The representatives on the APB are present both in their individual as well as in their representative capacities. In this way these representatives commit their respective constituent bodies to support the standards set out in the statements. Bearing in mind the requirement of the Companies Act that financial statements should be drawn up in accordance with generally accepted accounting practice, and bearing in mind the representative capacity of the APB, it is felt that the statements which emerge carry substantial weight. It was considered, at the time, that compliance with the APB statements was strong, perhaps irrefutable, evidence of compliance with the Companies Act, whilst non-compliance was possibly evidence of failure to observe the

requirements of the Act. This matter is considered in more detail in Chapter 5.

In 1982 the APC commenced attaching "Technical Releases" to the Accounting Exposure Drafts issued where it was considered beneficial. Explanations and/or comments which are not considered necessary for inclusion in the Exposure Drafts themselves are included in such Technical Releases. Also from this date the APC attached "Comment Releases" to the Statements of Generally Accepted Accounting Practice issued under the authority of the APB. In these Comment Releases information is included with regard to the comments received on the respective Exposure Drafts and this, too, is considered helpful in improving the quality of the Statements, particularly in assisting with the interpretation of any contentious or problematical issues contained in the Statements.

Although Everingham and Hopkins consider that the development of GAAP in South Africa is at an "embryonic stage"<sup>19</sup> when compared to the United States, it must be recognised that this area of accounting has come a long way in South Africa in the past fifteen years.

CHAPTER 4

Footnotes

1. *The Accountant*, (6 February 1932)
2. George O. May, *Twenty-Five Years of Accounting Responsibility*, Vol. I, (Lawrence, Kansas, 1936), p. 105.
3. F.R.M. de Paula, 'Accounting Principles', *The Accountant*, (27 July 1946).
4. George O. May, *op. cit.*, pp. 76 - 81.
5. See for example the leader articles in *The Accountant*, (9 and 16 January 1932), and letters in those and later issues.
6. *The Accountant*, (12 and 19 December 1931).
7. *The Accountant*, (16 April 1932).
8. *The Accountant*, (9 January 1932).
9. *The Accountant*, (30 April 1932).
10. *The Accountant*, (12 December 1942).
11. *The Accountant*, (20 March 1943).
12. *Accountancy*, (December 1966), p. 883.
13. E. Stamp and C. Marley, *Accounting Principles and the City Code : The Case for Reform*, (London, 1970), p. 69.
14. Sir Joseph Latham, *Take-Over : The facts and the myths of the GEC - AEI battle*, (London, 1969), pp. 54 - 56.
15. E. Stamp and C. Marley, *op. cit.*, pp. 72 - 73.
16. W.J. Fairbairn, 'Recommendations on Accounting Principles', *The South African Accountant*, (March 1959), p.46.
17. The National Council of Chartered Accountants (S.A.), 'Statement of Intent', *The South African Chartered Accountant*, (September 1971), p. 319.
18. *Ibid.*
19. G.K. Everingham and B.D. Hopkins, *Generally Accepted Accounting Practice - A South African Viewpoint*, (2nd ed, Cape Town, 1982), p.3.

CHAPTER 5

The Search for Truth and Fairness, Economic Reality,  
and a New Direction for Accounting

The role of annual financial statements has evolved this century, from being primarily a report on stewardship, to become a source of information to potential investors. At the turn of the century the balance sheet was the prime document showing how the directors had dispensed the funds entrusted to them and providing assurance that dividends were not being paid out of capital. With the spread of share ownership facilitated by the medium of stock exchanges and with the parallel growth of professional management with its greater interest in retaining profits to finance growth rather than distributing profits as dividends, the income statement came into prominence.

The early auditor's report on a balance sheet was concerned primarily with its correctness. The income statement, however, involving assumptions as to realisation of revenues and allocation of costs, required an opinion more on its fairness. The concept of fairness, then, has come to be associated with financial statement presentation. The increasing sophistication of the accounting function has led to much controversy over what constitutes fairness. Controversy ranges over such matters as:

- (a) what matters should be brought to account; e.g. assets such as mineral resources and human resources are not brought to account until realised;

- (b) the acceptability of alternative concepts of realisation and allocation;
- (c) the effect of changing values of money;
- (d) the appropriateness of balance sheet values being dependent on future outcomes.

Experience has shown that it is far from easy to ascertain fairness and the competence of the profession has, on occasions, been seriously questioned. The profession has attempted to minimize its exposure to such accusations by researching these problems and by proclaiming specific accounting standards with the objective basically being to improve the quality and uniformity of reporting and to introduce a definitive approach to the concept of what gives a true and fair view.

The phrase "generally accepted accounting principles" is widely used and refers to both accounting standards prescribed by the profession and to other accounting principles/practices for which there is substantial authoritative support so far as they are not inconsistent with prescribed accounting standards. It is hoped that the financial community will accept the body of G.A.A.P.s as being synonymous, for practical purposes, with "fairness" in the accounting and auditing sense of the word.

The development of the phrase "true and fair" is illustrated by the opinion paragraph of the report issued by Price Waterhouse in 1903 on the financial statements of The United States Steel Corporation which reads, "... and we certify that in our opinion the Balance

Sheet is properly drawn up so as to show the true financial position of the Corporation and its Subsidiary Companies, and that the Relative Income Account is a fair and correct statement of the net earnings for the fiscal year ending on that date".<sup>1</sup> The balance sheet is, therefore, described as being true and the income statement as fair.

Early U.K. Companies Acts variously called for "full and fair views" and "true and correct views" until 1948 when the phrase "true and fair" first entered the statute book.<sup>2</sup> Attempts have been made to identify a literal meaning of the phrase,<sup>3</sup> but the phrase has become little more than a symbol representing whatever assurance users believe they have a right to expect from a set of audited accounts.

The U.S. profession, in discussion with the S.E.C., adopted a standard form report in the 1940s which remains basically unchanged today. This report consists of two paragraphs, scope and opinion. The scope paragraph identifies the statements reported on and describes the scope of the examination, and reads as follows: "We have examined the balance sheets of X Corporation Limited as at December 31, 1980 and 1979, and the related statements of income and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances". The opinion paragraph expresses the auditor's opinion as to the fairness of presentation, conformity with G.A.A.P. and consistency, and reads as follows:

"In our opinion these financial statements present fairly the financial position of the company at December 31, 1980 and 1979, and the results of its operations and the changes in its financial position for the years then ended in conformity with generally accepted accounting principles consistently applied".<sup>4</sup>

This report is interesting in that its wording was devised by the profession and not imposed upon it by legislation, as is the case in the United Kingdom and South Africa, although this does not, of course, mean that the profession has not been instrumental in influencing the legislation, but the final decisions have been legislative and the interpretations judicial. Canadian company law was amended to facilitate use by Canadian auditors of American style audit reports, differing only from the American report in the non-reference to prior year figures.<sup>5</sup>

Prior to 1969 the precise interpretation of the phrase "presents fairly in conformity with generally accepted accounting principles" was rarely examined. The Continental Vending case, however, drew attention to the different interpretations that were possible and resulted in much nervous debate in the profession as to auditors' responsibilities.

In the Continental Vending case,<sup>6</sup> the auditors, Lybrand, Ross Bros. & Montgomery, attested to a set of financial statements that, perhaps on

the surface, satisfied codified generally accepted accounting principles. Certain additional disclosures not specifically required by GAAP were omitted from the financial statements.

The auditors sought to have the charges against them - that they had certified a false or misleading financial statement - dismissed on the grounds that the statements were prepared in accordance with GAAP and, therefore, should be accepted as presenting fairly the financial position of Continental Vending.

This was a criminal case tried before a lay jury. The president of Continental Vending, Harold Roth, had, from 1958 to 1962, borrowed large sums of money from an affiliated company, Valley Commercial Corporation, to finance his personal investment program. This money had originally been lent to Valley by Continental Vending and appeared as a receivable in the latter's books. In previous years, Roth had sold off much of his portfolio prior to year end and this had freed enough funds to repay substantially all of the borrowed money to Valley and allowed Valley, in turn, to reduce its indebtedness to Continental Vending.

In 1961-62, however, the market was very poor and Roth was not able to sell his stock and repay his personal loan to Valley at 30 September. Consequently, Continental had in its books a large receivable from Valley, which was only as good as Roth's ability to repay Valley.

The public accountants were fully aware of Roth's activities and the nature of the receivable from Valley. They insisted that Roth pledge

the securities to guarantee his indebtedness to Valley. When assessing the adequacy of the security, however, they discovered that 80% of the stock pledged was, in fact, shares in Continental Vending. To add to the mess, further funds were lent after the year end by Continental to Valley and from Valley to Roth. The stock market and the security pledge continued to weaken.

With regard to the disclosure of this web of activity in the financial statements of Continental, the auditors accepted the following note as providing reasonable disclosure:

"The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr Harold Roth is an officer, director and shareholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable."

The court considered the following would have been more appropriate:

"The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr Harold Roth is an officer, director and stockholder), which bears interest at 12% a year, was uncollectable at September 30, 1962, since Valley had loaned approximately the same amount to Mr Roth, who was unable to pay. Since that date Mr Roth and others have pledged as security for the repayment of his obligation to Valley and its obligation to Continental (now \$3 900 000 against which Continental's liability to Valley cannot be offset) securities which, as of February 15, 1963 had a market value of \$2 978 000. Approximately 80% of such securities are stock and convertible debentures of the Company."

Counsel for the defendants pressed the court to instruct the jury that the auditors should be found guilty only if:

- (1) the financial statements taken as a whole did not present fairly in accordance with generally accepted accounting principles, and
- (2) if there were any departure from accepted standards, and the departure was made with wilful disregard for those standards, accompanied by an intent to deceive.

The court rejected this plea and charged the jury to keep the following in mind when assessing the adequacy of the disclosure:

"The critical test .... is whether the financial statement as a whole, fairly presented the financial condition of Continental as of September 30, 1962, and whether it accurately reported the operations for fiscal 1962."

The jury was further instructed to consider proof of compliance with generally accepted accounting principles as evidence "which may be persuasive, but not necessarily conclusive", thereby inviting the jury to apply their own private standards of fairness in financial reporting.

The AICPA in submitting an amicus brief to the Court of Appeals, contended that the Judge was wrong in instructing the jury to disregard standards of the accounting profession since the jury had no basis for deciding otherwise. The original conviction was, however, upheld, but was since interpreted by counsel as saying that the auditors must exercise individual judgement in areas in which no specific rules or prohibitions exist, to determine that financial statements are not misleading. It was apparently not asking auditors to judge individual rules or prohibitions that do exist. The court was, in effect, asking auditors to appraise the application of GAAP, including adequate disclosure, but was not asking auditors to appraise presentations based on their own private standards completely apart from GAAP.

Prior to this date, compliance with GAAP had been regarded as evidence of fair presentation. A few commentators had queried this presumption before Continental Vending, but after this landmark case the whole concept of fair reporting and GAAP was overhauled in the United States and Canada.

The first step was to examine the meaning of "presents fairly in accordance with GAAP". Three views were expressed:

- (1) Conformity with GAAP results in fair presentation (the pre-Continental Vending version, or the "one-part" opinion);
- (2) There is both conformity with GAAP and fair presentation (the post-Continental Vending "two-part" opinion);
- (3) There is conformity with GAAP and GAAP have been fairly applied (the current one-part opinion).

After the Continental Vending case there were moves, particularly in Canada, to regard the second interpretation as more responsible. In 1972 the Canadian Institute of Chartered Accountants (CICA) published its new audit reporting standard which called upon auditors to "express an opinion, or report that they are unable to express an opinion, as to whether:

- (a) the financial statements present fairly the financial position of the enterprise, the results of its operations and, where applicable, the sources and application of its funds, and

- (b) the financial statements were prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period."

In order to avoid any misunderstanding, the CICA sent to its members a separate letter clearly outlining its views on the matter. This letter emphasized the need to examine the question of whether GAAP had been complied with separately from the question of whether the financial statements fairly presented the financial position of the enterprise and of the results of its operations.

As Rosenfield and Lorenson point out,<sup>7</sup> since an individual auditor can have a personal opinion that a presentation in conformity with GAAP is not fair and that a presentation in conformity with principles that are not generally accepted is fair, requiring him to state separate opinions on conformity with his private standard of fair presentation would cause him to draw one of four possible conclusions:

- (1) The presentations conform with GAAP and are fair.
- (2) The presentations conform with GAAP and are not fair.
- (3) The presentations do not conform with GAAP and are fair.
- (4) The presentations do not conform with GAAP and are not fair.

This approach adopted by the CICA was criticised severely on the grounds particularly that it would serve to undermine the profession's attempts to formulate generally accepted accounting standards.

There has been much debate in the United States also, summarized by Rosenfield and Lorenson,<sup>8</sup> as to whether it was appropriate for auditors to identify fairness by the application of private standards separate from conformity with GAAP. Finally, in July 1975, the AICPA issued SAS 5, "The meaning of presents fairly in conformity with generally accepted accounting principles", which states that "The independent auditor's judgement concerning the fairness of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework the auditor would have no uniform standard for judging the presentation in financial statements". The Canadians followed, in November 1975, by scrapping the two-part opinion and restoring the old one-part opinion, but with the renewed emphasis on the auditor's responsibility for evaluating whether GAAP have been fairly applied in the circumstances.

Both the Adams and the Cohen Committees, set up by the profession in Canada and the United States respectively in the 1970s to consider the auditor's responsibilities, commented adversely on the use of the phrase "presents fairly". The Cohen Report states that "fairness is an empty box ..... judgement should be exercised within the existing accounting framework, not independently of it" such that the report would simply state that "the financial statements present the financial position .... and the results of its operations ..... in conformity with generally accepted accounting principles appropriate in the circumstances".<sup>9</sup>

As has been pointed out in the United Kingdom and South Africa the form of the auditors report is prescribed by the Companies Acts. In the United Kingdom we have, thus, a requirement to report on truth and fairness and on compliance with certain requirements of the Companies Act. The major differences between the U S and U K audit reports are, therefore:

- (1) the requirement to report on truth as well as fairness, and
- (2) the replacement of compliance with GAAP with compliance with the reporting requirement of the Act. While auditing text books abound with definitions of truth and fairness, none of these do more than scratch the surface. Unlike the United States there has never been a case in the United Kingdom (or South Africa for that matter) where accountants or auditors have been called upon to defend an opinion on the strength of its truth and fairness alone.

In my opinion, if one were to consider the word truth as existing separately from the word fairness, truth should perhaps imply a simulation of (economic) reality over and above the fairness of the use of the accounting conventions or principles. In practice, however, the phrase "true and fair" is accepted as a single concept.

What ensued, therefore, in the United Kingdom was that the only real guidelines to reporting requirements were the disclosure requirements of the Act. Compliance with these disclosure requirements became synonymous with truth and fairness. This was even less satisfactory than the U S assumption at the time that compliance with GAAP was

sufficient to ensure fair presentation. I have already referred to the dissatisfaction of the public with financial reporting in the 1960s. As recently as 1967, however, in a major revision of the accounting requirements of the U K Companies Act, the phrase "true and fair" was seen to be quite appropriate and not inconsistent with the accounting requirements to which the revised Act required companies to conform.

In the face of government intervention in the regulation of accounting standards, the profession in the U K then took to issuing accounting standards and:

- (1) all members were required to exert their influence to encourage compliance, and
- (2) auditors were required to reveal departures in their audit reports.

In making these requirements, the profession announced that the standards introduced a definitive approach to the concept of what gives a true and fair view.

In the United States listed companies are required to comply with the SEC listing requirements, one of which is to ensure that their financial statements are drawn up in accordance with the accounting standards produced by the FASB. No such requirement exists for unlisted companies. In Canada the Companies Act makes it mandatory for all companies to comply with the accounting standards produced by the Canadian Institute of Chartered Accountants - these standards, therefore, have the force of law. In South Africa and the United

Kingdom, however, the accounting standards produced by the professional bodies do not directly have the force of law. The Companies Acts in these two countries do require all companies to prepare financial statements which fairly present the financial position and the results of operations in conformity with generally accepted accounting practice ("true and fair" used in the United Kingdom), but generally accepted accounting practice is not defined. There is, therefore, no direct legal link between "generally accepted accounting practice" and the accounting standards produced by the Accounting Practices Board (APB) of the South African Institute of Chartered Accountants.

In 1976 National Council (now the South African Institute of Chartered Accountants) became concerned about the growing number of public companies which were issuing financial statements which did not always comply with the requirements of the statements of generally accepted accounting practice (GAAP) issued by the APB. Accordingly National Council in a circular dated October 1976 notified all chartered accountants that:

"In view of the widely representative and authoritative composition of the Accounting Practices Board, statements of generally accepted accounting practice issued by the body derive authority, indirect but clearly substantial, from the Companies Act. National Council accordingly feels compelled

to remind chartered accountants that failure to comply with APB statements of generally accepted accounting practice may constitute contraventions under the Companies Act and/or may result in disciplinary action being taken against them by the Public Accountants' and Auditors' Board or their provincial societies. The only, and probably rare circumstances which would justify non-compliance is where compliance would result in unfair presentation."

The APB followed this up in 1978 by seeking Senior Counsel's opinion on the following two questions:

- . Does compliance with statements of GAAP, issued by the APB, constitute compliance with the GAAP requirements of the Companies Act, 1973?
- . Does non-compliance with these statements constitute a contravention of the GAAP requirements of the Companies Act, 1973?

The APB summarized Senior Counsel's opinion as follows:

"3. With reference to the first question posed, Senior Counsel is of the opinion that, having regard to the procedure adopted by the APB in considering and approving GAAP statements and to the composition of the

APB, that to the extent that a company in drawing up its financial statements complies with, and an auditor in carrying out his duties follows a statement of the APB, they can safely assume that they have complied with the provisions of the Companies Act in respect of 'generally accepted accounting practice'.

4. In discussing the second question, Senior Counsel expressed the opinion that 'the question whether any particular practice complies with the statutory requirement remains a matter of fact and of professional opinion to be decided upon the merits of each particular case' and the existence of an APB statement therefore constituted evidence of what generally accepted accounting was, but need 'not necessarily be decisive'. It therefore 'does not necessarily follow that non-compliance with these statements will constitute a contravention' of the requirement of the Companies Act.
5. Counsel reached the conclusion that, while compliance with APB statements removes any fear of non-compliance with the GAAP requirements of the Companies Act, non-compliance 'could' or 'may'

constitute a contravention of the Act in that regard, but would not necessarily do so.

6. Counsel, however, also pointed out that statements issued by the APB were likely to win growing acceptance from the profession and the business community. Consequently a practice which 'today may be regarded as within the limits of the permissible, although it is not in accordance with the statement of the Board, may well within a few years or less be regarded as falling outside those limits'."

National Council, accordingly, laid down the following guidelines:

- "4.1 Where the practice is consistent with an APB statement of GAAP, the preparer and auditor need only satisfy themselves that its use does not conflict with fair presentation.
- 4.2 Where the practice is not yet covered by an APB statement of GAAP, the preparer and auditor should satisfy themselves that its use:
  - 4.2.1 yields fair presentation; and
  - 4.2.2 is generally accepted as appropriate to the class of business carried on and to the types of transactions concerned.

4.3 Where the practice adopted is inconsistent with an APB statement of GAAP, similar criteria to those set out in 4.2 apply. However, the preparer and auditor must recognise the risk inherent in using a practice which is not in accordance with an authoritatively determined standard; and must therefore exercise due care and professional judgement to satisfy themselves that the practice adopted continues to qualify as 'generally accepted'."

Guideline 4.1 appears to hinge on the border of the earlier Canadian "two-part opinion" - fair presentation to be examined separately from GAAP - unless the intention is, in fact, that the accountant or auditor should consider whether the particular GAAP has been fairly applied according to the circumstances of the case. The lack of decisive court cases in this area makes it very difficult to arrive at any definitive conclusions on this question of "fairly presents" (or "truth and fairness" in the UK).

It appears, therefore, that in the United States, Canada, the United Kingdom and South Africa the accounting model on which financial reporting is based is an artificial construct. The phrases "presents fairly" and "true and fair view" have no definitive meaning outside of this artificial construct. Alternative accounting principles provided for in the standards, serve the purpose of defining the limits within which a true and fair view can exist.

Unlike the United States and Canada, however, departures from accounting standards in the United Kingdom and to a lesser extent in South Africa have been all too common and are sometimes regarded as appropriate to reveal a true and fair view. This creates problems: if we are unable to define truth and fairness outside of the accounting model, how can the auditor agree to a treatment that is not regarded as "good accounting" by the APB statements as presenting a truer and fairer view than one that is? It is said that accounting principles or practices not provided for in the accounting standards may be acceptable provided they are generally accepted (i.e. provided there is sufficient authoritative support for them). How is the auditor to determine whether there is sufficient authoritative support for such practices? Does this mean that the auditor should qualify his report on the relevant financial statements initially as not presenting a true and fair view until he is satisfied that sufficient other companies' audit reports are also being qualified in a similar manner before eventually this method of accounting is accepted as being generally accepted? If the auditor does decide subsequently that there is sufficient authoritative support for the particular accounting treatment although the accounting standard does not "allow" this method, is he then required to mention in his audit report that the financial statements do not comply with the accounting standards as laid down by the profession, but that, nevertheless, they do present a true and fair view?

