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An address by Alvin R. Jennings, nominee for  
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HOW CAN CPAs MEET PRESENT DAY  
CHALLENGES OF FINANCIAL REPORTING?

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AN ACCOUNTANT'S VIEWPOINT

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There are few, if any, undertakings in which the process of self-examination is not helpful. In our own case it is indispensable if we are to avoid stagnation.

Many groups have legitimate and vital interests in the economy. Often these interests are shared in common although at times they are diverse. Some of these groups depend more frequently than do others on financial data; it is important to all of them that financial reporting should be soundly based.

We CPAs represent ourselves as able to serve these interests with competency and independence. Their reliance upon us clearly entitles them to question and criticize. We welcome their participation and are particularly privileged to have this opportunity of getting the points of view of Mr. Barr and Mr. Crane on how well we are measuring up to our responsibilities.

The topic of our discussion, and the plans of the Committee which arranged this meeting, suggest something in the nature of a debate in which my role is to act as a defender of the faith. I hope you will not be too disappointed if no major controversy develops because I expect to agree with our other speakers if I think they are right - particularly if they have any nice things to say about us!

PLEASE TO

We serve in two capacities - as accountants and as auditors. Often the roles overlap. Our subject today could conceivably involve us in re-examination of our activities in both roles. To avoid creating a false sense of expectancy, I would like to make it clear that I propose to address my remarks primarily to the consideration of the question of how successful we have been in our narrowing areas of differences and inconsistency in the preparation and presentation of financial information which, of course, relates almost exclusively to our role as accountants.

Many of the criticisms which have been leveled at our profession and which suggest failure on our part to provide and maintain proper standards of financial reporting seem to me to involve a misunderstanding of the nature of financial statements and of accounting as well as of the limitations which are inherent in both. We are told that the public finds reports inadequate and insufficient; that stockholders have need for more quality and less quantity; and that it is our responsibility that it is not possible to compare operating results of companies within a given industry or one industry with another because of the wide choices in accounting methods which are available.

It is difficult to deal with some of these criticisms because they are expressed in such broad terms as to make it a matter of speculation as to the precise nature of the complaint. In part, the difficulty arises because people impute to the accounting function a degree of certainty which it does not have and which it never can attain. Many years ago Mr. George O. May said "accounting can rise no higher than the scale of certainty of the events which it reflects." A fuller appreciation of this truth would do much to bring matters back into proper focus.

We must recognize, too, that often variations in reported operating results among companies in a given industry are reflections of differences in the quality of management and of variations in basic business policies. It seems clear that it is not a proper function of accounting to control such decisions. The continuity of earning capacity depends upon economic forces and the skill of management, and not upon accounting. Things which basically are not comparable cannot be made so merely by refinement of accounting principles.

GENERALLY ACCEPTED PRINCIPLES - THE DEVELOPMENT OF A STANDARD:

We have done a great deal to try to explain the real nature of financial statements and to warn of their limitations. Twenty-five years ago a special committee of our Institute on Cooperation with Stock Exchanges engaged in a series of discussions and correspondence with representatives of the New York Stock Exchange. The purpose of these discussions was concisely stated in these words:

". . . . there are two major tasks to be accomplished - one is to educate the public in regard to the significance of accounts, their value and their unavoidable limitations, and the other is to make the accounts published by corporations more informative and authoritative."

The correspondence pointed out that the nature of the balance sheet, and therefore of the income account, was generally misunderstood, even by those who might be presumed to be sophisticated. It stressed the fact that the fundamental process of allocation of expenditures to operations of a series of years, which is the critical point of all accrual accounting, necessarily depended upon a body of assumptions and conventions which were based in part

upon theoretical, and in part, on practical considerations. It observed that, while there was fairly general agreement on certain broad principles to be followed in the formulation of conventional methods of accounting, there remained room for differences in the application of those principles which affect the results in an important degree.

I do not propose to review the whole record of the two-year period in which the Special Committee was in correspondence with the New York Stock Exchange. There are parts of this correspondence which I would like to remind you of because of their extreme importance in setting the pattern for later developments.

You will recall that for many years, in fact, until 1934, the opinion paragraph of the independent public accountant made no reference to principles of accounting. He contented himself with certifying that the statements set forth the financial condition and results of operations without reference to any standards of accounting or reporting. The discussions of the Special Committee were the first serious attempt to establish criteria which would serve the dual purpose of assisting the independent public accountant in reaching an opinion on whether financial statements fairly presented what they purported to show and, at the same time, would be helpful to users of financial statements in appraising the significance of the opinion of the independent public accountant.

The Alternatives: It was the view of the Special Committee that two possibilities existed for narrowing the areas of difference and eliminating inconsistencies in financial reporting. The first alternative would be to have a competent authority select from the body of acceptable methods then in use detailed sets of rules which would become binding upon all corporations of a given class. Under this alternative, financial reporting by all corporations would be patterned after the procedures

which applied to regulated industries such as the railroads which are under the jurisdiction of the Interstate Commerce Commission and are required to follow accounting classifications prescribed by the Commission. The Committee, without specifying reasons, stated its belief that the arguments against any attempt to apply this alternative to industrial corporations were overwhelming.