One hopes, of course, that should the particular method of accounting gain such authoritative support, the relevant accounting standard would promptly be amended. This raises the further question of when,

exactly, the method can be said to have gained general acceptance - before the accounting standard is altered or after?

The above, somewhat exaggerated, example has been looked at merely to emphasize that auditors' qualifications on departures from accounting standards with which they concur can only serve to create confusion and to undermine the standard setting process.

It is interesting to note, in this regard, that the suggestion of the Cohen Committee to drop the word "fairly" from the phrase "presents fairly" as was pointed out on page 110 does not really solve the problem if GAAP are defined as including those principles or practices which are not provided for in the accounting standards, but for which there may exist sufficient authoritative support, which appears to be the policy adopted by the United Kingdom and South African professions. If the Cohen Report recommendation in this regard is to eliminate such confusion, the profession's accounting standards must be regarded as the only source of generally accepted accounting principles that are acceptable.

The adoption of such an inflexible policy would, no doubt, be welcomed by some. It would certainly "narrow the areas of difference" and reduce the multiplicity of different accounting treatments that are used in practice. Percy, for example, writes:

"The producer (of financial statements)  
wishes his accounting policies to be  
consistent over time, but the user also

wants as much uniformity as possible...

I feel very strongly that Standards should ideally specify a single accounting treatment, rather than allow alternatives. They should certainly not be restricted to providing broad guidelines of best practice. Once alternatives are allowed, comparability - one of the main reasons from the user's point of view for having standards - is undermined".<sup>10</sup>

To put Percy's comments into perspective it should, perhaps, be pointed out that he is an investment analyst. The disadvantages of this inflexible approach to standard setting, however, far outweigh the advantages.

While Percy argues that the current system of setting standards is too flexible, Tegner regards the current standards as not being flexible enough for preparers of financial statements to achieve their objective, which he sees as presenting accounts which give a fair account of stewardship to the shareholders and a realistic economic picture of the enterprise to them and to any other party with a proper interest in the company. He fears that the current tendency to "legislate and to rule" by way of setting inflexible standards, as inhibiting future progress and innovation. "Is it not astonishing", he says, "that so much time, effort and even perhaps tears have been expended over the last nine years in evolving arithmetic rules for the calculation of a figure - called profit - which is undefined, and

which is associated with a vastly differing number of ideas by different people? This figure, moreover, as presently calculated on the basis of historic costs and blessed with the sanction of an audit opinion, is generally accepted by all those with a reasonable grasp of the realities of economic life to be at best meaningless and at worst - and much more likely - misleading".<sup>11</sup> He criticizes present accounting standards as attempting to "force differing enterprises into accounting strait-jackets" and states that "too much faith is at present being placed in the false assumption that there is a single, right answer in accounting. It may be that this is true in each individual situation, but that right answer certainly cannot be defined in abstract by a body such as the Accounting Standards Committee".<sup>12</sup>

Tegner, himself a former partner in an auditing firm, goes on to accuse the profession of formulating standards

"... as much, if not more, for the protection of the auditor as for the improvement in comparability and comprehensibility of accounts. It is easy for the auditor to say that an accounting standard has not been complied with and thus to shelve the responsibility for making a professional judgement. His power to exercise judgement is to a large extent being replaced by reference to the rule book, and there appear to be many accountants in practice who are as deeply concerned about

this trend as I am. The report in the Financial Times of March 9, 1979 that Deloitte Haskins & Sells, dissatisfied with the Stock Exchange listing requirements, is calling for a government body to enforce accounting standards, must have appalled many accountants who, like me, wish to see their profession survive, develop and flourish. The suggestion that registration should be refused for 'those accounts which do not show a true and fair view *because* they do not comply with Standards' is terrifying in its assumption, coming as it does from a source which wields such influence".<sup>13</sup>

Tegner advocates that standards should be formulated so as to provide guidelines which are flexible, enabling well managed companies to apply the accounting treatment which is most appropriate to their own individual circumstances. "The onus of protecting the shareholders and other users against misrepresentation", he says, "is then placed firmly where it belongs - on the auditor".<sup>14</sup>

Certainly one can sympathise with Tegner's views. The complexity of today's business world emphasizes his viewpoint - one should not attempt to standardise diverse, complex business transactions merely for the sake of uniformity. There is a limit to the extent that one can standardise such diversity without the results becoming unreliable.

On the other hand to rely more heavily on professional judgement and less upon detailed standards raises the difficult question as to how judgement of this kind should be defined; how society can ensure that the best qualities of judgement are applied, and how the users of financial reports can be satisfied that consistent standards of judgement are being exercised across the whole of the financial reporting spectrum.

A related issue is the criticism which is often levelled at the corporate reporting function - that financial statements are prepared in such a way that only people with a great deal knowledge, skill and experience can interpret them. In fact, even trained accountants sometimes have difficulty understanding some features of public companies' financial statements. It is argued that accountants should be more aware of the users of financial statements and their needs and should assist the vast number of lay-users by simplifying financial statements so as to make them understandable to such laymen.

Whilst, again, one can see some merit in this argument - financial statements should certainly not be made unnecessarily complex (and one gets the feeling that they sometimes are) - users should be made to understand that there is also a limit to which one can simplify complexity. Oversimplification can result in the information becoming unreliable, but clarity, on the other hand, should always be regarded as being of the utmost importance.

In this regard financial statements should always emphasize substance over form. It is essential that the underlying economic reality of

the company's position and performance should, so far as it is possible for accounting to do so, be revealed in the financial statements. It should not be "concealed or masked by ingenious artifices whose justification is that they conform to some rule or legal device whose purposes are irrelevant to the portrayal of the true underlying position".<sup>15</sup> This leads to the all important question of what constitutes economic reality.

Accountants have come in for an increasing degree of criticism, particularly in the last decade or so, for preparing financial statements which fail to depict economic reality. Closely related to this problem is use of the historical cost method of accounting. While the historic cost method appears to be sound for the purpose of the stewardship function, it is clear that there are many other purposes which financial statements are expected to serve today. Accounting, therefore, is not an end in itself - it is only a means towards an end. It only has value if it serves the needs of the users of corporate reports. It is a widely held view today that financial statements prepared on the historical cost basis fail to serve adequately the needs of these users, in that such statements do not contain adequate information to enable the users to make reliable economic decisions.

Marvin L. Stone, a partner of an auditing firm in the United States says, for example, "There is ample evidence that the financial statements we presently prepare are not very useful. They are largely ignored by management, by investors, by almost everyone for whom they are prepared".<sup>16</sup> A masters candidate at the University of Denver asked businessmen and investors the extent to which they based their

decisions on financial statements. He was somewhat shocked to learn that practically no-one paid any attention to financial statements, which made him conclude that generally accepted accounting principles seem to produce generally ignored financial statements. "This is not to say that accountants are not trying to improve their product", says Stone facetiously, "certainly we are not standing still nor ignoring modern technology. Not at all. We are striving diligently to invest all of this useless data which no-one wants or uses with increasing degrees of precision. Computers permit the production of useless data much faster; we are constantly improving accounting terminology so that this useless data will be more understandable; and, of course, we are improving our audit techniques tremendously so that we can make this useless data more credible".<sup>17</sup>

Frank S. Capon, former president of the Canadian Institute of Chartered Accountants, criticizes accountants for living in the past and thereby failing to adapt to the changing demands of society.

"Accounting has meaning only in terms of the economic and social structures it serves. The stewardship reporting function remains essential because honesty and performance need to be watched and because statements of past transactions are required for tax and legal purposes. But such information is of little real significance to those who must formulate objectives and plan the strategies and policies for attaining these

objectives. Forward planning managers, who are in fact making the essential decisions today for business, for government, and for all the institutions of society, have long since ceased to spend much time with traditional financial statements and reports that come from the accounting process."

"We financial executives are, of course, orientated to the future as well as to the past. But our balance is wrong. We pay far too much reverence to past performance. Our standards and principles are locked into value systems which are rapidly becoming meaningless to the future development of society. And most innovative or imaginative thinking or writing on what ought, in my opinion, to be the role of accounting and finance is coming from leaders who do not for a moment think of themselves as accountants. The future has already replaced the past as the basis for planning objectives and the strategies and policies needed to attain them, but I do not yet see accountants out there on the frontiers of change."<sup>18</sup>

Capon further points out that accountants are too often wedded to their own traditional concepts on the grounds that they are generally accepted. He accuses accountants of being afraid of change and innovation because they are not sufficiently familiar with proposed new systems. He argues, however, that this insistence on adherence to tradition at all costs is not a viable option for accounting unless accountants are willing to accept that their role is to be limited to the bookkeeping function of recording past transactions. To call on others, such as financial analysts, to supplement financial statements with other information in their evaluation of results, is to concede, he says, that we are only interested in a minor role and that some discipline other than accounting must take over the task of total information systems.<sup>19</sup>

In criticizing the historical cost system, Littleton, however, reminds us that "we should be careful to give our nineteenth century predecessors the credit due to them, and not to take them to task because their practices do not meet our needs today. We would do better to try to improve our understanding of our present needs, so that we can devise means of meeting them and will no longer have to make do with inherited practices, some of which have outlived their usefulness".<sup>20</sup>

If corporate reporting and accounting in general is to be improved so as to maximize the usefulness of such information to the users of financial statements (and it seems that the profession is indeed hard at work attempting to do just this, particularly in the United States), then there exists a number of fundamental questions which will have to

be examined in detail. Foremost among these are questions such as:

- (1) Who are the users of financial statements and what are their needs?
- (2) What is economic reality?
- (3) Can all the users' needs be satisfied by a single set of "general purpose" financial statements?
- (4) How should a new order be developed for accounting so as to meet the needs of society?

#### THE USERS AND THEIR NEEDS

Accounting standards and corporate reporting in general cannot be developed and improved until there is agreement between the preparers of financial statements and the standard setters as to which of the various user groups a company (particularly a public company) is accountable and in what manner such company is accountable to each group. Accountability, in this context, does not refer only to the purely legal sense of the word. It is rather a question in which the whole community has an interest and this wide interpretation of accountability should, therefore, be borne in mind by the standard setters.

In considering the information which should be included in financial statements, it is not sufficient merely to identify such user groups. It is also necessary to examine the kinds of decisions that the members of each of these groups are likely to make based on the information contained in the financial statements. This may appear obvious on the face of it, but it should, nevertheless, be emphasized

as it establishes the primary if not the sole objective of accounting standards and corporate reporting - namely to ensure that the legitimate needs of users are properly met. This also appears to be the area in which current methods of corporate reporting have been seriously lacking.

The question arises as to which groups have a *legitimate* interest in the financial affairs of a company. Where user groups have a statutory or contractual relationship with the company, there is, of course, no doubt concerning their legitimacy. In this regard user groups such as shareholders (present and prospective), debenture-holders (present and prospective), creditors (present and prospective), regulatory agencies such as stock exchanges and other government departments such as the taxation authorities and the department of statistics. Other user groups generally acquire their right to companies' financial information by virtue of the pressure which they are able to exert on the company. Such groups may include employees, trade unions, suppliers, industry groups and customers.

A major problem concerning this question as to which user groups have a legitimate interest in the financial affairs of a company and what types of information should be released to them is the matter of a company's right to privacy. Some people believe that privacy should be the normal condition of mankind while others believe that everything should be made public unless there exists a "compelling reason" to maintain privacy. Clearly, there is no "correct" answer to this problem and there has to be some kind of trade off between management's legitimate concerns in this area and the right of those whose lives

are affected by a company.

The Canadian research study into a conceptual framework, in this regard, states:

"Since the law, through parliament and the courts, exists in order to balance the mutual rights, duties and obligations of all of the various elements that make up society, it seems incumbent upon the accounting profession to take a lead in broadening the notion of public accountability. An evolutionary development of this kind is likely to be beneficial to society as a whole, and what is good for society is bound to be good for the profession."<sup>21</sup>

The research study lists fifteen user groups and comments on their needs as follows: <sup>22</sup>

- (1) Shareholders (present and potential)
- (2) Creditors - long-term (present and potential)
- (3) Creditors - short-term ( " " " )
- (4) Analysts and Advisors serving the above (present)
- (5) Employees (present, past and potential)
- (6) Non-executive Directors (present and potential)
- (7) Customers (present, past and potential)
- (8) Suppliers (present and potential)
- (9) Industry groups (present)
- (10) Labour Unions (present)

- (11) Government departments (present)
- (12) The Public - Political parties (present)
  - Public Affairs Groups
  - Consumer Groups
  - Environmental Groups
- (13) Regulatory Agencies (present) (e.g. Stock Exchange)
- (14) Other companies (Domestic and Foreign) (present)
- (15) Standard Setters, Academic Researchers (present)

USERS' NEEDS

<u>Needs</u>	<u>Classes of Users having these needs</u>
(1) Assessment of overall performance	
(a) In absolute terms	(1) to (15)
(b) Compared to goals	(1) to (15)
(c) Compared to other entities	(1) to (15)
(2) Assessment of management quality	
(a) Profit, overall performance, efficiency	(1) to (11) especially
(b) Stewardship	(1)(4)(6)(11)(12)(13)
(3) Estimating future prospects for	
(a) Profits	(1) to (11) especially
(b) Dividends and interest	(1) to (4) especially
(c) Investment of capital needs	(1) to (6), (8) to (14)
(d) Employment	(5)(10)(11)(12) especially
(e) Suppliers	(3)(5)(11)(12)(14) especially
(f) Customers (warranties, etc)	(7)(9)(11)(12) especially
(g) Past employees	(5)(10)(11)(12)(13)

<u>Needs</u>	<u>Classes of Users having these needs</u>
(4) Assessing financial strength and stability	(1) to (15)
(5) Assessing solvency	(1) to (15)
(6) Assessing liquidity	(1) to (15)
(7) Assessing risk and uncertainty	(1) to (15)
(8) As an aid to resource allocation by	
(a) Shareholders (present and potential)	(1)(4)(11)(12)(13)(14)
(b) Creditors (present and potential; long- and short-term)	(2)(3)(4)(8)(11)(12)(13)(14)
(c) Governments	(11)(12) especially
(d) Other private sector bodies	(4)(9)(12)(13)(14)
(9) In making comparisons	
(a) With past performance	(1) to (15)
(b) With other entities	(1) to (15)
(c) With industry and economy as a whole	(1) to (15)
(10) In valuation of debt and equity holdings in the company	(1) to (4) especially
(11) In assessing adaptive ability	(1) to (15)
(12) Determining compliance with law or regulations	(11) to (13) especially
(13) Assessing entity's contribution to society, national goals, etc.	(11)(12) especially

With so many different user groups having an interest in the financial information of a company, it is clear that this may well lead to a position where the interests of some of these users are in conflict with the interests of others. There is often, for example, a potential conflict between what management is willing to disclose, and the way it discloses it, and what outside users need to know. Other conflicts which may exist are, for example, the interests of present and potential shareholders as well as between shareholder and creditor groups in the case of a company that is running into financial difficulties. It is in these areas, in particular, that auditors and accounting standards play an important role. Clearly, it is essential that accounting standards, therefore, command the greatest possible credibility among all of these different groups.

The United States F.A.S.B. conceptual framework project in its "Tentative Conclusions on Objectives of Financial Statements of Business Enterprises", published in December 1976, identifies among potential users of financial statement information: owners, lenders, suppliers, potential investors and creditors, employees, management (including directors), financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, taxing authorities, regulatory authorities, financial press and reporting agencies, labour unions, trade associations and customers. The study identifies investors and creditors as the primary users of financial statements and suggests that the objectives of financial statements should be focussed on the financial information needs of these user groups.<sup>23</sup> The terms investors and creditors are, however, clearly meant to include security analysts and advisors, brokers, lawyers, regulatory agencies

and others who advise, represent or protect the interests of investors and creditors.

The AICPA published the "Report of the Study Group on the Objectives of Financial Statements" (The Trueblood Report) in 1973 and this led in 1974 to the preparation of a Discussion Memorandum and public hearing on the subject of objectives. The FASB considered the report, the written responses to the Discussion Memorandum, and the testimony at the public hearing and reached the following tentative conclusions about the objectives of financial statements of business enterprises:

- . Financial statements of business enterprises should provide information, within the limits of financial accounting, that is useful to present and potential investors and creditors in making rational investment and credit decisions. Financial statements should be comprehensible to investors and creditors who have a reasonable understanding of business and economic activities and financial accounting and who are willing to spend the time and effort needed to study financial statements.
- . Financial statements of business enterprises should provide information that helps investors and creditors assess the prospects of receiving cash from dividends or interest and from the proceeds from the sale, redemption, or maturity of securities or loans. Those prospects are affected (1) by an enterprise's ability to obtain

enough cash through its earning and financial activities to meet its obligations when due and its other cash operating needs, to reinvest in earning resources and activities, and to pay cash dividends and interest and (2) by perceptions of investors and creditors generally about that ability, which affect market prices of the enterprise's securities relative to those of other enterprises. Thus, financial accounting and financial statements should provide information that helps investors and creditors assess the enterprise's prospects of obtaining net cash inflows through its earning and financing activities.

Financial statements of a business enterprise should provide information about the economic resources of an enterprise, which are sources of prospective cash inflows to the enterprise; its obligations to transfer economic resources to others, which are causes of prospective cash outflows from the enterprise; and its earnings, which are the financial results of its operations and other events and conditions that affect the enterprise. Since that information is useful to investors and creditors in assessing an enterprise's ability to pay cash dividends and interest and to settle obligations

when they mature, it should be the focus  
of financial accounting and financial  
statements.<sup>24</sup>

The first objective, therefore, emphasizes usefulness and understandability and recognises that there are limits to financial accounting. The second objective emphasizes that investors and creditors are interested in the future cash-generating ability of business enterprises and the third objective emphasizes that the focus of financial accounting is information about economic resources, obligations to transfer economic resources, and earnings. Such information should, therefore, form the contents of financial statements.

The efforts of the Study Group and the FASB have resulted in making the objectives of financial statements more specific or concrete. They indicate that financial statement users are really interested in the future cash-generating ability of the enterprise. But our current financial reports simply do not reflect future cash-generating ability. While it is recognised that short-term periodic cash flows are not a good indicator of profitability or earning capacity, it is contended that the long-term cash flows approximate the long-term earnings of a business entity and financial statements should, therefore, include information which enables investors and creditors to assess the future cash generating ability of the entity.

### ECONOMIC REALITY

The historical cost method of accounting has long been criticized for its inability to measure and interpret economic reality and, thereby, not satisfying the needs of users of financial statements. It is as well to point out two matters at the outset:

- (1) Users of financial statements should not be misled into believing that financial statements prepared with the aim of depicting economic reality (for example by using one of the current value based methods of accounting) are able to make decisions for the user. The user must be educated to make his own decisions or, alternatively, seek expert advice in this regard.
- (2) It should be recognised that even a fully-fledged current value balance sheet will never be able to measure the current worth of an enterprise. To suggest otherwise is to argue that it is possible to produce a balance sheet on which the figure for shareholders' funds represents the price which any willing buyer or seller would be prepared to pay or accept in return for the issued shares of the company. Apart from the fact that goodwill, often a major asset of a company, is not uniquely determinable and usually not included on the balance sheet of a company, the price of a share in a company can vary significantly according to the whims of a willing buyer or seller and it is, therefore, not possible to prepare a balance sheet disclosing a unique value of the business. The problems of measuring and accounting for goodwill are extremely complex and it is not surprising that none of the current value accounting methods contain any prescriptions for the measurement of the current

value of goodwill or for its inclusion in the balance sheet.

Having made these points, one cannot, however, argue that it is desirable that users should be provided with as much information as possible in order to assist them to make their decisions.

This section examines some of the problems facing accountants in attempting to measure or depict "economic reality" in the financial statements.

The major problem is, of course, trying to define economic reality. There can be no doubt that there is such a thing as economic reality. We see it all around us in the form of land, buildings, plant and equipment, motor vehicles, stocks of all kinds and so on. We recognise it even in its less tangible form such as amounts owing to or by ourselves, share investments and even business goodwill. The difficulty is, however, not in recognising it, but in attempting to assign numerical values in measuring or valuing it, in order to denote wealth and income.

In non-market economies, where the normal method of transacting is by barter, the problem of assigning cash values to assets and liabilities does not arise. In industrialised countries, however, the only ultimate financial economic reality is cash and the only unambiguous and objective economic measurement is the cash paid out in a past transaction. Even cash, however, loses its "value" during a period of inflation and the measures of the value of all other assets depend upon whether we are interested in how much the asset cost when it was bought originally, how much it would cost today, or how much it could

be sold for today. Furthermore, it must be recognised that all values reside ultimately in the future since it is our estimate of the future benefits we shall derive from an asset (ultimately, in economic terms, in the form of cash) that determines its present value.

Although accountants are concerned both with measuring the results of transactions which have happened in the past and with attempting to portray the financial position as it exists in the present, they are unable to eliminate the existence of the future in making their measurements.

It is, therefore, not possible to measure economic reality in unambiguous terms. In attempting to make the corporate reporting process as unambiguous and as objective as possible, the profession has clung to the historical cost method of accounting. This is not to say that the historical cost method, as currently used, achieves an unambiguous definition of wealth and income - even if one ignores the alternative methods of dealing with certain items permitted by the present system, there will always be a need to exercise one's own judgement in the preparation of such statements. Examples of this are attempts to estimate the realisable value of debtors, examining the possibility of stocks becoming obsolete or of estimating the useful lives of certain assets.

The defenders of the historical cost method, however, argue that the adoption of a current value-based method, while attempting to depict a more meaningful definition of economic reality, will make the measurement process so subjective as to result inevitably in financial statements which lack uniformity and comparability, which, it is

contended, are most important from the users' viewpoint. This leads, perhaps, to the question of which qualities (relevance, objectivity, comparability, etc) financial statements should possess in order to be most useful to the users and how they should be ranked in order of importance. This is, however, dealt with in Chapter 7 in discussing attempts to formulate a conceptual framework for accounting. Also, it is not intended to deal with alternative methods of accounting in this section - these methods are discussed in Chapter 6.

Further problem areas that will need to be examined in detail in order to arrive at a "generally accepted" view of economic reality are:

- . How is "income" to be defined?
- . The choice between proprietorship and the entity concepts.
- . How is the capital maintenance concept to be interpreted?
- . Which valuation basis should be adopted?

#### CONCEPTUAL VIEWS OF INCOME

Part One of the FASB's "Discussion Memorandum on the Conceptual Framework" referred to earlier, addresses the question "which, if any, of those elements (assets, liabilities, revenues, expenses, etc.) are the most fundamental, and, therefore, control the definitions of the other elements?" Are assets and liabilities more fundamental than revenues and expenses, or vice versa? The answer to this question depends on one's conceptual view of earnings. The two major conceptual views of earnings are the asset-liability view and the revenue-expense view.

Under the asset-liability view, income is measured by the change in an enterprise's net economic resources for a specified period of time.

Under this view, assets and liabilities are the most fundamental elements of financial statements. Definitions of revenues and expenses are expressed in terms of changes in assets and liabilities.

Under the revenue-expense view, income is regarded as a direct measure of the effectiveness of an enterprise in using its inputs to obtain and sell outputs and are not necessarily limited to changes in net economic resources. This view considers revenues and expenses to be the most fundamental elements of financial statements. It focuses on the realisation and matching concepts. The revenue-expense view often results in showing deferred charges and deferred credits on the balance sheet, while these items are not included on the balance sheet under a strict interpretation of the asset-liability view.

Definitions of assets, liabilities, revenues and expenses depend upon the conceptual view of income that is adopted. If the asset-liability view is adopted, assets will be defined in terms of resources. Disagreements will centre on whether or not legal concepts should affect the definition of assets, whether or not a resource has to be exchangeable to be considered an asset, and whether or not assets can arise from wholly executory contracts. If the revenue-expense view is adopted, then the definition of an asset will depend upon income measurement. Assets will include the economic resources included as assets under the asset-liability view, but will also include deferred charges and other costs that are waiting to be matched with future revenues.

Under the asset-liability view, liabilities will be defined as obligations to transfer economic resources to other entities in the future. Under the revenue-expense view, such obligations will continue to be included in liabilities, but so also will deferred credits which result from a "proper" matching of costs with revenues.

Clearly, this is an area where basic differences of opinion can exist side by side, but it seems desirable that one of the two (or indeed a combination of the two) should be adopted. The decision as to precisely which method is finally agreed on should not be made, however, without considering all viewpoints and it is interesting to note the FASB's approach of preparing discussion memoranda, holding public hearings and generally inviting participation and discussion amongst all interested parties to assist the board in this regard.

It is difficult to say that the asset-liability view is more important than the revenue-expense view. It is not possible, however, to measure changes in wealth without first measuring the wealth itself. The asset-liability view focuses on valuation and would likely involve measurements of assets and liabilities at current values. The revenue-expense view focuses on matching and could involve measuring assets and liabilities at modified historical costs (as is the practice in many instances today) or at current values.

If Arthur R. Wyatt, Chairman of the AICPA Accounting Standards Executive Committee and a partner in Arthur Anderson & Co., has his way, however, the FASB will opt for the asset-liability view.

"As cost came to be perceived as an objective of accounting rather than as a method of providing value information, the notion also developed that balance sheets were not very useful and that asset valuations were not practicable. This viewpoint also emphasized the importance of the statement of income and took the position that such a statement is unsatisfactory unless it is so framed as to constitute the best reflection reasonably obtainable of the earning capacity of the business. In effect, this approach seemed to assume that earnings could be measured in a vacuum - that increases in wealth could be measured without measuring the wealth itself. This approach, which is reflected in the so-called matching concept, is the primary cause of many of the accounting deficiencies that have plagued our profession."<sup>25</sup>

Wyatt also states that undue emphasis has been placed on the matching concept and that this has led to an unrealistic picture of income stability for many companies.

"What we have created in accounting is an artificial levelling of the peaks and valleys of actual earnings and thereby have smoothed the trend in reported

earnings. Stable growth in earnings is highly valued in the market place. However, if this stability is artificial, the result may be exaggerated market values for a company's stock. The truth probably is that changes in economic resources come unevenly. If the ups and downs in earnings were reported as they occurred, rather than being smoothed by various amortization techniques, the risks in business might be evaluated more realistically by the investor. The investor has the right to know about the fluctuations: the trend line is for him, not the accountant, to draw as a part of his analytical process in making investment decisions."<sup>26</sup>

In opting for the asset-liability view of earnings, he points out that accounting should be grounded in realities, and that the realities of a business enterprise are its assets and liabilities. He looks upon revenues and expenses merely as conventional ways of describing or explaining the consequences of changes in assets and liabilities. In effect, they are part of the analysis of the changes in owner's equity.<sup>27</sup>

Most people are not exclusively in one camp or the other. For example, many revenue-expense people - who emphasize that proper matching is their main concern - do not agree with a provision for self-assurance,

which is an obvious case of smoothing or averaging income. Many revenue-expense adherents assert that there is a big difference between matching and smoothing; they do not believe that charges should be deferred unless it can be shown that a future benefit will be obtained to match the later charge. Nor do they believe in arbitrary provisions to cover future costs that have no bearing on the present period. Likewise, many asset-liability people steadfastly believe in the need for deferred taxes to achieve proper income matching.

The most specific of the tentative objectives states that information about economic resources and obligations should be provided. This may point to a favouring of the asset-liability view, but until the final conclusions are arrived at one can only speculate as to which approach will be adopted.

#### PROPRIETORSHIP OR ENTITY CONCEPTS

Also relevant to the determination of income is the question of the choice between these two concepts. The proprietorship concept examines the financial affairs of the company through the eyes of its owners, the shareholders. The entity concept, on the other hand, views the company as an entity apart from its shareholders, the shareholders being regarded in the same way as any other stakeholders who have claims against the company. As the adoption of one of these concepts in preference to the other can have a significant effect on the measurement of income, it is important that any conceptual framework project examines this matter in detail.

### CAPITAL MAINTENANCE

This is another issue which can result in different definitions of income and is of particular importance if a move from the traditional historical cost method to a current value method of accounting is contemplated. The Sandilands Report in this regard quotes a passage from Sir John Hick's *Value and Capital*: "... it would seem that we ought to define a man's income as the maximum value which he can consume during a week and still expect to be as well off at the end of the week as he was at the beginning". This is translated into an analogous definition for a company - maintaining well-offness is treated as "equivalent to maintaining capital intact".<sup>28</sup>

A decision has to be made whether income is to be regarded as having been earned after the preservation of financial capital or of physical capital. While this decision cannot affect the shareholders' funds figure that is reported, it can have an effect on the individual figures reported for capital and retained income.

The maintenance of financial capital is linked with the proprietorship concept and is, generally speaking, preferred by accountants in the United States and Canada. The maintenance of physical capital, on the other hand, is linked to the entity concept and expresses, in financial terms, the results of assuming that profit can only be measured after the capacity of the enterprise to continue at its current level of operations has been maintained. This method is favoured by accountants in the Netherlands.

The principal differences between the two concepts involve certain changes in prices or assets during accounting periods, the so-called "holding gains and losses". In the financial capital concept, they are included in income (usually not until realised) because every difference between financial (historical) cost and the amount realised is considered income. In the physical capital concept they are called "capital maintenance adjustments" and are usually included in owners' equity in the form of a non-distributable reserve.

The present framework (US approach) mentioned above, deals only with financial capital, although the LIFO inventory cost of sales techniques exclude the inflated cost of replacement from income. To that extent, although the balance sheet does not reflect the new value of physical capital, the income statement gives recognition to the physical capital recovery concept. Replacement cost depreciation concepts are another example of an attempt to replace financial capital with physical capital.

#### VALUATION BASIS

As has already been mentioned, one cannot arrive at an income figure or measure changes in wealth without first measuring the wealth itself. It is obvious, therefore, that income is directly dependent on the particular valuation basis that is chosen for purposes of determining wealth.

There are a variety of possible alternative valuation bases that have been suggested by various schools of thought during the past two or

three decades. Each of these different bases may be appropriate depending on the circumstances prevailing and, more particularly, depending on the needs of the users of the financial statements.

It is worth noting that the historical cost method has been defended vigorously on the grounds that it is the most objective method, relying for its measurements on the amounts of cash actually paid out in a past acquisition of the assets. Other bases entail making estimates of what might occur in the future if the asset were to be replaced or disposed of. In this respect it is argued that such estimates would make the task of verifying such valuations impossible and that this will substantially reduce the reliability of the reported results.

It is clear, therefore, that there is a need in the development of a conceptual framework to determine which qualities are more important than others from the viewpoints of the users. Accountants obviously regard objectivity as one of the most important qualities of corporate reporting. This is, of course, a highly desirable quality; the question which the users will also have to examine is whether objectivity should be achieved at the expense of realism and usefulness.

Accountants have often been accused of clinging to the historical cost method of accounting so as to make their auditing task of verification as easy as possible. This is, perhaps, understandable from the auditor's viewpoint, bearing in mind the risks and legal responsibility with which they have to contend when performing audits of business enterprises.

However, it must be borne in mind that accounting is not an end in itself. Rather, it should provide the means whereby users' needs can be met. If accountants are not to lose much of the credibility which they have built up over many decades, there is a case for paying more serious attention to the needs of the users of their product.

The question of which qualities financial statements should possess and their relative importance is dealt with in Chapter 7 in considering the profession's attempts at developing a conceptual framework for accounting, whereas some of the different valuation bases which have been proposed for accounting are examined in Chapter 6.

#### A SINGLE SET OF "GENERAL PURPOSE" FINANCIAL STATEMENTS?

It has been pointed out above that different methods of accounting (particularly different valuation bases) may be appropriate for different users of financial statements. It is extremely unlikely that a single method will serve the needs of all users at all times. As a consequence it has been argued that during this period of "experimentation" with different methods of accounting, consideration should be given to the production by companies of multi-column financial statements, each column depicting the financial position and the results of the operations for the period based on a different accounting method. Clearly, in such a case full disclosure of all the different methods or valuation bases used should be spelt out so as to allow the users to choose whichever system suits them best and to formulate their decisions based on the maximum financial information that is available.

While this approach would certainly be welcomed by some of the more serious investors, others would consider it as providing too much information and resulting, therefore, in unnecessary complexities and uncertainties while the costs to the company of providing all this information and having it audited should also not be overlooked.

A NEW ORDER FOR ACCOUNTING?

This question is examined in Chapter 7, with particular reference to developments in the United States, Canada and the United Kingdom.

CHAPTER 5

Footnotes

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CHAPTER 6

Alternative methods of accounting

The origin of historical cost accounting, as was pointed out in previous chapters, goes back to the days when the stewardship function was considered to be of primary importance. It has also been seen how the development of business enterprises led to the stewardship function being relegated down the list of priorities, and how society has come to regard other functions to be at least of equal, if not greater, importance than the stewardship function.

The profession has over the years made modifications and adaptations to the historical cost method in an attempt to make financial statements more useful generally and to present a fairer picture of economic reality. Fixed assets, for example, were increasingly being revalued rather than their being disclosed at cost.

The Sandilands Committee, set up by the British Government in 1974 to consider whether, and if so how, company accounts should allow for changes in costs and prices, and to make recommendations, came to the conclusion that

"Taken as a whole these modifications and adaptations have made present day accounting conventions more complex and less standardised than many would consider desirable. They have strained historic cost accounting principles to breaking point, reduced its objectivity and have still failed to produce a satisfactory answer. It is clear that more comprehensive proposals for dealing with the problem need to be considered."<sup>1</sup>

Various attempts have been made in recent years to formulate alternative methods of accounting in order to overcome the criticism levelled at the historical cost method. While these methods have contributed substantially to research being done on the corporate reporting function and the problems facing accounting, they generally all suffer the same defect, namely that they do not appear to serve the needs of all users of financial statements. Furthermore, without a properly formulated conceptual framework for accounting generally accepted by the profession as well as users in general, it appears that the selection of one method as superior to any of the others will always generate much criticism. The profession is hard at work attempting to formulate such a conceptual framework (see Chapter 7) and until this has been done, it is unlikely that any of the alternative methods will gain general acceptance.

Some of the alternative methods which have gained some degree of recognition in recent years have been the following:

1. Current Purchasing Power (CPP) or General Purchasing Power (GPP) Accounting.
2. Cash Flow Accounting.
3. Replacement Cost Accounting.
4. Present (or Current) Value Accounting.
5. Continuously Contemporary Accounting.
6. Current Cost Accounting.

The major features of each of these methods is examined below in some detail.

CURRENT PURCHASING POWER ACCOUNTING

The objective of the purchasing power method of accounting for inflation is to show the affairs of a company in terms of a unit of measurement of constant value when costs and prices are rising. The method involves expressing the net assets in terms of "purchasing power units" rather than money. This method is, therefore, not a genuine value-based method in that it does not attempt to measure the value of the net assets at the balance sheet dates.

The method is based on the assumption that the most significant problem arising for the preparation of financial statements during a period of high inflation is that the conventional unit of measurement - money - becomes unstable and itself changes in value too quickly to be useful as a unit of measurement for financial statements. The central feature is the adoption of a different unit of measurement - the "purchasing power unit" - in place of the monetary unit. This enables financial statements during a time of changing prices to be expressed in a unit of measurement which has a constant value, and the balance sheet would, therefore, show the amount of 'purchasing power' represented by the company's net assets rather than the amount of money. The profit for the period under review would, consequently, be the amount of "purchasing power" gained or lost since the beginning of the period.

In the United States it was recommended that the Gross National Product Implicit Price Deflator (GNP Deflator) be used as a means of measuring the change in the prices of goods and services in general, and hence of the change in the 'general purchasing power' of the US dollar. In the

UK and Ireland, however, it was suggested that changes in the "purchasing power" of money should be measured in relation to items purchased by individuals (or consumers) for their own personal use, not to all items of goods and services. It was proposed that the movement of the RPI should be used, because although it was not a "perfect" indicator of the changes in the purchasing power of money held by "consumers in general", it was regarded as "the best available indicator of changes in the general purchasing power of money to consumers".<sup>2</sup>

Briefly, this method of accounting works as follows:

1. All items included in the balance sheet (with the exception of the equity interest) are classified as either "monetary" or "non-monetary" items. "Monetary" items are defined as items "whose amounts are fixed by contract or otherwise in terms of numbers of pounds, regardless of changes in general price levels".<sup>3</sup> All other items (excluding equity) are then regarded as "non-monetary" items. Examples of monetary items are cash, debtors, creditors and loans. Examples of non-monetary items are stocks, plant and buildings.<sup>4</sup>
  
2. Items in the opening balance sheet of the basic financial statements are converted into current purchasing power units relating to the beginning of the year by:
  - (a) Adjusting all amounts representing non-monetary items by the change in the RPI between the time of acquisition or most recent valuation and the beginning of the year; and

- (b) making no adjustment to the amounts representing monetary items because these are already in terms of both monetary units (pounds) and current purchasing power units relating to the beginning of the year;

provided that in the case of non-monetary items where the value to the business of fixed assets (expressed in terms of pounds) or the net realisable value of current assets (expressed in terms of pounds) is less than the adjusted figures after conversion, these items should be written down accordingly in the supplementary statement.<sup>5</sup>

Step 2 will only be necessary during the first year of introduction of the CPP method. In the second and subsequent years, the closing CPP balance sheet of the previous year will be taken as the opening CPP balance of the year under review without further adjustment.

3. All items (both monetary and non-monetary) in the converted balance sheet for the year are adjusted by the change in the RPI between the beginning and end of the year in order to express the items in the opening balance sheet in terms of current purchasing power units relating to the balance sheet date at the end of the year. This process is known as "updating".
4. Items in the closing balance sheet of the basic financial statements are converted into current purchasing power units relating to the end of the year by:
  - (a) adjusting all amounts representing non-monetary items by the change in the RPI between the time of acquisition or most recent revaluation and the end of the year; and

(b) making no adjustment to the amounts representing monetary items because these are already in terms of both monetary units and current purchasing power units relating to the end of the year; subject to the same proviso in respect of non-monetary items as was applied in 2. above.

This process enables the opening and closing converted balance sheets to be compared in terms of the same units of current purchasing power (i.e. current purchasing power units relating to the end of the year under review). The difference between the total equity interest in the converted balance sheets for the beginning and end of the year, after updating the opening balance sheets (and after allowing for dividends and the introduction of new capital) is regarded as profit or loss for the year, measured in terms of current purchasing power units relating to the end of the year. Looking at it from the viewpoint of capital maintenance, therefore, the CPP supplementary statement shows the amounts which may be regarded as profit after maintaining the "purchasing power" of the shareholders' interest, measured in terms of the movement of the RPI.

Because the updating process described in 3 above is applied to all items (including monetary items) in the opening balance sheet, the profit in terms of current purchasing power units relating to the end of the year will include an element due to the change in the "purchasing power" of monetary items. If the RPI has increased during the year, the updating process will reveal a gain of "purchasing power" to the shareholders due to the decrease in the "purchasing power" of the company's monetary liabilities, and a loss due to the decrease in

"purchasing power" of monetary assets. This net gain (or loss) of "purchasing power" on monetary items is included in the profit for the year expressed in terms of units of current purchasing power relating to the end of the year.

Disadvantages of the CPP method

- (a) The major disadvantages of this method appears to be a lack of understanding as to the precise nature of the information being conveyed by CPP adjusted financial statements and a serious doubt as to whether the information, in fact, serves a useful purpose to the shareholders and other users of financial statements. The fact that CPP adjusted financial statements make use of a different unit of measurement is not clearly understood even by experienced accountants. Evidence of this is the comparison by certain companies of the profit disclosed by the basic financial statements and the CPP adjusted ones, with the suggestion that the one is "higher" or "lower" than the other, and the drawing of some conclusion from this difference. The profit in the CPP adjusted statement is, in fact, the same as the profit in the basic statement, merely expressed in a different unit of measurement.

As far as the usefulness is concerned, the CPP adjusted balance sheet basically allows the shareholder to determine whether the purchasing power of the (book value)<sup>6</sup> of his investment has kept pace with the change in the RPI.

It is doubtful whether this information will serve much purpose to a shareholder. As the Sandilands Report puts it,

"... while a consumer may use the RPI as a measure of the 'worth' of money which he now possesses, compared with the same amount of money possessed at some time in the past, we doubt whether he would use this index to measure the worth of money he has already spent. For example, a consumer who spent £100 on a washing machine at the beginning of 1975 is unlikely at the end of 1975 to make the calculation that the £100 spent 12 months previously could have bought other goods and services which would now cost £120 (assuming that the RPI increased by 20 per cent during the year). Yet this is what SSAP7 implies he should do since it regards a non-monetary asset as a storehouse of 'purchasing power' for the money invested in it." <sup>7</sup>

Even if the consumer makes the calculation suggested above, it is difficult to see how the information he obtains will be of use. Consumers are aware that money already spent is not available for alternative purposes and would be unlikely in their own accounts to make such calculations. Furthermore, when applied to the purchases and investments made by a company the use of a price index related to the spending patterns of consumers in general appears to be even more irrelevant than its use in relation to the specific purchases and investments made by a consumer. While in

theory the money held by a company might be regarded as available to the shareholder for alternative uses, in practice it is not available in this way nor will it be, unless the company is wound up. However, even if the company is wound up the net assets or equity per the CPP adjusted financial statements cannot serve as an indication of how much the shareholder will receive, since the "values" used in these financial statements are not intended to approximate the replacement cost or net realisable value of the net assets.

So far as the shareholders are concerned, therefore, it is doubtful whether this method of accounting will provide them with useful information. Furthermore, if the information is unlikely to be of much use to the shareholders, it is clear that other user groups will also find the information to be of little use.

- (b) Other disadvantages of this method of accounting include:
- . the fact that CPP adjusted financial statements are to be regarded as supplementary information may detract from any impact they are intended to have
  - . the application of the method is likely to be regarded as complicated, apart from it being conceptually the most difficult to understand
  - . the gain (or loss) on monetary items exists only in terms of units of current purchasing power and not in terms of monetary units. This may serve to confuse users.
  - . CPP adjusted statements of different companies whose financial years end on different dates cannot be compared directly as

they would be expressed in units of purchasing power at different dates.

### CASH FLOW ACCOUNTING

Some advocates of cash flow accounting point out that there can be no objective or "correct" measure of income and financial position of a company and that the traditional income statement and balance sheet should, therefore, be replaced by a statement of cash flows. The advantages of such a system are:

- (a) It is more objective and more easily verifiable than other systems of accounting.
- (b) Problems of changing costs and prices are automatically dealt with - all costs and revenues are entered at their cash values when paid or received and are, therefore, at current value when they are made. The problems of charging against revenues the value of goods consumed do not arise.
- (c) The problems of gains and losses arising from holding monetary liabilities or assets when costs and prices are changing do not arise, as all transactions are recorded only when the cash is received or paid.

The disadvantages of replacing the traditional financial statements with cash flow statements are, however, too serious to make this a viable proposition:

- (a) There are many reasons (in law and tax, for example) why it is necessary to determine a profit figure in the traditional manner (possibly with some modification acceptable to the authorities and society generally).

- (b) Cash flow accounting is probably the oldest form of accounting and accrual accounting was devised in order to overcome the difficulties of cash flow accounting.
- (c) Further as to (b), although cash movements are very important to business enterprises, earning activities are generally regarded as being of greater overall importance. The two are, however, related. A company which has a short-term cash crisis may go insolvent. It is the long-term cash generating ability of the company that is, however, seen as being of more use to most users of financial statements. Unless the company successfully brings in more cash from earning activities than it invests in them in the medium to long term, investors can expect no return on their investments and their risks will consequently increase and the relative market prices of their shares (or debentures or whatever ...) will decrease.

Cash flow reports on an accrual basis would result in inadequate information because of the complexity of the operations of most business enterprises and the long periods involved between the time an enterprise spends cash on earning activities and the time its earning activities bring in cash. The cash receipts and disbursements of a short period are usually not related to each other in a way that makes them useful indicators of the enterprise's ability to bring in cash through its earning activities.

Due to the importance, however, of the availability of cash to a business enterprise, the Sandilands Report recommends that "... directors of all companies should be required in future to include in their annual reports a statement on the adequacy of the cash

resources likely to become available to meet the company's requirements in the ensuing year".<sup>8</sup>

#### REPLACEMENT COST ACCOUNTING

Replacement cost accounting is the best known form of value accounting, although there is no general definition of it agreed on by all who practise it. The method is in widespread use in Holland, where it was developed for practical applications during the 1920s and where a number of large companies use it, the best known of these being the Philips Company of Eindhoven.

The basic concept underlying the replacement cost principle is that a business is attempting to achieve continuity in its operations and that as continuity necessitates replacement of assets, charges for the consumption of assets should be based on the cost of replacing them.

The essential features of replacement cost accounting are:

- (a) The financial statements are presented in terms of monetary units.
- (b) Assets (including current assets) are in general valued in the balance sheet by reference to the price that would have to be paid at the date of the balance sheet to purchase another asset of the same type as the existing asset, i.e. the replacement cost of the asset. In the case of depreciable assets, valuation is by reference to the written down current replacement cost. Replacement costs may be determined by a variety of methods including the use of specific price indices appropriate to the assets in question.
- (c) Replacement cost accounting identifies itself with the entity concept for the purposes of capital maintenance. A profit is not regarded as having been earned until provision has been made for

the replacement of the value of assets "consumed" during the year. Expressed in another way, a profit is not earned until the company's assets have been maintained at a constant physical level.

It is perhaps worth pointing out that the replacement cost used is not the estimated future replacement cost, but the current replacement cost at the date of the balance sheet. Many companies who consider themselves to be applying replacement cost accounting principles, in practice apply a convention similar to one that is used under historical cost accounting, namely that assets are valued at the (written down) current replacement cost or net realisable value, whichever is the lower. This could effectively be interpreted as the "value to the business" method of valuing assets, as recommended by some accountants.

As far as the calculation of profit is concerned, there are usually two important adjustments to be made in the income statement in order to set off against revenues the value of assets "consumed" during the period. These two adjustments deal with depreciation and stock (or cost of sales).

#### 1. Depreciation adjustment

Depreciation is usually provided for each year based on the replacement cost of the fixed asset at the end of the year. Thus, for example, if an item of plant which is assumed to have a five year life with no scrap value was acquired on 1 January 1978 for R1 000, and assuming the replacement cost of the plant at the end of the next five years is as follows, the depreciation expense charged to the income statement during each of those five years (assuming replacement cost accounting is used)

is:

<u>Year end</u>	<u>Replacement cost</u>	<u>Depreciation expense</u>
31 December 1978	R1 200	R240
" 1979	1 500	300
" 1980	1 600	320
" 1981	1 900	380
" 1982	2 000	<u>400</u>
		<u>1 640</u>

The income statement during each of these years is, therefore, charged with the value of the asset "consumed" during each of the years on a replacement cost basis. In this way one of the "inflationary" elements of the historical cost profit is eliminated.

If the aim of using the replacement cost method is twofold, however, that is to properly charge against revenues the value of the assets "consumed" during the year as well as to provide for the replacement of the assets used up (maintain the physical capital intact), then clearly there is a problem as far as "backlog" depreciation is concerned. In the example examined above the accumulated depreciation at the end of the life of the plant is only R1 640, whereas the replacement cost of the asset is R2 000. Hence, there is a backlog of R360, which also needs to be provided for during the life of the asset if the physical capital is to be maintained. There is no generally accepted method of providing for this backlog depreciation. There appears to be three schools of thought:

- (a) the backlog (R60 in year 2, R40 in year 3, R180 in year 4 and R80 in year 5) should merely be added to the depreciation expense each year in arriving at the operating profit.

- (b) the backlog should be deducted from the opening balance of retained income, so as not to affect the operating profit for the year.
- (c) the backlog should be provided for out of the reserve arising on the revaluation of the asset, and not the income statement at all.

In the absence of any fundamental objective or conceptual framework for accounting it is not possible to state that any of the methods is wrong and, in practice, the answer is, generally speaking, that any of the methods is acceptable provided full disclosure is made.

It is, of course, not necessary to provide for backlog depreciation if the aim is not to provide for the future replacement of "identical" assets. If backlog depreciation is NOT provided for, the aim is then clearly to regard the earnings of the company to be of paramount importance, whilst recognising that it may not be the intention of the company to replace its existing assets with identical ones, and, hence there is no need to maintain physical capital in that sense. The survival of a company does not depend on its ability to replace its existing assets with identical ones and a company should retain reserves and make appropriate cash forecasts based on its future replacement policies.

## 2. Stock (cost of sales) adjustment

This is similar to the depreciation adjustment in that it aims to charge against revenues not the portion of the historical cost of the stocks "consumed" during the year, but the cost of replacing the stocks sold.

The credit arising as a result of this increase in cost of sales is not treated as a profit, but is transferred to a stock revaluation reserve on the balance sheet.

Disadvantages of replacement cost accounting

(a) The major disadvantage of this method is that, in the absence of a fundamental objective or conceptual framework for accounting, there are a number of different bases of valuation that can be used and the system is, therefore, regarded by many as being too subjective to form the basis of accounts which are used for many different purposes. The valuation basis being less objective than historical cost, for example, this introduces the further problem of verifiability - clearly this may make the auditor's job of ascertaining whether the financial statement "fairly" present the financial position more difficult.

A counter argument is that objectivity is only one of the qualities that users of financial statements consider desirable and it is possible that users will, if they are given the choice, opt for greater relevance and usefulness at the expense of a certain degree of objectivity.

(b) It is sometimes argued that the "going concern value" of an asset is often different from the (written down) replacement cost or net realisable value and this basis is, therefore, still not satisfactory (see current cost method below).

(c) Some argue that in times when prices are falling the replacement cost method will lead to charges being made to the income statement which would result in the profit figure being more than the profit

under historical cost accounting. This objection is obviously based on the assumption that the historical cost profit is in some way the "correct" or benchmark profit for comparative purposes. If replacement cost principles regarding the calculation of profit and capital maintenance are accepted, this assumption does not necessarily apply.

- (d) The replacement cost method is also criticized as not being a technique of "accounting for inflation" in that it does not distinguish between changes in the value of money and changes in the relative prices of specific goods and services. Inflation, however, is not easily definable in that it affects different persons and companies differently and it appears to be meaningful to measure "inflation" with regard to a company based on the spending patterns of that particular company.
- (e) Another objection raised is that replacement cost accounting will result in companies' financial statements becoming less comparable due to:
- . inflation affecting different companies in different industries in different ways. A single general index is seen to be more appropriate for the sake of comparability.
- It can be argued that, in fact, the reverse is true - because inflation affects different companies in different industries in different ways, the use of a single general index will be misleading. Where genuine underlying differences exist, they should not be forced into "straight jackets" merely for the sake of uniformity and comparability.
- . the variety of different valuation bases that will be used by different companies (possibly even in the same industry) in

practice. While it is conceded that this could reduce comparability to a certain extent, it could also be argued that it would not result in any more of a problem than present (modified) historical cost financial statements present. Furthermore, it must be remembered that the present system has had the benefit of many decades of development and it could be argued that, should replacement cost accounting become accepted, research studies and projects undertaken by various accounting bodies may well result in such problems being overcome.

- (f) It may also be argued that the measurement of replacement cost may not be feasible, particularly for assets for which there do not exist a well-established market. Similarly, the "equivalent" version of an asset possessed by a company may have undergone some technological advances and the old version may no longer be available. This again introduces the question of estimates being made and the resultant lack of objectivity. This problem may further be linked to the time and expense factor - measuring replacement costs is likely to be more time-consuming and expensive than measuring historical cost, for the company itself as well as for the auditor. These disadvantages, however, must once again be measured against the resultant benefit to be achieved through the added relevance of the information in the financial statements, and it may well be that the shareholders (and other users) would opt for this method, given the disadvantages. It is also likely that if the replacement cost method of accounting became the normal practice, relevant replacement cost data would become more readily available than is the case at present, and this would reduce the time and cost spent

on the measurement process.

#### PRESENT (OR CURRENT) VALUE ACCOUNTING

The features which are usually associated with present value accounting are as follows:

- (a) Like all techniques of value accounting, present value accounting is based on the monetary unit as the unit of measurement.
- (b) It is further based on the principle that both assets and liabilities should be shown in the balance sheet at their "economic value" (or present value). In its pure form this method would value an asset by reference to the present value of the expected future cash flows to be derived from it. Liabilities are similarly valued at the present value of future cash outflows.
- (c) Another feature of present value accounting is that the usual distinction between "income" and "capital" gains is disregarded. All gains made during the period, including unrealised holding gains, are taken to the income statement.

The principles of present value accounting are familiar to the life assurance industry where profit for a year is assessed on the basis of the actuary's assessment of the present value in a life assurance fund of assets and liabilities which may both stretch many years into the future. In a similar way, present value accounting is based on the concept that the increase in the total net assets of the company during a year is the company's profit, and should be included in the income statement.

For many users, however, the distinction between operating profit and holding or capital gains is a useful one and this method would, therefore, not satisfy all their needs.

Whereas replacement cost accounting in practice stops short of adjusting the value of those liabilities which are subject to changes in value, present value accounting assumes that liabilities as well as assets should be valued on this basis. This indicates the origins of present value accounting in the insurance industry where the valuation of future liabilities in this manner is a familiar concept. Whereas this method may be particularly useful to companies in the financial sector, particularly insurance companies, it is almost certain that other sectors would find that the problems involved in attempting to adopt this method of valuation would outweigh the benefits which may be derived from its implementation. A particular problem which such other sectors would face is the almost impossible task of attempting to forecast the future cash inflows which many assets may produce with any degree of reliability.

While it is acknowledged that this "economic value" is theoretically a sound basis, the practical difficulties render the method's general acceptance extremely unlikely. It is further submitted that the replacement cost method (using the system whereby assets are valued at the lower of (written down) replacement cost and net realisable value) is likely to be a fair approximation of the "economic" value, with the added advantage of being easier to apply in practice.

CONTINUOUSLY CONTEMPORARY ACCOUNTING

It has been strongly and persuasively argued by Professor Chambers of the University of Sydney that the appropriate characteristic of an asset for measurement is its current cash equivalent.<sup>9</sup> The current cash equivalent of an asset is its current net selling price. Briefly, Chambers argues that the objective of accounting is "to provide a continuous source of financial information as a guide to future action in markets".<sup>10</sup> Included in financial information is financial position which he defines as "the capacity of an entity at a point in time to engage in indirect exchanges".<sup>11</sup> In other words, Chambers interprets financial position as a measure of the ability of an entity to adapt to a changed environment. If the environment in which an entity exists is changed in any way, the entity must adapt itself to the new environment or fail to survive. For a business, adaptation means disposal of the assets no longer appropriate for the environment and the acquisition of new assets which will serve it better. The ability of an entity to adapt is, therefore, dependent on the saleability of its assets. An entity which has assets which could be readily sold for a good price is in a better financial position than an entity which has assets that can only be sold for low prices or that cannot be sold at all.

Under this proposal some items which are regarded as assets in contemporary accounting would not appear on the balance sheet because their current cash equivalents are nil. Goodwill, for example, cannot be sold by itself and would not, therefore, appear on an adaptive capacity balance sheet.

Chambers believes that financial position calculated in this way would be very useful from several points of view.<sup>12</sup> First, if the current cash equivalents of assets were measured, shareholders would be able to satisfy themselves that management had maintained the adaptive capacity of the entity during the preceding period. "The money equivalent of the assets as at the beginning of any year is the basic amount of money for which directors and managers are accountable in that year." This, argues Chambers, gives a "proper account" of stewardship. If management fails to maintain adaptive capacity, then it has failed in its stewardship role. As far as the capital maintenance concept is concerned, this method, therefore, in effect, attempts to preserve or maintain the purchasing power of the shareholders' funds at the beginning of the year. The unit of measurement, however, is the monetary unit, not the current purchasing power unit.

Second, measuring current cash equivalence provides a useful measure of solvency. If current operations cannot provide sufficient cash to settle debts as they fall due, an entity may be forced to sell some assets to raise cash. If assets are shown at current cash equivalent, creditors will have a good indication of a firm's ability to avoid insolvency by selling assets. If assets are shown at historical or replacement cost, the balance sheet provides little information about an entity's ability to avoid insolvency by selling assets.

Third, the measurement of current cash equivalents gives useful information about an entity's creditworthiness. Where assets are offered as security, the only characteristic of the asset of any interest to the lender is its net realisable value. In addition the unpledged current

cash equivalents of assets would represent reserve borrowing power.

Fourth, this measure of assets gives a more useful rate of return for shareholders. The shareholder is able to see how efficiently management is using the resources entrusted to it and to compare the rate of return on shareholders' funds with the rate that could be earned by selling the assets and switching to some alternative activity. Inter-company rates of return can also be compared because assets are measured on a comparable basis.

Chambers also argues that showing assets at their current cash equivalents accords with the general practice of individuals who tend to measure the current cash equivalents of their personal assets when calculating their own worth. Statement users will understand the meaning of a balance sheet prepared in conformity with their own behaviour. The measurement of current cash equivalents in this way represents, therefore, a "common sense" approach to asset measurement.

#### Disadvantages of the continuously contemporary accounting method

- (a) The major criticism of this method is the use of the current cash equivalent (or net realisable value) as the basis for measurement of the assets. The Sandilands Report, for example, states:

"We agree that major creditors will be interested to know the market value of the assets of a company to which they are lending money, particularly if security is formally taken in the form of all or part

of these assets. We doubt, however, whether the majority of companies regard their assets either as a 'means of buying other things' or as a means of 'paying off debts'. As a last resort companies may be forced to realise their assets to pay off their debts and perhaps to 'buy other things'. In normal circumstances, however, most companies would expect to pay off their debts and purchase the materials and supplies for their continued operation out of earnings generated by the assets, not from the assets themselves."<sup>13</sup>

The "going concern" value of the assets of a company are, therefore clearly considered to be of more use to most users of financial statements than the sum of the net realisable (liquidation) values of the individual assets. Such information is regarded as being relevant to the investor only if the management does, in fact, plan to liquidate and sell its assets. If the company plans, instead, to continue its normal manufacturing and service activities, then that information is totally irrelevant for almost all parties.

- (b) Many users wish to know what the "operating profit" of a company was for the year under review and in this regard, particularly, it may be argued that unrealised holding gains should not be included in this "operating profit" figure.

CURRENT COST ACCOUNTING

This method of accounting, recommended in the Sandilands Report, is similar to the replacement cost method, but it is suggested that assets be shown in the balance sheet at their "value to the business" which is defined as follows:

"The value of an asset to a company is its written down current replacement cost (current purchase price), except in situations where the written down current replacement cost is higher than both the 'economic value' and the net realisable value in which case the value of the asset to the company is the 'economic value' or the net realisable value, whichever is the higher."<sup>14</sup>

The "value to the business" of an asset is, therefore, equated with the amount of loss that will be suffered by the business if the asset is lost or destroyed. The current written down replacement cost is, clearly, the upper limit because the loss which a firm suffers cannot exceed the cost of restoring it to its former position. Net selling price is the lower limit because the loss suffered must be at least equal to the net amount which could be obtained from the sale of the asset. Where the choice is between the "economic value" and the net realisable value, it is fair that the higher of the two should be chosen as this is, in fact, the present value of the loss suffered by

the owner. It is conceded that this estimation of the valuation of assets will necessarily introduce a certain degree of subjectivity into the measurement process, but it is contended that "an approximation to a valuation, even if subject to a margin of uncertainty, is likely to provide more useful information when prices are changing rapidly than a precise figure of historic cost".<sup>15</sup>

The report considers it important that all three of these valuation bases should be compared in the above manner, rather than just one basis being used exclusively. A system of accounting based on the measurement of assets by reference exclusively to any one of these three bases is, in the opinion of the Committee, too restrictive in that, while it may provide useful information for certain purposes, it is unlikely to be as useful for the majority of users of financial statements based on the "value to the business" concept.<sup>16</sup>

As far as the income statement is concerned, the Report recommends that "operating profit" be determined after charging the "value to the business" of assets consumed during the period, thus excluding holding gains from income and showing such gains separately in the balance sheet. It is suggested that the "operating profit" be termed "current cost profit".

The adjustments that are required to be made to the historical cost income statement are similar to those required by the replacement cost accounting method, namely a depreciation adjustment and a cost of sales adjustment. National Council (now the South African Institute of Chartered Accountants) appears to have taken the view in their

Guideline 4.003 published in August 1978 that the current cost income statement ought to disclose the current cost income both from the entity as well as from the owners' points of view. It, therefore, recommends that once the current cost operating income from the entity viewpoint has been arrived at, a further adjustment, namely the financial gearing adjustment, should be made so as to relate the operating income of the enterprise also to the owner's equity. This adjustment takes into account the following two factors:

- (a) Where fixed assets and stock are partly financed by outside lenders, the current cost adjustment for depreciation and cost of sales should be reduced by the proportion attributable to outside lenders, and
- (b) where the owners' equity partially finances monetary assets, over and above fixed assets and stock, an additional charge should be made in the current cost income statement to represent the decline in the real value to the business of that part of the monetary assets financed by owners' equity.

As far as the presentation of the Current Cost financial statements is concerned, the Sandilands Report suggests that the following additional features should be recognised:<sup>17</sup>

- (a) All unrealised gains arising from the revaluation of fixed assets (and stock, where applicable) should be shown in revaluation reserves in the balance sheet.
- (b) Realised holding gains arising on fixed assets should similarly be included in movements in balance sheet reserves.
- (c) The cost of sales adjustment should be credited (or debited as the case may be) to a balance sheet "stock adjustment reserve".

- (d) Extraordinary gains should be classed as "extraordinary items" and accounted for as at present, so as to separate them from current cost profit.

It is further recommended that:

- (i) A summary statement be included as a note to the financial statements showing total gains or losses for the year. In this way operating gains (current cost profit), extraordinary gains and holding gains would be added together so as to arrive at the total gains for the year, as follows:<sup>18</sup>

Summary statement of total gains or losses for the year

Current cost profit (as shown in income statement)	X X
Extraordinary items less tax	<u>X X</u>
Net profit after tax and extraordinary items	X X
Movements on reserves net of tax:	
Stock adjustment reserve	X X
Revaluation reserves:	
Gain/loss due to changes in the basis of valuation of assets	X X
Other gains/losses	<u>X X</u>
	<u>X X</u>
Total gain (loss) for the year after tax	<u><u>X X</u></u>

- (ii) The historic cost figures for the net book value of fixed assets, broken down into major categories (land, buildings, plant and machinery, and vehicles) and for the depreciation provisions for the year (also broken down into these similar categories) be shown in the notes to the financial statements.<sup>19</sup>

- (iii) So far as intangible assets are concerned, the historic cost basis of measurement be used as it is recognised that the problems of estimating the current "value to the business" of such assets are significant.<sup>20</sup>
- (iv) While in principle, liabilities should be shown in a company's balance sheet at their "value to the business", the translation of this principle into practice would pose difficulties, and it is, therefore, recommended that no change be made to the conventional method of disclosing liabilities, but that further research should be undertaken in this area.<sup>21</sup>

This method appears to be an improvement on the replacement cost method in that it overcomes many of the disadvantages of the latter method. Perhaps the most important point which is revealed by the proponents and critics of these various methods of accounting is that the relevance of a measure of an asset can only be determined by reference to the underlying objectives of accounting. There exists, at present, no such fundamental objectives or conceptual framework for accounting and there are, therefore, no valid criteria for choosing between the objectives proposed by these various schools of thought. The result is that we have to consider the persuasiveness of the arguments supporting the various proposals. As McFarland has written: "While these are logical structures, persuasively presented, they are founded wholly upon assumptions as with respect to the kinds of data their proponents think statement users ought to need or want".<sup>22</sup> The disadvantages or criticisms of the methods suggested above illustrate the futility of trying to solve accounting problems without first having a generally agreed objective or conceptual framework for accounting.

CHAPTER 6

Footnotes

1. *Report of the Inflation Accounting (Sandilands) Committee, (London, 1975), p. 83.*
2. Accounting Standards Steering Committee, *SSAP7*, Appendix 1, para. 4.
3. *ibid.*, para. 4.
4. *ibid.*, para. 18.
5. *ibid.*, para. 21.
6. i.e. according to the historical cost (or modified historical cost) method of accounting.
7. *Report of the Inflation Accounting Committee, op. cit.*, pp. 126 - 7.
8. *ibid.*, pp. 152 - 3.
9. R.J. Chambers, *Accounting, Evaluation and Economic Behaviour*, (New York, 1966).
10. *ibid.*, p. 49.
11. *ibid.*, p. 81.
12. R.J. Chambers, *Securities and Obscurities : A Case for Reform of the Law of Company Accounts*, (Melbourne, 1973), ch. 4.
13. *Report of the Inflation Accounting Committee, op.cit.*, p. 153 - 4.
14. *Report of the Inflation Accounting Committee, op. cit.*, p. 169.
15. *ibid.*, p. 161.
16. *ibid.*, p. 161.
17. *ibid.*, p. 189.
18. *ibid.*, p. 190.
19. *ibid.*, p. 189.
20. *ibid.*, p. 162.
21. *ibid.*, p. 162.
22. W.B. McFarland, 'Letters to the Editor', *Financial Analysts Journal*, Vol. 26, (January - February 1970), p. 123.

CHAPTER 7

A new order for accounting?

Attempts at developing a conceptual framework

Reference has been made in earlier chapters to the need to establish a fundamental objective or conceptual framework for accounting. There have been various attempts to formulate such a framework and some of these are still in progress. The ultimate success of these projects is of great importance to the corporate reporting function and to the profession itself. It is also generally agreed that the very existence of the Financial Accounting Standards Board (FASB) is dependent on the success of its conceptual framework project which commenced in 1974.

This chapter examines attempts that have been and are being made to develop a conceptual framework in the United States, Canada and Britain.

UNITED STATES

The two predecessors of the FASB, The Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB), attempted to develop a conceptual framework for financial accounting and reporting.

ATTEMPTS BY THE CAP (1938 - 1959)

During its 21-year history, the CAP on various occasions considered the desirability of preparing a "comprehensive statement of accounting principles that would be virtually all-inclusive".<sup>1</sup> The CAP first considered the matter at its initial meeting, but very quickly rejected the idea. The reason given was:

"It would doubtless have taken a very long period before any such statement could have been agreed upon. In the meantime, the committee would have been performing little or no service in the direction of reducing current controversies over accounting procedures. Furthermore, it seemed doubtful whether it would be feasible to prepare a statement of accounting principles that would be sufficiently comprehensive to afford a practical guide to settling any very large number of accounting problems. Accordingly, the committee decided to deal with specific areas of difference." <sup>2</sup>

Carman Blough provides additional insight concerning the reasoning underlying the committee's decision:

"At first it was thought that a comprehensive statement of accounting principles should be developed which would serve as a guide to the solution of the practical problems of day to day practice. It was recognised that for such a statement to be of much help to the practitioner it would have to be much more comprehensive and in far greater detail than the 'Tentative Statement' of the American Accounting Association issued two years previously. (1936 AAA Statement).

After extended discussion it was agreed that the preparation of such a statement might take as long as five years. In view of the need to begin to reduce areas of differences in accounting procedures before the SEC lost patience and began to make its rules on such matters, it was concluded that the committee could not possibly wait for the development of such a broad statement of principles."<sup>3,4</sup>

The CAP considered the question of a comprehensive statement of accounting principles again in 1940 and decided "that it might be constructive to review the postulates implied in much accounting literature, often without direct expression".<sup>5</sup> Accordingly, subcommittees of the CAP were appointed to consider the monographs "A Statement of Accounting Principles" by Sanders, Hatfield and Moore, and "An Introduction to Corporate Accounting Standards" by Paton and Littleton. Although the subcommittee reports were published in 1941,<sup>6</sup> apparently the CAP never acted on the reports. The country's involvement in World War II was probably a reason for this inaction since "the committee on accounting procedure was forced to devote itself almost exclusively to questions involving war transactions".<sup>7</sup> The research department of the AI(CP)A published a brief statement entitled "Corporate Accounting Principles" in 1945,<sup>8</sup> which was based on the Accounting Research Bulletins issued to that date, the 1936 AAA Statement, and the SEC's Accounting Series Releases.

According to Blough, the CAP never gave up the idea that it would be desirable to develop a comprehensive statement of accounting principles, and the Committee undertook another effort in 1949 by appointing a subcommittee to work on a statement. Although the subcommittee did considerable work, the results were "highly unsatisfactory".<sup>9</sup> The effort was abandoned in favour of a restatement and revision of the 34 existing Bulletins, which was published in 1953 as Accounting Research Bulletin No. 43.

#### ATTEMPTS BY THE APB (1959 - 1973)

The APB decided at its first meeting that work on the basic postulates and principles of accounting should begin as soon as possible. The two projects were assigned to eminent accounting scholars, Maurice Moonitz and Robert T. Sprouse.

Two years after the APB's initial meeting, Accounting Research Study No. 1, "The Basic Postulates of Accounting", by Moonitz, was published. Moonitz selected a "problem oriented" approach in which the focus was upon "the problems that accountants deal with". The "pragmatic" approach was rejected because its emphasis on usefulness required answers to questions such as "useful to whom? and for what purpose?"<sup>10</sup>

Moonitz later said that the research study "did not evoke much reaction from the APB or the profession generally at the time of its publication" as both were waiting for the research study on principles.<sup>11</sup> Only one member of the project advisory committee, Leonard Spacek, published comments in the study. Spacek disagreed with the basic approach in

the research study and indicated that "the essential prerequisite of the establishment of a sound framework of accounting theory must be a clear determination of the purpose and objectives of accounting".<sup>12</sup>

A summary by the AICPA's Research Division of fifty-two comment letters received on the study stated that "many persons" agreed with Spacek's position.<sup>13</sup>

In an article considering both the postulates and broad principles studies, Vatter stated that the "central idea in any methodology is one of ... objectives, and "postulates are not objectives".<sup>14</sup> He also noted:

"Before we specify the problems with which accounting must deal, we must first establish a set of purposes or aims to be served, what should be measured, recorded, and reported? To whom and under what circumstances are reports to be directed? How should the data to be reported be structured with respect to the persons who will read the reports and the uses they try to serve?"<sup>15</sup>

According to Zeff, the thrust of the foundation presented in the postulates study was lost by its immediate translation into principles. Publication of Accounting Research Study No. 3, "A Tentative Set of Broad Accounting Principles for Business Enterprises", by Sprouse and Moonitz, in April 1962 diverted attention "to the policy implications of the foundation".<sup>16</sup> Sprouse and Moonitz were guided in their work by a requirement of "compatibility" with the "basic postulates". The

tentative set of principles called for the reporting of inventories and plant and equipment at current values and receivables and payables at present (discounted) values. The study's focus on the measurement of assets and liabilities, therefore, shattered tradition.

The principles study caused considerable controversy among the members of the project advisory committee. Only one of the nine comments from that group which were published in the study, was favourable. Each copy of the research study that was distributed publicly was accompanied by a statement from the APB stating that Accounting Research Studies Nos. 1 and 3 were "too radically different from present generally accepted accounting principles for acceptance at this time".<sup>17</sup>

The next effort to establish a conceptual framework occurred in 1965 with the publication of Accounting Research Study (ARS) No. 7, "Inventory of Generally Accepted Accounting Principles for Business Enterprises", by Paul Grady. The APB approved the undertaking of this study in June 1963. Unlike ARS No. 3 which had been concerned with "what ought to be" (a normative approach), ARS No. 7 was concerned with "what is" (i.e. a description or codification of existing practices). It has been stated that since Grady had been associated with the Committee on Auditing Procedure that produced the set of generally accepted auditing standards, he "had every reason to expect that Accounting Research Study No. 7 would satisfy the profession's need for a code from which it could progress".<sup>18</sup> The APB, however, did not take formal action on ARS No. 7; the study did, however, serve as one of the sources used by the APB in its next effort to develop a conceptual framework.

Six years had elapsed and the APB had not yet been successful in adopting a conceptual framework. Concern over the lack of success was apparent. The first recommendation in the final report of the AICPA's Special Committee on Opinions of the Accounting Principles Board (Seidman Committee) indicated in part:

"At the earliest possible time, the Board should:

- (a) Set forth its views as to the purposes and limitations of published financial statements and of the independent auditor's attest function.
- (b) Enumerate and describe the basic concepts to which accounting principles should be oriented.
- (c) State the accounting principles to which practices and procedures should conform."<sup>19</sup>

The special Committee believed that ARS No. 7 contained "most of the raw material" needed to fashion the type of document implied in its recommendation.<sup>20</sup> In response to the Seidman Committee's Report, the chairman of the APB appointed a subcommittee, which met for the first time in May 1965 and produced APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", which was published in October 1970. At the beginning of the project, the plan was to develop a series of pronouncements on fundamentals of financial reporting to serve as a foundation for more specific opinions on the application of accounting procedures. According to Clifford Heimbucher, the then chairman of the APB, the first

three of the series were to cover:

- (1) the nature and objectives of financial statements,
- (2) basic concepts underlying financial statement preparation, and
- (3) broad accounting principles.<sup>21</sup>

The documents were expected to be published as "brochures or booklets" with "the full status of Opinions of the Board" but clearly distinguishing "between those portions constituting Opinion, departure from which will in the future call for disclosure, and those portions representing merely explanatory or background material".<sup>22</sup>

APB Statement No. 4 was, however, issued as a Statement which did not have the authority of APB Opinions although earliest drafts of the document carried the label of "Opinion".<sup>23</sup> Also contrary to the initial plan, Statement No. 4 was an attempt to develop, in one sweeping effort, a conceptual framework for financial accounting and reporting.

Some parts of this Statement are similar to ARS No. 7 in that they are descriptive rather than prescriptive. However, unlike ARS No. 1 on postulates, Statement No. 4 does not contain a specific section devoted to the objectives of financial accounting and financial statements. A noticeable shift in emphasis is found in the "new" definition of accounting:

"Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions - in making reasoned choices among alternative courses of action."<sup>24</sup>

The old definition in 1941 stated:

"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof." <sup>25</sup>

The emphasis, therefore, is no longer on "internal" accounting processes, but on the processes "external" to accounting (economic decision-making). However, the shift is merely one of interpreting accepted accounting practices from a "more user-orientated viewpoint" rather than any shift in the fundamentals of accounting. <sup>26</sup>

Evaluations of Statement No. 4 have been mixed. Moonitz observed that it "does not satisfy the need for a comprehensive authoritative definition of generally accepted accounting principles", nor does it satisfy "the directive from the April 1965 meeting of the AICPA Council with respect to matters other than the codification of accounting principles". <sup>27</sup> Grady also stated that the Statement did not fulfil the task assigned in the APB Charter and in the Special Committee's final report. <sup>28</sup>

Staubus, however, concluded that Statement No. 4 was "a big step forward" and that the section on objectives of financial accounting and financial statements is "progressive" and the Statement's "strongest feature". <sup>29</sup> Ijiri stated that the APB "should be congratulated for its courage and effort in tackling this difficult task and in publishing the results", although an important missing factor was the "Board's

authentication" of the Statement.<sup>30</sup>

A final effort by the APB in the area of a conceptual framework came in 1968 when a subcommittee was appointed to work on a statement of objectives of financial statements. Some staff work and Board discussion did occur, but after the President of the AICPA appointed the Study Group on objectives of Financial Statements (Trueblood Committee) in April 1971, the APB Subcommittee did not actively pursue its task.

#### FASB's CONCEPTUAL FRAMEWORK PROJECT

The appointment by the AICPA of two committees in 1971 to study ways to improve the Institute's role in establishing standards of financial reporting has already been referred to in Chapter 3. The first committee, with a deadline to report in one year and chaired by Francis M. Wheat, appointed to study the operations of the APB led to the formation of the FASB in 1972. The second committee, with a two-year deadline and chaired by Robert M. Trueblood, was directed to study the objectives of financial statements.

When the FASB selected its initial technical agenda in April 1973, one of the seven projects chosen from a list of more than thirty possibilities suggested by the Financial Accounting Standards Advisory Council and others was the topic of "Broad Qualitative Standards for Financial Reporting".<sup>31</sup> The original intent of the FASB was "to develop qualitative standards to provide guidance in determining the substance of a transaction or event, regardless of its form, and a qualitative basis for fair presentation in financial reports".<sup>32</sup> It was expected that the Report of the Study Group on the Objectives of

Financial Statements (Trueblood Report),<sup>33</sup> when completed, would be of assistance in the project.

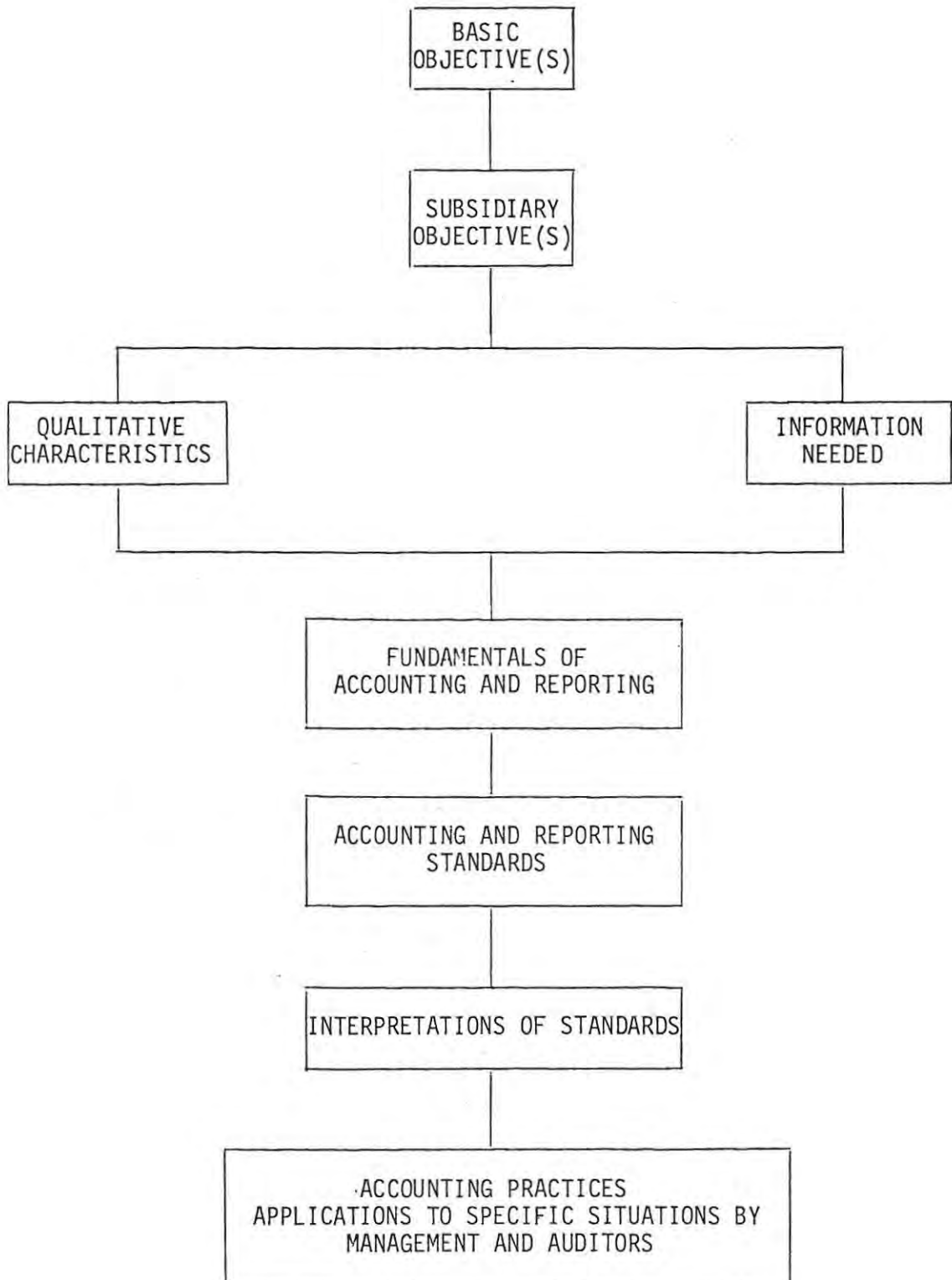
After working on the Broad Qualitative Standards project and meeting with some members of the Trueblood Committee, the FASB concluded that the scope of the Broad Qualitative Standards project should be broadened to encompass the entire conceptual framework of financial accounting and reporting, including objectives, qualitative characteristics, and the information needs of users of accounting information so as to lead to a *constitution*, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. Accordingly, the name of the project was changed to "Conceptual Framework for Financial Accounting and Reporting". A ten-member task force composed of individuals from industry, public accounting, the financial community, and academe was selected for the project in December 1973.

The task force held its first meeting early in 1974. The initial step in this long-term project recognized the primacy of the objectives of financial statements in the adoption of financial accounting standards, and the FASB, therefore, issued, with the advice and counsel of the task force, a "Discussion Memorandum" on the subject of objectives of financial statements and qualitative characteristics of financial reporting. This Discussion Memorandum, published in June 1974, relied almost exclusively on the Trueblood Report Objectives Study.<sup>34</sup> One of the most notable features of the Trueblood Report was its argument that an objective of financial statements is to provide information useful

to investors and creditors "for predicting, comparing and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty".<sup>35</sup> The report also referred to certain characteristics that financial reports should possess in order to satisfy user needs. The committee felt that though these qualities may appear obvious and are presumed to be implicit in any intelligent reporting of information, they were, nevertheless, significant. These qualitative characteristics consisted of: relevance and materiality; form and substance; reliability; freedom from bias; comparability; consistency; and understandability.<sup>36</sup>

The Discussion Memorandum raised some general questions about the objectives and qualitative characteristics of the Trueblood Report for public consideration and comment, and examined and raised specific questions with respect to each of the twelve objectives raised in the Report. In addition, a hierarchical arrangement of the various elements of a conceptual framework system was discussed in an appendix to the memorandum. The hierarchy, shown below, attempts to portray the way in which the many facets of financial accounting and reporting might fit together to form a cohesive and operable whole. The hierarchy is tentative and may be modified as the project develops.

HIERARCHY OF ELEMENTS IN A CONCEPTUAL FRAMEWORK  
FOR FINANCIAL ACCOUNTING AND REPORTING.<sup>37</sup>



The hierarchy provides for more than one basic objective should that be considered appropriate. It also allows for those objectives which might be considered subsidiary in that they are supportive of the basic objective(s). The objectives provide a basis for the development of the remainder of the elements.

At the next level in the hierarchy are the qualitative characteristics which are the attributes of accounting information that tend to enhance its usefulness and general acceptance. The "information needed" section involves identification of the broad categories of financial information needed by the users. As an example, the Trueblood Report mentions specific types of financial statements and some of the information that should be included in those statements to comply with the information needs of the users. The statements referred to were a statement of financial position, a statement of periodic earnings, a statement of financial activities, and financial forecasts.

At the next level in the hierarchy are the fundamentals of accounting and reporting such as definitions of assets, liabilities, capital, earnings, revenue and expense. Each of the fundamentals is critical in fulfilling the objectives and is also important in resolving most of the specific accounting issues that confront the FASB. Included in this level are issues concerning valuation bases to be used, whether earnings are to be determined on a revenue-expense basis or on an asset-liability basis, what concept of capital maintenance ought to be used in determining earnings, etc. The Trueblood Report did not really deal with the contents of this box in any detail. Some of these issues have been examined in some detail in Chapter 5.

Below the fundamentals box are the two boxes labelled "accounting and reporting standards" and "interpretations of standards". The Statements and Interpretations of Statements issued by the FASB to date are examples of the contents of these two boxes. The final element is referred to as accounting practices which are the means to achieve the objectives, and include the decisions made by managements and auditors in applying the contents of all the other boxes to specific situations. In essence, financial statements are reflections of those applications.

#### STAGES OF THE PROJECT

As has already been mentioned the conceptual framework project is a major long-term continuing project and is being carried out in several stages, the first two of which are currently under way. It is apparent from the Board's work on the project so far that it does not intend to finalise one stage before dealing with a further stage. In this connection, it is important to note that the Board intends to publish a series of Statements of Financial Accounting Concepts related specifically to its conceptual framework project. These Statements are intended to establish the objectives and concepts that the FASB will use in developing future standards of financial accounting and reporting.

The Board, in establishing a new framework of accounting - by its own terms a "constitution" - will not have the time to re-examine past pronouncements which it and its predecessors have issued. These will remain in effect until amended or rescinded - a later project. Under the AICPA Rules of Conduct, members must adhere to principles

promulgated by the FASB and its predecessors; departures create problems. Consequently the Board's pronouncements arising out of the conceptual framework project may be inconsistent with the concepts underlying some prior pronouncements, and thus creating a dilemma, the Statements of Financial Accounting Concepts are deemed not to be the establishment of accounting principles within the meaning of the AICPA's Rules of Conduct. Thus while the new series will provide guidance to both the Board and the profession in resolving new problems and developing new standards (and later in re-examining old standards) they will not create immediate problems of inconsistency.

#### STAGE 1.

The first stage deals with the top four boxes of the hierarchy diagram (i.e. the objectives, qualitative characteristics and informational needs).

#### Objectives

As far as the objectives are concerned, the Board published its "Tentative Conclusions on Objectives of Financial Statements of Business Enterprises" in December 1976. These have been referred to in Chapter 5. Further comments were invited on these tentative conclusions and this led to the publication, first of an exposure draft and later, in November 1978, of FASB Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises". While the exposure draft dealt, in part, also with "qualitative characteristics" and "elements of financial statements", (i.e. the box dealing with "fundamentals" in the hierarchy diagram), it was decided to omit these sections from the Statement and to make these the subject of separate exposure drafts and statements.

A further significant change in approach from the "Tentative Conclusions..." came about largely as a result of a symposium that was held on the conceptual framework in 1977.<sup>38</sup> The AICPA, the Financial Analysts Federation, the Financial Executives Institute and the Robert Morris Associates (joined by the Bank Administration Institute) offered to devote the triennial Seaview Symposium they sponsored to the conceptual framework project. The FASB enthusiastically endorsed this idea and, accordingly, three members of the FASB participated actively in the symposium. The chairman and acting chief accountant of the SEC as well as representatives of the New York Stock Exchange and the General Accounting office also attended.

In general, the group expressed the view that the limits of financial accounting were considerably narrower for financial statements than they were for financial reporting in general and the Board was urged to devote more attention to this issue. The group was of the opinion that financial statements should be limited to objectively verifiable data and that where a necessary trade-off existed between objectivity and better predictive information, the Board should opt for the criterion of objectivity in measurement as the primary one. There was a strong desire for "credibility" in financial statements and it was thought that the greater the need for subjective estimates, the less assurance would attach to the financial statements.

While it was recognised that this approach would lessen the predictive value of financial statements, the majority view seemed to be that the statements themselves should not emphasize predictive data. On the other hand a predictive approach was favoured for financial reporting

outside the financial statements. The objective that "financial accounting and financial statements should provide information that helps investors and creditors assess the enterprise's prospects of obtaining net cash inflows through its earning and financial activities" was believed to be sound if applied to financial reporting broadly construed, but not to the usual financial statements.

It was felt, therefore, that the "soft" information should be included outside of the financial statements in a separate section of the annual report. It was further contemplated that such information would not be the subject of an audit in accordance with today's generally accepted auditing standards, but would be the subject of some type of audit review, as yet undefined.

There was broad agreement that the FASB should have the responsibility of defining what information should be included in this broader financial reporting as well as in financial statements, and participants thought the Board should clearly specify the distinctions between the two kinds of reporting.

This symposium clearly influenced the FASB's thinking. While the tentative conclusions referred to the "objectives of Financial Statements...", the Statement was entitled "objectives of Financial Reporting...". Furthermore, the objectives have been expanded significantly as a result of this broader approach.

SUMMARY OF PRINCIPAL CONCLUSIONS OF STATEMENT OF FINANCIAL ACCOUNTING  
CONCEPTS NO. 1 - OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS  
ENTERPRISES<sup>39</sup>

- . Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions.
- . The objectives of financial reporting are not immutable - they are affected by the economic, legal, political and social environment in which financial reporting take place.
- . The objectives are also affected by the characteristics and limitations of the kind of information that financial reporting can provide.
  - The information pertains to business enterprises rather than to industries or the economy as a whole.
  - The information often results from approximate, rather than exact, measures.
  - The information largely reflects the financial effects of transactions and events that have already happened.
  - The information is but one source of information needed by those who make decisions about business enterprises.
  - The information is provided and used at a cost. Moreover, the benefits derived from financial information are usually difficult or impossible to measure objectively, whereas the costs often are.
- . The objectives dealt with in this Statement are those of general purpose external financial reporting by business enterprises.
  - The objectives stem primarily from the needs of external users who lack the authority to prescribe the information they want and must rely on information management communicates to them.

- The objectives are directed towards the common interests of many users in the ability of an enterprise to generate favourable cash flows, but are phrased using investment and credit decisions as a reference to give them focus. The objectives are intended to be broad rather than narrow.
- The objectives pertain to financial reporting and are not restricted to financial statements.
- . The major broad objectives state that:
  - Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
  - Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise.
  - Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

- . "Investors" and "Creditors" are used broadly and include not only those who have or contemplate having a claim to enterprise resources, but also those who advise or represent them.
- . Although investment and credit decisions reflect investors' and creditors' expectations about future enterprise performance, these expectations are commonly based at least partly on evaluations of past enterprise performance.
- . The primary focus of financial reporting is information about earnings and its components.
- . Information about enterprise earnings based on accrual accounting generally provides a better indication of an enterprise's present and continuing ability to generate favourable cash flows than information limited to the financial effects of cash receipts and payments.
- . Financial reporting is expected to provide information about an enterprise's financial performance during a period and about how management of an enterprise has discharged its stewardship responsibility to owners.
- . Financial accounting is not designed to measure directly the value of a business enterprise, but the information it provides may be helpful to those who wish to estimate its value.
- . Investors, creditors, and others may use reported earnings and information about the elements of financial statements in various ways to assess the prospects for cash flows. They may wish, for example, to evaluate management's performance, estimate "earning power", predict future earnings, assess risk, or to confirm, change, or reject earlier predictions or assessments. Although financial reporting should provide basic information to aid them, they do

their own evaluating, estimating, predicting, confirming, changing, or rejecting.

- . Management knows more about the enterprise and its affairs than investors, creditors, or other "outsiders" and accordingly can often increase the usefulness of financial information by identifying certain events and circumstances and explaining their financial effects on the enterprise.

#### OBJECTIVES OF FINANCIAL REPORTING BY NONBUSINESS ORGANISATIONS

The FASB conceptual framework project is not aimed at producing such a framework for business enterprises only. Having established the objectives of financial reporting by business enterprises, the Board set about finalising also the objectives of financial reporting by non-business organisations, which culminated in the issuing, in December 1980, of FASB Statement of Financial Accounting Concepts No. 4, "Objectives of Financial Reporting by Nonbusiness Organisations". Based on its review of the similarities and differences between the two sets of objectives, the Board concluded that it was not necessary to develop an independent conceptual framework for any particular category of entities. Rather, its goal is to develop an integrated conceptual framework that has relevance to all entities and that provides appropriate consideration of any different reporting objectives and concepts that may apply to only certain types of entities.<sup>40</sup>

The distinguishing characteristics of nonbusiness organisations include:<sup>41</sup>

- a. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to resources provided.
- b. Operating purposes that are other than to provide goods or services at a profit equivalent.
- c. Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organisation.

The Statement points out that the objectives are affected by the characteristics and limitations of the kind of information that financial reporting can provide, i.e. financial reporting is primarily financial in nature, and it is generally quantified and expressed in units of money. Other information, however, may also be needed to understand the significance of the information expressed in units of money or to help in assessing the performance of a nonbusiness organisation.<sup>42</sup>

The objectives state that:<sup>43</sup>

- . Financial reporting by nonbusiness organisations should provide information that is useful to present and potential resource providers and other users in making rational decisions about the allocation of resources to those organisations.
- . Financial reporting should provide information to help present and potential resource providers and other users in assessing the services that a nonbusiness organisation provides and its ability to continue to provide those services.

- . Financial reporting should provide information that is useful to present and potential resource providers and other users in assessing how managers of a nonbusiness organisation have discharged their stewardship responsibilities and about other aspects of their performance.
- . Financial reporting should provide information about the economic resources, obligations, and net resources of an organisation, and the effects of transactions, events and circumstances that change resources and interests in those resources.
- . Financial reporting should provide information about the performance of an organisation during a period. Periodic measurement of the changes in the amount and nature of the net resources of a nonbusiness organisation and information about the service efforts and accomplishments of an organisation together represent the information most useful in assessing its performance.
- . Financial reporting should provide information about how an organisation obtains and spends cash or other liquid resources, about its borrowing and repayment of borrowing, and about other factors that may affect an organisation's liquidity.
- . Financial reporting should include explanations and interpretations to help users understand financial information provided.

#### Informational needs

While the Statement on objectives described above does deal with the informational needs of users in broad terms, it does not indicate in detail the information to be communicated to the users, nor does it distinguish between the information that should be included in the

financial statements and the information which should be provided by other means of financial reporting. The Statement also does not indicate what types of statements are to be included in the definition of "financial statements". These matters are to be considered at some future date in a further Statement of Financial Accounting Concepts.

Qualitative characteristics.

A Discussion Memorandum was issued in December 1976 dealing, in part, with the qualitative characteristics of financial information. These characteristics are regarded as standards by which the usefulness of financial statement information can and should be judged. The Board considered that there was substantial agreement about the qualities or characteristics that financial statements should have to be most useful - relevance, reliability, freedom from bias and comparability generally considered as being on most people's lists. However, it was recognised that those terms were often highly abstract and that there was often disagreement about their concrete meanings for financial statement information. Moreover, various qualities often conflicted with one another and it is, therefore, often necessary to trade-off a certain degree of one quality (e.g. reliability) in order to gain more of another (e.g. relevance). Of particular concern to the Board was how the qualities that were already widely accepted could become effective criteria or standards.

Although the section of the Discussion Memorandum dealing with "Qualities of Useful Financial Information" raised no specific issues, it asked respondents to explain what they meant by relevance,

reliability, comparability, and other "qualitative characteristics" and to illustrate those meanings in responding to the issues about elements of financial statements and their measurement (also included in the Discussion Memorandum) and by completing a set of matrixes designed to show trade-offs between various qualities or characteristics.

The Board held a public hearing in January 1978 on the sections of the Discussion Memorandum dealing with capital maintenance, qualities of useful financial information, and measurement of the elements of financial statements. The Board had also previously issued a Discussion Memorandum on "Criteria for Determining Materiality" and public hearings on this topic were held in May 1976. These Discussion Memoranda and public hearings generated numerous written and oral communications with the Board. The Board explored ways of incorporating the conceptual aspects of the materiality project into the qualitative characteristics project and formally did so in October 1978. This resulted in an Exposure Draft being issued in August 1979, and after considering all the comments received during the exposure period, the Board issued FASB Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information".

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SUMMARY OF PRINCIPAL CONCLUSIONS

Introduction

The purpose of the Statement is seen as being the examination of the characteristics that make accounting information useful. Those who prepare, audit, and use financial reports, as well as the FASB, often have to select or evaluate accounting alternatives. The characteristics or qualities discussed in the Statement are the ingredients that make information useful and are the qualities to be sought when accounting choices are made.

All financial reporting is concerned in varying degrees with decision making (though decision makers also use information obtained from other sources). The need for information on which to base investment, credit, and similar decisions underlies the objectives of financial reporting. The usefulness of information must be evaluated in relation to the purposes to be served, and the objectives of financial reporting are focussed on the use of accounting information in decision making.

The central role assigned to decision making leads straight to the overriding criterion by which all accounting choices must be judged. The better choice is the one that, subject to considerations of cost, produces from among the available alternatives information that is most useful for decision making.

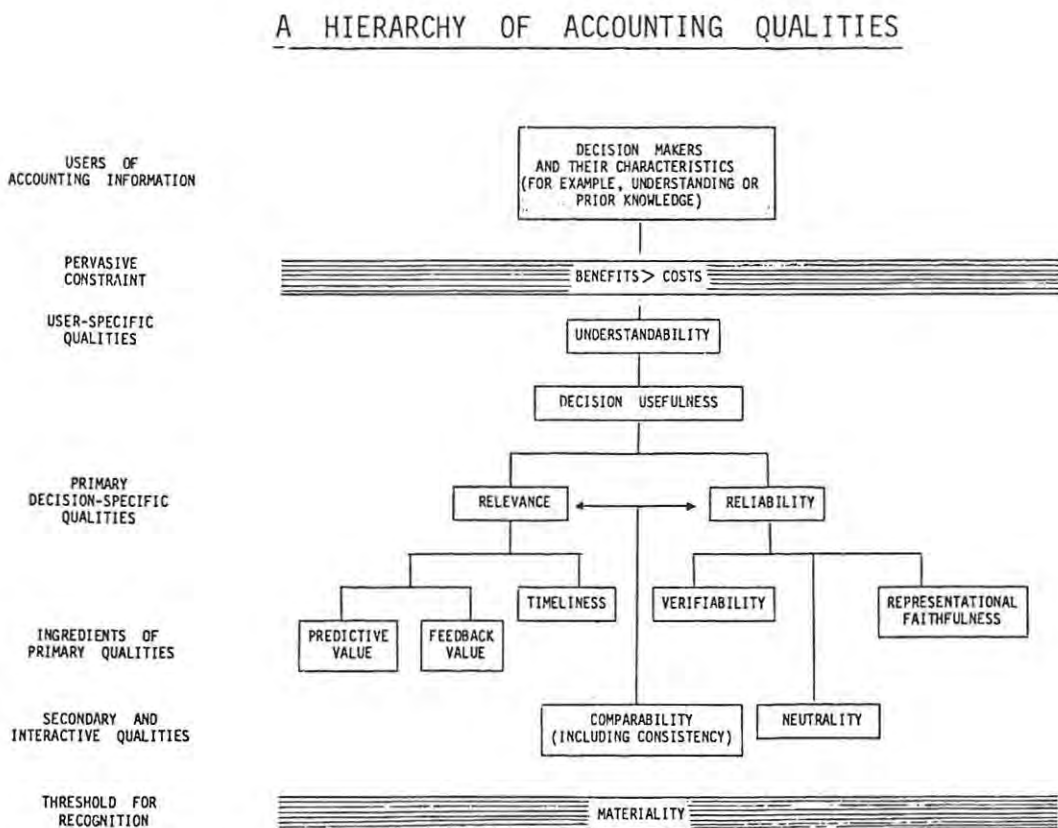
Even objectives that are orientated more towards stewardship are concerned with decisions. Stewardship deals with the efficiency, effectiveness, and integrity of the steward. To say that stewardship

reporting is an aspect of accounting's decision making rule is simply to say that its purpose is to guide actions that may need to be taken in relation to the steward or in relation to the activity that is being monitored.

### A Hierarchy of Accounting Qualities

The characteristics of information that make it a desirable commodity can be viewed as a hierarchy of qualities, with usefulness for decision making of most importance. Without usefulness, there would be no benefits from information to set against its costs.

The statement includes the following diagram of the hierarchy of accounting qualities:



### User-specific factors

In the last analysis, each decision maker judges what accounting information is useful, and that judgement is influenced by factors such as the decisions to be made, the methods of decision making to be used, the information already possessed or obtainable from other sources, and the decision maker's capacity (alone or with professional help) to process the information. The optimal information for one user will not be optimal for another. Consequently, the Board, which must try to cater to many different users while considering the burdens placed on those who have to provide information, constantly treads a fine line between requiring disclosure of too much or too little information.

The hierarchy separates user-specific qualities, for example, understandability, from qualities inherent in information. Information cannot be useful to decision makers who cannot understand it, even though it may otherwise be relevant to a decision and be reliable. However, understandability of information is related to the characteristics of the decision makers as well as the characteristics of the information itself and, therefore, understandability cannot be evaluated in overall terms but must be judged in relation to a specific class of decision makers.

### Primary decision-specific qualities

*Relevance* and *reliability* are the two primary qualities that make accounting information useful for decision making. Subject to constraints imposed by cost and materiality, increased relevance and increased reliability are the characteristics that make information a

more desirable commodity - that is, one useful in making decisions. If either of those qualities is completely missing, the information will not be useful. Though, ideally, the choice of an accounting alternative should produce information that is both more reliable and more relevant it may be necessary to sacrifice some of one quality for a gain in the other.

To be relevant, information must be timely and it must have predictive value or feedback value or both. To be reliable, information must have representational faithfulness and it must be verifiable and neutral. Comparability, which includes consistency, is a secondary quality that interacts with relevance and reliability to contribute to the usefulness of information. Two constraints are included in the hierarchy, both primarily quantitative in character. Information can be useful and yet be too costly to justify providing it. To be useful *and* worth providing, the benefits of information should exceed its cost. All of the qualities of information shown are subject to a materiality threshold, and that is also shown as a constraint.

### Relevance

- . Relevant accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of the past, present and future events or to confirm or correct prior expectations. Information can make a difference to decisions by improving decision makers' capacities to predict or by providing feedback on earlier expectations. Usually, information does both at once, because knowledge about the outcomes of actions already

taken will generally improve decision makers' abilities to predict the results of similar future actions. Without a knowledge of the past, the basis for a prediction will usually be lacking. Without an interest in the future, knowledge of the past is sterile.

- . Timeliness, that is, having information available to decision makers before it loses its capacity to influence decisions, is an ancilliary aspect of relevance. If information is not available when it is needed or becomes available so long after the reported events that it has no value for future action, it lacks relevance and is of little or no use. Timeliness alone cannot make information relevant, but a lack of timeliness can rob information of relevance it might otherwise have had.

### Reliability

- . The reliability of a measure rests in the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user that it has that representational quality. To be useful, information must be reliable as well as relevant. Degrees of reliability must be recognised. It is hardly ever a question of black or white, but rather of more reliability or less. Reliability rests upon the extent to which the accounting description or measurement is verifiable and representationally faithful. Neutrality of information also interacts with those two components of reliability to affect the usefulness of the information.
- . Verifiability is a quality that may be demonstrated by securing a high degree of consensus among independent measurers using the same measurement methods. Representational faithfulness, on the other

- hand, refers to the correspondence or agreement between the accounting numbers and the resources or events those numbers purport to represent. A high degree of correspondence, however, does not guarantee that an accounting measurement will be relevant to the users' needs if the resources or events represented by the measurement are inappropriate to the purpose at hand.
- . Neutrality means that, in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest. A neutral choice between accounting alternatives is free from bias towards a predetermined result. The objectives of financial reporting serve many different information users who have diverse interests, and no one predetermined result is likely to suit all interests.

#### Comparability and consistency

- . Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to the same benchmark.

### Materiality

- . Materiality is a pervasive concept that relates to the qualitative characteristics, especially relevance and reliability. Materiality and relevance are both defined in terms of what influences or makes a difference to a decision maker, but the two terms can be distinguished. A decision not to disclose certain information may be made, say, because investors have no need for that kind of information (it is not relevant) or because the amounts involved are too small to make a difference (they are not material). Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgement has to be made, will not generally be a sufficient basis for a materiality judgement. The Board's present position is that no general standards of materiality can be forwarded to take into account all the considerations that enter into an experienced human judgement. Quantitative materiality criteria may be given by the Board in specific standards in the future, as in the past, as appropriate.

### Costs and benefits

- . Each user of accounting information will uniquely perceive the relative value to be attached to each quality of that information. Ultimately, a standard-setting body has to do its best to meet the needs of society as a whole when it promulgates a standard that sacrifices one of those qualities for another; and it must also be aware constantly of the calculus of costs and benefits. In order to justify requiring a particular disclosure, the perceived benefits to be derived from that disclosure must exceed the perceived costs

associated with it. However, to say anything precise about their incidence is difficult. There are costs of using information as well as of providing it; and the benefits from providing financial information accrue to preparers as well as users of that information. Though it is unlikely that significantly improved means of measuring benefits will become available in the foreseeable future, it seems possible that better ways of quantifying the incremental costs of regulations of all kinds may gradually be developed, and the Board will watch any such developments carefully to see whether they can be applied to financial accounting standards. The Board cannot cease to be concerned about the cost-effectiveness of its standards - to do so would be a dereliction of its duty and a disservice to its constituents.

The Statement also includes a glossary of terms as follows:

GLOSSARY OF TERMS

Bias

Bias in measurement is the tendency of a measure to fall more often on one side than the other of what it represents instead of being equally likely to fall on either side. Bias in accounting measures means a tendency to be consistently too high or too low.

Comparability

The quality of information that enables users to identify similarities in and differences between two sets of economic phenomena.

Completeness

The inclusion in reported information of everything material that is necessary for faithful representation of the relevant phenomena.

Conservatism

A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered.

Consistency

Conformity from period to period with unchanging policies and procedures.

Feedback Value

The quality of information that enables users to confirm or correct prior expectations.

Materiality

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgement of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Neutrality

Absence in reported information of bias intended to attain a pre-determined result or to induce a particular mode of behaviour.

Predictive Value

The quality of information that helps users to increase the likelihood of correctly forecasting the outcome of past or present events.

Relevance

The capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations.

Reliability

The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent.

Representational Faithfulness

Correspondence or agreement between a measure or description and the phenomenon that it purports to represent (sometimes called validity).

Timeliness

Having information available to a decision maker before it loses its capacity to influence decisions.

Understandability

The quality of information that enables users to perceive its significance.

Verifiability

The ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.

Comments received on exposure draft and other qualitative characteristics<sup>45</sup>

Several respondents who commented on the Exposure Draft doubted that qualitative characteristics discussed in it were "operational" in the sense that they provided clear criteria for the selection of a preferred accounting method if two or more alternatives were available. Only in a few cases were other methods of selection proposed that were claimed to be more operational, and after careful review by the Board's staff, those claims were rejected as being unrealistic. The Board believes that the approach to preferability choices put forward in the Statement achieves as much operationality as is feasible in the present state of knowledge. The true test will be in the contributions that the criteria discussed can make to the formulation of future standards. Unanimous acclaim for the Board's decisions is not expected, but the

basis for those decisions should be better understood if they can be seen to be aimed at obtaining an optimal mix (as judged by the Board) of certain clearly defined informational characteristics.

A number of respondents urged the Board to include additional qualitative characteristics in its "hierarchy". All of these were considered and excluded because it was felt that they added little value to the characteristics that were already included. The more items are added, the more, it was considered, the impact of each would be diluted.

Objectivity, for example, was mentioned by several respondents. In this regard, it was decided that verifiability better expresses the quality that such respondents were concerned with preserving.

"Objective" means having an existence independent of the observer, and this does not fit accounting measurements well, especially measurements such as profit, depreciation and other cost allocations, earnings per share, etc. It was felt that accounting terminology would be improved if verifiability, which reflects what accountants do, replaces objectivity in the accountants' lexicon.

"Feasibility" was another quality for inclusion in the hierarchy, but was excluded as it was considered that it added nothing to the cost-benefit constraint. In accounting, as in other fields, many things are feasible *at a cost*, but an accounting method that, although feasible, yields information that is worth less than it costs is not a good one to choose. For this reason feasibility was excluded.

Many respondents raised the idea of "substance over form", but this was considered to be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form.

Substance over form was, in any event, considered to be a vague idea that defies precise definition.

STAGE 2.

This stage of the project is concerned primarily with the box in the hierarchy labelled "Fundamentals of Accounting and Reporting" which, in effect, deals with the "elements" of financial statements, i.e. assets, liabilities, equity, revenue, expenses, etc. This stage is a major one and is likely to cause many problems for the Board. Some of the matters that will have to be dealt with here are the definitions of the elements (an item will have to meet the requirements of the definition in order to be included in the financial statements of a business enterprise), how the elements are to be measured and disclosed, when elements ought to be formally recognised in the financial statements, which attributes of those items should be measured, which unit of measure should be used, etc.

The Discussion Memorandum issued by the FASB in December 1976 dealt mainly with elements of financial statements and their measurement. The original Exposure Draft issued on objectives was entitled "Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises". As a result of the public hearings held by the Board, as well as the letters of comment received on both the Discussion Memorandum and the Exposure Draft, the Board decided to divide the subject matter of the Exposure Draft - one part resulted in the FASB Concepts Statement No. 1 and the other became the basis of a revised Exposure Draft, "Elements of Financial Statements of Business Enterprises", issued in December 1979. Furthermore, the Exposure Draft

did not deal with the measurement of elements, but was concerned primarily with the definitions. As a result of further comments received on the revised Exposure Draft, a few minor changes in wording and organisation were made and this resulted in the issuing of Statement of Financial Accounting Concepts No. 3, "Elements of Financial Statements of Business Enterprises".

As has been mentioned, the Statement deals specifically with the definitions of the elements of financial statements - the Board emphasizes that other aspects with regard to the elements (measurement, in particular) are to be the subject of future Statements.

SUMMARY OF PRINCIPAL CONCLUSIONS OF FASB  
STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 3,  
"ELEMENTS OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES".<sup>46</sup>

- . Elements of financial statements are the building blocks with which financial statements are constructed - the classes of items that financial statements comprise. The items in financial statements represent in words and numbers certain enterprise resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims.
- . The Statement defines 10 interrelated elements that are directly related to measuring performance and status of an enterprise (other possible elements of financial statements are not addressed).
  - Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

- Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
- Equity is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.
- Investments by owners are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.
- Distributions to owners are decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.
- Comprehensive income is the change in equity (or net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.
- Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

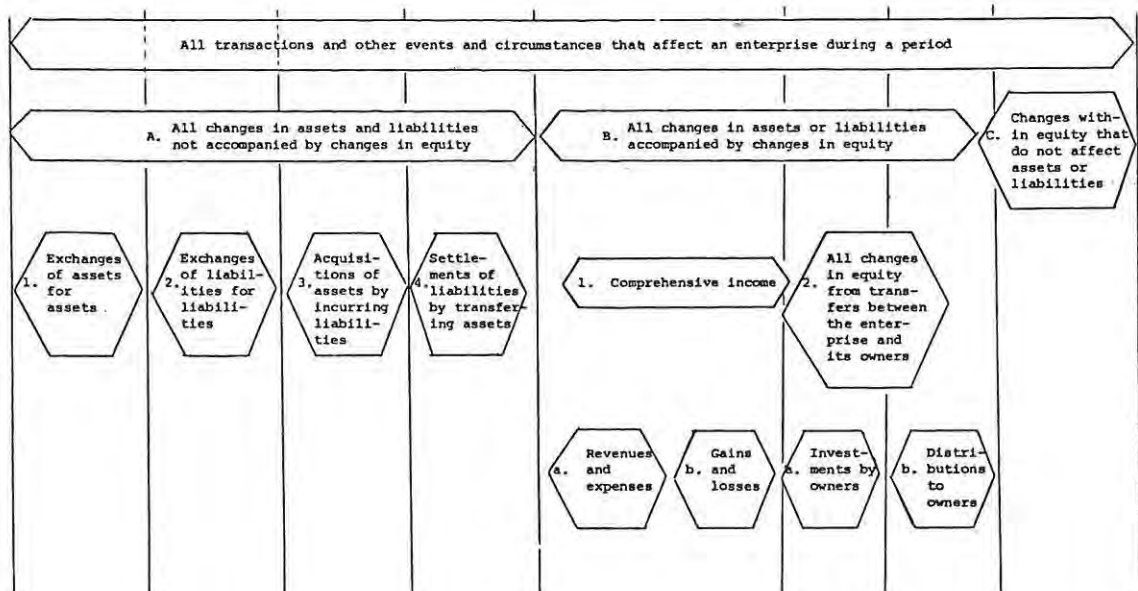
- Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
  - Gains are increases in equity (or net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
  - Losses are decreases in equity (or net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.
- . The Statement also defines or describes certain other concepts that underlie or are otherwise closely related to the 10 elements defined in the Statement, such as transactions, events and circumstances; accrual accounting; accrual and deferral (including allocation and amortization); realisation, recognition and matching. The distinction between "realization" and "recognition", for example, is described as follows:

"Realization in the most precise sense means the process of converting noncash resources and rights into money and is most precisely used in accounting and financial reporting to refer to sales of assets for cash or claims to cash. The related terms *realized* and *unrealized* therefore identify revenues

or gains or losses on assets sold and unsold, respectively. Those are the meanings of realization and related terms in the Board's conceptual framework. Recognition is the process of formally recording or incorporating an item in the financial statements of an entity. Thus, an asset, liability, revenue, expense, gain, or loss may be recognised (recorded) or unrecognised (unrecorded). *Realization* and *recognition* are not used as synonymous (sic), as they sometimes are in accounting and financial literature."<sup>47</sup>

The relationship between the various elements are set out in a diagram in the Statement as follows:

Elements of Financial Statements of Business Enterprises



The full width of the diagram, represented by the two-pointed arrow labelled "All transactions and other events and circumstances that affect an enterprise during a period", encompasses all potentially recordable events and circumstances affecting an enterprise. Moving from top to bottom of the diagram, each level divides the preceding level into classes that are significant for the definitions and related concepts dealt with in the Statement. (Size of classes does not indicate their relative volume or significance.)

- . The Statement does not define the term "earnings", which is reserved for possible use to designate a significant intermediate measure or component that is part of comprehensive income.
- . The Board expects most assets and liabilities in present practice to continue to qualify as assets or liabilities under the definitions in the Statement. It is emphasized that the definitions neither require nor presage upheavals in present practice, although they may in due course lead to some evolutionary changes in practice or at least in the ways certain items are viewed. They should be especially helpful in understanding the content of financial statements and in analysing and resolving new financial accounting issues as they arise.
- . The two appendices are not part of the definitions but are intended for readers who may find them useful. They describe the background of the Statement and elaborate on the descriptions of the essential characteristics of the elements, including some discussions and illustrations of how to apply the definitions and what they mean.

The fact that an item possesses the essential characteristics of one of the elements (in terms of the definitions) is a necessary, but not a

sufficient condition for formally recognising the item in the financial statements of the entity. To be included in the financial statements an item must not only qualify under the definition of an element, but must also meet the criteria for recognition and must have a relevant attribute (or surrogate) that is capable of reasonably reliable measurement or estimate. Thus, some items that meet the requirements of the definitions may have to be excluded from formal incorporation into the financial statements because of recognition or measurement considerations, e.g. uncertainty existing at the time of measurement. Matters involving measurement problems, effects of uncertainty, reliability and other such factors may, therefore, be significant in applying a definition, but they are not part of the definition. These problems once again point to the fact that all practical financial accounting and reporting is subject to various limitations. Definition, recognition, measurement and display are separate in the Board's conceptual framework and the latter three are not dealt with in any detail in the Statement, but are to be examined in later Statements.

#### EARNINGS, COMPREHENSIVE INCOME AND MEASUREMENT

With the problems related to the definitions of the elements out of the way, the next major hurdle, namely the phase of the conceptual framework dealing with earnings, comprehensive income and the measurement thereof, is probably going to be the most difficult section of the entire project. Many authoritative divergent and often conflicting views will have to be analysed. With general acceptance by all interested parties being so important to the success of the Board's conceptual framework project, it will be interesting to see how a definitive approach to the determination of earnings and comprehensive income is going to be arrived at.

The FASB has already indicated clearly that "the primary focus of financial reporting is information about an enterprise's performance by measures of earnings and its components".<sup>48</sup> In furtherance of this objective, the FASB is, at present, undertaking a comprehensive review of the form and content of earnings reports. Improvements in the quality of earnings reports will provide a more sound basis for the assessment of the amounts, timing and uncertainty of future cash flows to an enterprise. This will, furthermore, enable users of financial reports to use this improved report of past earnings as a basis for the assessment of future earnings, and to adjust their assessments of future earnings in order to derive an assessment of future cash flows. Based on the outcome of the FASB's projects on earnings, comprehensive income and the measurement thereof (as well as other related projects such as the funds flow and liquidity project which has now been coordinated with the reporting earnings project)<sup>49</sup> there is a possibility that the income statement, as we now know it, will have to be changed dramatically. This is hinted at in the Discussion Memorandum issued by the FASB in July 1979.<sup>50</sup>

The Discussion Memorandum considers various methods of expanding the information contained in present income statements. The intention is, clearly, not to recommend that income statements should be amended to incorporate such information as discussed in the Discussion Memorandum (DM) - rather it is intended to promote discussion and comment from all interested parties in order to assist the FASB with the project. Many of the changes discussed in the DM would undoubtedly involve an increase in cost. Apart from the costs generally associated with the provision of additional information (costs of collecting, disclosing and

auditing the data), there is also the cost attributable to the competitive disadvantage that might result from disclosing some of the types of information discussed.

A 1978 study conducted by Robert K. Mautz and William G. May for the Financial Executives Research Foundation, which included a survey of 2 000 financial executives (479 responding) and 1 000 financial analysts (147 responding) concludes that:

The potential for a disclosure to create competitive disadvantage increases directly with:

1. The timing of the event or activity being disclosed, e.g. current or past activities or events versus future activities or events.
2. The extent or specific detail disclosed.
3. The number and variety of interests finding the disclosed information useful.
4. The extent to which disclosure relates to specific measures of market success, e.g. disclosure of profitability by narrow product lines versus broad product lines, disclosure of the names of major customers versus indicating only the existence of major customers, etc.
5. The likelihood that the disclosure could destroy or threaten a competitive advantage.<sup>51</sup>

Specific types of disclosure regarded as potentially harmful by the respondents to the 1978 survey included line-of-business information (e.g. sales, costs and income by product lines), product development projects, pricing, expansion plans and market penetration plans. But information of that type might well prove useful to users in their assessments of future revenues and expenses.

Furthermore, as Norman N. Strauss and Alex T. Arcady point out,<sup>52</sup>

"In some respects, disclosing such information results in a vicious circle. An enterprise provides more information about its operations in the hopes of providing information to assist users' assessments of cash flows, a competitive disadvantage occurs and, as a result, future cash flows are adversely affected."

This problem will have to be given due consideration by the FASB in their reporting earnings project.

The Discussion Memorandum on reporting earnings, in examining possible extensions to disclosure, discusses, amongst other issues: regular versus irregular earnings, fixed and variable costs, gross margin versus contribution margin, operating earnings, a multiple-step versus a single-step income statement and including or excluding certain items from net income. In addition, the DM discusses and solicits commentary on whether companies should present five-year summaries of earnings information, earnings per share information and segment data. Also discussed is the possibility that certain items should not be shown in the income statement, but, instead, should be direct adjust-

ments to shareholders' equity, i.e. whether the income statement should report comprehensive income or only a portion of it (possibly "earnings" component of comprehensive income).

Clearly, the reporting of earnings in the income statement cannot be finalised independently of the questions of "recognition" and "measurement", in particular whether the asset/liability or the revenue/expense view of earnings is to be adopted (or possibly a combination of both). This problem has already been discussed in some detail in Chapter 5.

#### CONCLUSION ON FASB CONCEPTUAL FRAMEWORK PROJECT.

It has already been pointed out that the aim of the FASB in undertaking this project is to establish a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting. No one should, however, be deluded into believing that such a framework will automatically lead to a single definitive answer to every specific financial accounting problem. A conceptual framework can only provide guidance in identifying the relevant factors to be considered by standard setters, managers and auditors in making the judgements that are inevitable in financial reporting decisions.

The FASB appears to be determined to succeed where its predecessors have failed, and a significant proportion of its time is being spent on the conceptual framework project. It is generally agreed that the credibility and perhaps even the very existence of the FASB is dependent on the success of this project.

## CANADA

The Canadian Institute of Chartered Accountants (CICA) commissioned a research study at the beginning of 1976 as its response to the Trueblood Report and The Corporate Report (UK study - see next section on page 240). The Study Group's terms of reference were:<sup>53</sup>

1. To identify the various groups who have a legitimate claim to corporate information.
2. To examine the objectives of corporate reports published in the private sector and the underlying concepts on which they rest and to recommend the form of financial reporting needed.
3. To identify the entities that should report publicly.
4. To identify the type of information that each reporting entity should provide to the various user groups.
5. To consider the implications to the auditor of the conclusions of the Study.
6. To make specific proposals for implementing the conclusions arrived at in the Study.

The aim of the Study Group was not to formulate a conceptual framework along the lines of the FASB project - rather, it wished to generate discussion and debate among various groups including accountants, businessmen, academics, financial analysts, and others with an interest in financial reporting.

In developing the Study, reference was made to the important work being undertaken on financial reporting in other countries, particularly in the United States. Consultative meetings were held with interested groups and individuals across Canada. The Study Group ran into

troubles, however, when they tried to produce an acceptable report and consequently enjoined the assistance of Professor Edward Stamp, Director of the International Centre for Research in Accounting in the University of Lancaster to produce a final Research Study. Stamp was given a period of three months to complete the project and, after holding consultations with a number of accountants and lawyers across Canada, produced the Research Study, "Corporate Reporting : Its Future Evolution".<sup>54</sup>

In short, the Study proposes objectives that are predicated on legitimate user needs and interests and on the importance of gaining general acceptance for accounting standards. It proposes a set of criteria for the assessment of the quality of accounting standards and of corporate accountability and recommends a programme for action by accounting standard setting bodies (the Accounting Research Committee in Canada). Stamp points out that much further thought and work will be required in order to make the proposals operational.<sup>55</sup>

The Report considers the FASB's approach to the development of a conceptual framework and comes to the conclusion that this approach is not likely to be appropriate to the needs of the various user groups in Canada. The FASB's approach is considered to be too definitive, too authoritarian and too dependent on normative or axiomatic solutions, apart from being too narrow in its scope in that the FASB focusses primarily on the needs of investors and creditors, whereas the Report considers that the Canadian approach should acknowledge the interests of a wider group of users. The Report points out that it should not be regarded as strange that the US approach is not considered entirely

appropriate for Canada considering the history and the legal and social development of the two countries. This, of course, does not mean that accounting standards developed in Canada must necessarily be different in kind from those issued in the United States. On the contrary, the fewer such differences the better; but the differences in environment mean that a different approach is considered necessary for Canada.

#### The nature of accounting

Part of the Report is devoted to considerations of the nature of accounting. "Is it an art, a language, an axiomatic discipline like geometry, a science, a kind of legalistic discipline depending upon rules and definitions propounded by authority, or is it *sui generis* - a subject that has to develop its own mode of operation and development?"<sup>56</sup> Each of these possibilities are explored, but the conclusion reached is that accounting, and accounting standards more particularly, are similar in nature to legal laws. "They can be enacted, but they need an enforcement system or mechanism to ensure that they are obeyed, and they are unlikely to be obeyed at all unless there is a consensus within the community that they are reasonable".<sup>57</sup>

The Report then goes on to recommend that a conceptual framework should be established in an evolutionary manner along the lines of the common law. A set of criteria should be established that could be used by preparers, standard setters, and users alike in assessing and discriminating between alternative standards and in judging the extent to which preparers discharge their duty of accountability to users.

The task of accountants is regarded as being to provide measurements that are as objective and as useful as possible in portraying what has happened in the past, so that users can make better predictions of what is likely to happen in the future. It is suggested that a conceptual framework that is narrow and definitive in nature and which attempts to formulate one definition of economic reality acceptable to all users of financial reports has little chance of success, as a single definition of economic reality is unlikely to be useful to all user groups. This approach, it is contended, will also stifle innovation in accounting and corporate reporting. In this regard also the Report suggests that serious consideration should be given to the possibility of introducing multi-column financial statements, each column depicting the financial position and results of the operations on a different basis. In this way, it is thought, the needs of all the user groups could be satisfied, provided full information were disclosed explaining each basis.

#### Objectives of financial reporting and user groups.

The Study does not attempt to define the objectives of financial reporting in the way that the FASB has done. The Study emphasizes that "it is not possible to define the objectives of corporate financial reporting in one sentence, or even in a single paragraph..."<sup>58</sup>, but instead attempts to discuss the needs of various user groups and then states that "an important objective of financial reporting is the provision of useful information to all the potential users of such information in a form and in a time frame that is relevant to their various needs".<sup>59</sup>

A list of the "legitimate" user groups and a summary of their needs as seen by the Report is included in Chapter 5 (see pages 130 - 132).

Criteria for assessment of standards

The Study proposes that accounting standards should play a central role in the development and future evolution of a satisfactory system of corporate reporting, particularly in resolving conflicts or potential conflicts between the interests of different parties (preparers, auditors, users).

The Study defines 20 criteria, and proposes that they should form the central feature of decision-making on accounting standards in the future. In attempting to meet the needs of users, trade-offs must be made between various criteria (notably, for example, between objectivity and relevance) so as to achieve what is considered to be an optimal balance. It is hoped that the operational value of the criteria can be improved as they are used, and as users gain experience with them, in much the same way as the principles of jurisprudence are refined by lawyers and judges in the courts.

The following table sets out in abbreviated form the criteria for assessment of standards and of accountability:<sup>60</sup>

CRITERIA FOR ASSESSMENT OF STANDARDS AND OF ACCOUNTABILITY			
Criteria that may be in conflict with those in the other column, or require "trade-offs"		Criteria that are compatible with those in both of the first 2 columns	Constraints that may apply against any of the criteria in the first 3 columns
Relevance (to users' needs) Comparability Timeliness Clarity Completeness, or Full Disclosure	Objectivity (i.e. not subjective) Verifiability Precision	Isomorphism Freedom from bias Rationality Non-arbitrariness Uniformity	Substance over form Materiality Cost/benefit effectiveness Flexibility Data availability Consistency Conservatism (a very minor constraint)

The first two columns list the criteria that are, to a degree at least, sufficiently different in character that improvements made in respect of a criterion in the first column may have to be made at the expense of a lower adherence to one or more criteria in the second column, or vice versa. The third column lists criteria that are compatible with those listed in each of the first two columns - to take an example, an improvement in the rationality of an accounting standard, or of the contents of a set of financial statements, will generally be consistent with improved objectivity and improved relevance. The criteria listed in the fourth column constitute constraints that may apply against any of the criteria listed in the first three columns. Thus, for example, if a proposed standard is not cost effective (i.e. the costs of it are likely to exceed the benefits to be derived), or if data required by the standard are unlikely to be available, then this may militate against the introduction of the change no matter how attractive it may seem in terms of the criteria listed in the first three columns. Similarly, if an item is clearly not material, then it makes no difference whether it is verifiable, free from bias, etc.

#### The jurisprudential approach

It is recommended that documents issued by the Accounting Research Committee (ARC) in Canada, whether they be discussion memoranda, exposure drafts, or standards, should justify the positions that are taken in the documents by reference to the criteria and user needs outlined above. Comments and criticisms should be sought from all interested parties and these too should be justified in relation to the same sets of criteria that the ARC uses.

It is further contended that if an evolutionary system is to work in accounting, as it has in the law, it will be necessary to ensure that precedents, as they are established, are consistent, and to provide some means of appeal. These are the two features which the present accounting system lacks and means will have to be established whereby this can be overcome.

The Study cites a proposal that was made in an Australian Society of Accountants' Endowed Lecture in 1966, involving the establishment of a Board of Review to deal with these two issues.<sup>61</sup> The function of the Board, in brief, is given as advising, and if necessary, giving rulings, to auditors on any problems relating to accounting principles that might arise in an auditor's practice and which he thought fit to bring to the Board. The onus in all cases would be upon the auditor to decide whether it was necessary to approach the Board with the problem, or, having approached the Board, whether to accept its ruling.

Membership of the Board would be drawn from amongst the most experienced and able members of the profession, and among the benefits that might be expected to flow from its establishment would be the development of precedents in accounting, and the consequent evolution of accounting standards in a consistent and orderly fashion. Auditors who accepted Board rulings could expect this to weigh heavily in their favour should they ever subsequently be brought to Court on the issue involved.

The Study considers that a solution of that kind would have great merit. Two potential problems, however, are seen as being, firstly that it might be difficult to attract people of the right calibre to accept lifetime appointments to such a Board and, secondly, the introduction

of another layer of debate into the process of settling urgent and contentious issues between auditors and their clients would almost certainly have the effect of delaying the publication of financial statements.

The most feasible alternative, therefore, is seen as the ARC adopting a set of objectives and criteria (similar to the ones outlined above) and to use these as an integral part of their procedures in developing standards designed to meet the user needs. The adoption of these proposals, the Study suggests, will help in moving towards a "common law" rather than a "civil law" process of solving standard-setting problems. There will, however, be a problem with regard to confidentiality which will result in the precedents established in day-to-day practice between accounting firms and their clients remaining confidential, instead of becoming available to all. For this reason, and until such time as a Board of Review may be established, the Study suggests that it will be very important for public accounting firms and their clients to keep the ARC as fully briefed as possible on the day-to-day problems and the solutions that are being devised to deal with them. This will help to keep the ARC up to date on emerging problems and aid it in its task of developing standards that are as relevant and as useful as possible.

So far as an appeal procedure is concerned, the Study argues that this is perhaps not as necessary as it is in the law (where penalties or damages or other coercive remedies are imposed by the Courts). If a disagreement between a company and its auditors cannot be resolved, thus resulting in a qualified audit report, it is argued that the facts

will thereby become publicly known and the users can make their own judgement about what to do next. In that sense the appeal against non-implementation of standards is to the general public.

So far as appeal by preparers, users or auditors against the standards themselves is concerned, this, the Study suggests, should be made privately to the ARC, who should require the plaintiff to show how his argument is supported and justified by reference to the objectives and criteria outlined above.

Finally, if this system does not turn out to be effective, it is suggested that it may become necessary to introduce something along the lines of the Board of Review referred to above.

Will this approach work?

Many preparers, users and auditors are not in favour of revolutionary change to the accounting system. To this extent the Canadian approach is certain to be more attractive than an approach which recommends, for example, an entirely different method of determining income, valuing assets and liabilities, etc. The FASB approach has not yet reached the stage where it can be assessed whether fundamental or "revolutionary" change to the present system is proposed. The Canadian approach, therefore, is likely to appear more attractive to many. Whether or not it will in time overcome the defects and criticisms levelled at the present system of accounting is another matter.

The main problem, in my opinion, with the Canadian proposals is the degree of subjectivity involved in setting standards. It is one thing

to consider users' needs and to decide on criteria that should be used in the assessment of standards and of accountability, but it is another matter entirely to attempt to put this into practice in such a way as to satisfy most users' needs. The relative importance of the criteria and the degree to which one should make trade-offs between various criteria cannot be quantified and is highly subjective. Furthermore, different groups (of preparers, auditors and/or users) will have different views on these matters which may result in less "general acceptance" than is contemplated.

On the other hand, the extent to which the Study proposes that problems associated with compliance with the various accounting standards, or with the very contents of the standards themselves, should in some way be made available to a wider range of interested parties is to be welcomed. The idea of a Board of Review also is an interesting one that could assist greatly in the establishment of precedents and, generally, in making the product of the accountant (and auditor) as useful as possible to as many users with a legitimate interest in the affairs of the company as is possible.

The CICA will, no doubt, debate the issues raised in the Study and also watch the progress made on the FASB conceptual framework project for some time before reaching a conclusion as to the direction in which corporate reporting should evolve in the future.

UNITED KINGDOM

The Accounting Standards (Steering) Committee (ASSC) of the Institute of Chartered Accountants in England and Wales set up a working party in October 1974 to "re-examine the scope and aims of published financial reports in the light of modern needs and conditions", which resulted in the publication in August 1975 of a discussion paper "The Corporate Report". The Report did not deal in any detail with the problem of asset valuation and income measurement, but concentrated rather on examining the fundamental objective of the annual corporate report and the process of communicating this information to the users. The central point at issue was whether the objective should be the traditional one of serving the shareholder and creditor, or whether it should be construed more widely to embrace other sectors of society.

The Report considered that "The fundamental objective of corporate reports is to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information".<sup>62</sup> "Reasonable rights" to information are considered to be held not solely by the owners, creditors or managers of the company. It is suggested that account should be taken also of "that larger class of general users to whom a responsibility to report is owed and who are not in a privileged position to enforce special demands".<sup>63</sup> These general users are defined as the employee group, the analyst-adviser group, the business contact group (including customers, suppliers and, in a different sense, competitors and business rivals), the government and the public. A widening of public accountability generally is, therefore, sought, not just among companies but also local authorities, professional bodies,

trade unions, pension schemes and even charities, so as to achieve an acceptance by all those concerned of the need for full and frank disclosure. In this way entities can pursue their objectives without "incurring the opprobrium resulting from operating beyond the bounds of socially acceptable behaviour".<sup>64</sup>

The drawbacks concerning the current scope and content of published financial statements of business enterprises were seen as including the following:<sup>65</sup>

- (a) The maximisation of short term profit is not the sole aim of modern business enterprises although by making the profit figure the keynote figure of financial reports, users are encouraged to believe that it is the sole aim.
- (b) The figure of audited profit for the year is presented as being definitive although it is well known to be subject to many uncertainties.
- (c) As noted, users are encouraged to appraise the results of business enterprises on the basis of short term results. Management, consequently, may tend to concentrate on short term results rather than the longer view.
- (d) The format implies that the proprietors are the dominant interest and masks acknowledged responsibilities to other user groups.

In order to overcome these drawbacks the Report recommends that, in addition to the Income Statement, Balance Sheet and Funds Statement, the following statements also be included in the corporate report:<sup>66</sup>

- (a) A statement of value added, showing how the benefits of the efforts of an enterprise are shared between employees, providers of capital, the state and re-investment. This statement will assist users to evaluate the economic performance of the entity.
- (b) An employment report, showing the size and composition of the workforce relying on the enterprise for its livelihood, the work contribution of employees and the benefits earned. This report will assist users in assessing the performance of the entity, evaluating its economic function and performance in relation to society, assessing its capacity to make reallocations of resources and evaluating managerial performance, efficiency and objectives.
- (c) A statement of money exchanges with government, showing the financial relationship between the enterprise and the state. This statement will assist users to assess the economic function of the entity in relation to society.
- (d) A statement of transactions in foreign currency showing the direct cash dealings of the reporting entity between this country and abroad. This statement will assist users to judge the economic functions and performance of the entity in relation to society

and the national interest. It may also provide information of assistance in assessing the stability and vulnerability of the reporting entity and in estimating its capacity to make future cash payments.

- (e) A statement of future prospects, showing likely future profit, employment and investment levels. This statement will assist users to evaluate the future prospects of the entity and to assess managerial performance.
- (f) A statement of corporate objectives showing management policy and medium term strategic targets. This statement will assist users to evaluate managerial performance, efficiency and objectives.

The Report also states that historical cost figures alone are inadequate, and that the thrust of development should be towards the adoption of current value systems - defined as either replacement cost, net present value, net realisable value or "value to the firm", but does not undertake a detailed evaluation of these methods. It does, however, emphasize the importance of continuing research into many areas of accounting including current value systems.

Whereas the FASB and CICA Studies agree that any oversimplification of accounting representations that are essentially complex will only serve to misrepresent reality, the Corporate Report appears to come out strongly in favour of producing simplified versions and special-interest

extracts of corporate reports. With regard to multi-column financial statements, the Report warns that providing several appropriate measurement bases tailored to different users' needs would involve an enormous change in accounting practice and might fail the test of usefulness by impairing comprehensibility. It does, however, mention that this matter should be given further consideration by the profession.

With regard to qualitative characteristics of financial information, the Report simply mentions a preference for financial information that is relevant, understandable, reliable, complete, objective, timely and comparable. It also refers to the practical limitations of cost and confidentiality and recognises that the economic substance of corporate reports must take precedence over their legal and technical form.

The Report makes no attempt to develop or advocate a conceptual framework along the FASB lines. The aim is simply to indicate the concepts that should underlie the corporate report and, in practical terms, to indicate the broad framework around which the report should be structured.

The Corporate Report was published only a few months before the Sandilands Report appeared and, although it (The Corporate Report) attracted a fair amount of favourable comment from the academic community as well as from selected practitioners, according to Stamp, the British professional bodies "virtually washed their hands of it".<sup>67</sup> The Sandilands Report was based on extensive research and discussions with interested groups (which is probably one of the main shortcomings of The Corporate Report), examined various bases of asset valuation and

income measurement in some detail, and finally advocated the use of the current cost method of accounting. This Report, therefore, attracted far greater interest and this added to the apparent lack of interest shown in The Corporate Report.

The Corporate Report was not referred to at all in "Setting Accounting Standards", a document published by the Accounting Standards Committee (ASC) in 1978. Public hearings held by the ASC in 1979 to receive comments on this document, however, demonstrated support (especially from the major professional firms) for The Corporate Report and for a conceptual frame. Professor Macve of the University College of Wales, Aberystwyth, was, accordingly, commissioned to make a study with the following terms of reference:

"To review critically the current literature and opinion in the UK, US and elsewhere with a view to forming preliminary conclusions as to the possibilities of developing an agreed conceptual framework for setting accounting standards and the nature of such a framework; and to identify further areas for research."<sup>68</sup>

This Study will, no doubt, examine closely the events in the United States and Canada before reaching its conclusions.

## CONCLUSION

The more one reflects on the nature of the deficiencies in modern financial accounting and corporate reporting and the controversies which have resulted therefrom over the years, the more it seems apparent that accounting has lost touch with the needs of the modern world. It has, in a phrase, failed to adapt and evolve. Far too many accountants have adopted an attitude that can be summarized rather crudely as "There is nothing wrong with accounting that a good public relations campaign won't cure". These accountants seem to believe that, if layman could only be taught to understand the limitations of conventional financial statements, they would soon stop complaining about the inadequacies which have become so apparent in recent years. These professional apologists seem to regard the "limitations of financial statements" as immutable facts of life with which the world has to learn to live.

In truth, such "limitations" are often the mark of the failure of the profession to adapt its principles and practices to the needs of a modern world. Unless the profession soon learns to adapt itself it will become irrelevant and dispensable.

A conceptual framework is needed whether or not we have standards. Standards have increasingly come to be recognised as ad hoc solutions to problems that arise. While recognising the need to have firemen and water supplies, rather than architects, when a building is on fire,<sup>69</sup> it is, nevertheless, essential to have architects working on the long-term problems facing the profession.

The statements of concepts published to date by the FASB would seem to point to an intention to design a framework which is not as narrow in its scope as was first thought by the Canadian Study Group - it may well be that the Canadian Study has had an influence on the FASB in this regard. Many countries, including South Africa, will be following these developments of the FASB (and those of the CICA) with much interest. The dangers of adopting the findings of an overseas Study Group of this nature in its entirety must, however, be borne in mind. Each country will have to consider which approach will, in the final analysis, best suit its own circumstances and environment. It will be interesting to see the direction which the South African profession will seek to follow in the years ahead.

CHAPTER 7

Footnotes

1. 'History of the Accounting Procedure Committee - from the Final Report', *The Journal of Accountancy*, (November 1959), pp. 70-71.
2. *ibid.*, p. 70.
3. Carmen G. Blough, 'Development of Accounting Principles in the United States', In: *Berkeley Symposium on the Foundations of Financial Accounting*, (Berkeley, 1967), pp. 7 - 8.
4. Although the 1936 AAA Statement was not considered by the CAP to be of sufficient detail, it probably had some impact by serving as a broad outline for a conceptual framework for financial accounting and reporting. Regarding the 1936 AAA Statement, John Carey has observed: "The issuance of this statement irritated many practitioners of accounting. It appeared to be a step toward establishment of a uniform code of accounting principles - a concept formally rejected by the Institute, which was co-operating with the SEC in the 'common-law' approach of settling each case on its merits in view of the surrounding circumstances." (John L. Carey, *The Rise of the Accounting Profession*, Volume II, (New York, 1970), p.9.)
5. Midyear Report of the Committee on Accounting Procedure, *1940 Year-book of the American Institute of (Certified Public) Accountants*, p. 161.
6. 'Reports on "An Introduction To Corporate Accounting Standards" and "A Statement of Accounting Principles"', *The Journal of Accountancy*, (January 1941), pp. 48 - 62.
7. Carey, *op. cit.*, pp. 16 and 49.
8. 'Corporate Accounting Principles', *The Journal of Accountancy*, (October 1945), pp. 259 - 266.
9. Blough, *op. cit.*, p. 11.
10. Maurice Moonitz, *Accounting Research Study No. 1*, "The Basic Postulates of Accounting", (New York, 1961), pp. 4 - 5.
11. Maurice Moonitz, *Studies in Accounting Research No. 8*, "Obtaining Agreement on Standards in the Accounting Profession", (Sarasota, 1974), p. 18.
12. 'Comments of Leonard Spacek', in Moonitz, "The Basic Postulates of Accounting", *op. cit.*, pp. 56 - 57.
13. 'Comments on "The Basic Postulates of Accounting"', *The Journal of Accountancy*, (January 1963), pp. 45 - 46.
14. William J. Vatter, 'Postulates and Principles', *Journal of Accounting Research*, (Autumn 1963), pp. 182 - 3.
15. *ibid.*, p. 183.

16. Stephen A. Zeff, 'Discussion', In: *Berkely Symposium on the Foundations of Financial Accounting*, *op. cit.*, pp. 24 - 25.
17. *Statement by the Accounting Principles Board*, (April 13, 1962).
18. Moonitz, 'Obtaining Agreement of Standards in the Accounting Profession', *op. cit.*, p. 21.
19. *Report of Special Committee on Opinions of the Accounting Principles Board*, (New York, 1965) p. 12.
20. *ibid.*, p. 13.
21. Clifford V. Heimbucher, 'Improving Financial Accounting and Reporting', In: *The Fourth Annual Hayden, Stone Accounting Forum*, (November 18, 1965), p. 15.
22. *ibid.*, p. 15.
23. Maurice Moonitz, 'The Accounting Principles Board Revisited', *The New York Certified Public Accountant*, (May 1971), p. 342.
24. *Statement of Accounting Principles Board No. 4*, 'Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises', (New York: AICPA, 1970), para. 40.
25. *Accounting Research Bulletin No. 9*, 'Report of Committee on Terminology', (New York: AICPA, 1941), p. 67.
26. Yuji Ijiri, 'Critique of the APB Fundamentals Statement', *The Journal of Accountancy*, (November 1971), p. 45.
27. Moonitz, "Obtaining Agreement on Accounting Standards", *op. cit.*, p.22.
28. Paul F. Grady, 'Development of Accounting Principles - A Review of the Past Fifty Years', *The Florida Certified Public Accountant*, (January 1972, pp. 20 - 21.
29. George J. Staubus, 'An Analysis of APB Statement No. 4', *The Journal of Accountancy*, (February 1972), pp. 36 - 43.
30. Ijiri, *op. cit.*, p. 50.
31. Financial Accounting Standards Board (FASB), *Status Report No. 1*, (June 18, 1973), p.1.
32. FASB, *Status Report No. 8*, (December 27, 1973), pp. 1 - 2.
33. American Institute of Certified Public Accountants (AICPA), *Objectives of Financial Statements*, 'Report of the Study Group on the Objectives of Financial Statements', (New York, October 1973).
34. FASB, Discussion Memorandum, "*Conceptual Framework for Accounting and Reporting : Consideration of the Report of the Study Group on the objectives of Financial Statements*", (Stamford, 1974).

35. *ibid.*, p. 4.
36. AICPA, *Objections of Financial Statements*, *op. cit.*, Chapter 10.
37. 'Conceptual Framework for Accounting and Reporting : Consideration of the Report of the Study Group on the Objectives of Financial Statements', *op. cit.*, p. 15.
38. John C. Burton, 'A Symposium on the Conceptual Framework', *The Journal of Accountancy*, (January 1978), pp. 53 - 58.
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40. FASB, *Statement of Financial Accounting Concepts No. 4*, 'Objectives of Financial Reporting by Nonbusiness Organisations', (December 1980), paragraph 01.
41. *ibid.*, paragraph 06.
42. *ibid.*, paragraph 23.
43. *ibid.*, paragraphs 35 - 55.
44. FASB, Statement of Financial Accounting Concepts No. 2, 'Qualitative Characteristics of Accounting Information', *Journal of Accountancy*, (August 1980), pp. 105 - 120.
45. *ibid.*, paragraphs 152 - 160.
46. FASB, Statement of Financial Accounting Concepts No. 3, 'Elements of Financial Statements of Business Enterprises', December (1980), *Journal of Accountancy*, (March 1981), pp. 100 - 111.
47. *ibid.*, paragraph 83.
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50. FASB, Discussion Memorandum, *Reporting Earnings*, (Stamford, Conn., July 31, 1979).
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54. Edward Stamp, 'Accounting Standards and the Conceptual Framework : a plan for their evolution', *The Accountants' Magazine*, (July 1981), p. 217.
55. *ibid.*, p. 217.
56. CICA, *Corporate Reporting : Its future Evolution*, *op. cit.*, p. 76.
57. *ibid.*, p. 78.
58. *ibid.*, p. 32.
60. *ibid.*, p. 55.
61. *ibid.*, pp. 95 - 6.
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63. *ibid.*, p. 9.
64. D.P. Tweedie, 'The Corporate Report : Evolution or Revolution?' *The Accountants' Magazine*, (October 1975), p. 343.
65. *The Corporate Report*, *op. cit.*, p. 47.
66. *ibid.*, p. 48.
67. Edward Stamp, *op. cit.*, p. 216.
68. *Setting Accounting Standards*, Accounting Standards Committee, (London 1981), p. 33.
69. An analogy drawn by Stamp, *op. cit.*, p. 216.

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