The Choice: It considered that a more practical alternative would be to leave each corporation free to choose its own methods of accounting within broad limitations requiring disclosure of the methods employed and consistency in their application from year to year. The Committee's conclusion was influenced, to a large extent, by its belief that it was relatively unimportant to the investor which precise rules or conventions are adopted by a corporation in reporting earnings if the investor was informed as to what the methods were and had assurance of the consistency of their application.

The Program: The Committee concluded its report by recommending certain objectives to the New York Stock Exchange. I will not quote them in full but I believe, because of their importance, I should summarize them.

- (1) To encourage recognition of the fact that the balance sheet is not a representation of present values.
- (2) To emphasize that balance sheets necessarily are, to a large extent, historical in character and are largely the reflection of individual judgments.
- (3) To emphasize the relative importance of the income account and the recognition that it must be so presented as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the period to which it relates.

- (4) To require acceptance by corporations of certain broad principles of accounting which are regarded as having achieved general acceptance but to make no attempt to restrict the right of the corporation to select detailed methods of accounting.

Recognition of a Community of Interests: The Committee recognized that the broad principles which could be said to have achieved acceptance were relatively few in number. It recommended formulation of a statement of such principles after consultation with a group of qualified persons, including corporate officials, lawyers and accountants, and listed five such principles which it felt should be included in any such statement. It is of particular interest to note the Committee's belief that the formulation of acceptable principles was a matter in which corporate management and its professional advisors other than the independent public accountant had a fundamental interest.

The Stock Exchange took steps to place the recommendations of the Special Committee before all listed companies and to encourage the adoption of the accounting principles recommended by the Committee. At the request of the Stock Exchange the Special Committee suggested a revised form of independent public accountant's report, which achieved immediate acceptance in the profession. The opinion paragraph of this report for the first time related the fairness of presentation to the consistent use of accepted principles of accounting.

The Institute Accepts Responsibility: Promptly after the conclusion and publication of the correspondence, the Institute, in recognition of the need of a formal and continuous facility for considering matters in that field, appointed a special committee on the development of accounting principles. In 1938-39 the Special Committee was reorganized and enlarged and has since been known as the Committee on Accounting Procedure. Simultaneously, a Research Department was

organized within the framework of the Institute staff. The Committee's objectives, as initially stated, were:

- (1) to further development and recognition of generally accepted accounting principles, and
- (2) to narrow areas of difference and inconsistency in accounting practices.

By these actions, the Institute acknowledged a responsibility and assumed leadership.

Procedural Rules: The newly created Committee on Accounting Procedure adopted rules for its own conduct and guidance. In general, these provided that any opinion or recommendation before issuance is to be submitted to all members of the Committee that no opinion or recommendation would be issued unless it received the approval of two-thirds of the entire Committee, and that any member of the Committee who dissented from an opinion would be entitled to have the fact of his dissent and the reasons made a matter of record. The rules provided further that the Committee should give careful consideration to prior opinions, to prevailing practices, and to the views of professional and other bodies concerned with accounting procedures before reaching a conclusion in a particular instance.

Unless formal adoption by the Institute membership is asked and secured, the authority of opinions reached by the Committee rests upon the general acceptability of such opinions. It is recognized that extraordinary cases may exist in which departures from the opinions might be justified and it is understood that the burden of justifying any such departure must be assumed by those who adopt treatments other than those recommended by the Committee. Certain other rules not particularly pertinent to this discussion also were adopted.

Membership to the Committee, as you know, is by appointment of the

President. The Committee consists of a Chairman and twenty members. An attempt is made to see that a cross section of practice is represented in the Committee membership.

Operation and Problems of the Committee: Since its creation, the Committee has issued forty-eight Accounting Research Bulletins, the first forty-two of which were reviewed, restated, and revised as recently as 1953. On the whole, we have every reason to be proud of the product of this Committee. They have done a remarkably fine job. I do not propose today to defend either the reasoning or the conclusions of the Committee with respect to any one of these bulletins. Little purpose would be served by doing so. We might better concern ourselves with a re-examination of the more basic question as to whether the procedures are those which are best designed to achieve our purposes.

Accounting, if it is to have meaning, must remain utilitarian. Like the law, it must be fluid and responsive to the need of change. Basic principles may be conceived in a vacuum but they will be stillborn if they do not achieve acceptance by those who have the primary responsibility for financial representations. Good business practices and good accounting cannot long be at substantial variance.

Those in the Institute who, over the years, have had responsibility for the development of accounting research have recognized the importance of obtaining the views of industry spokesmen. They have tried to devise a procedural method which would achieve the purpose. We have not succeeded. The fault is not altogether ours - in fact, I think it rests largely upon a failure of industry to acknowledge in any major sense its own obligations, and a disposition to interpret leadership by the Institute as an indication of willingness to assume full accountability.

Restrictions of Existing Research Methods: In the field of medicine pure research is largely in the hands of biochemists and other specialists and not in the normal province of the practicing physician. Techniques exist to test new drugs before they are offered to the public. At law, the continued acceptability of established concepts is tested each time a case goes to trial.

We have no comparable laboratory in which the new may be examined and tested against the old. This is a serious handicap to creative thinking. I cite as an example the interesting and important question of the continued validity of the assumption that in spite of its instability, the dollar is the best common denominator of accounting expression. You all know that strong conflicting views exist in this matter. We are told that, as a profession, we are remiss because we have not recognized economic developments. To the extent that such criticism implies negligence in considering the question, it is in error. You all know the validity of the assumption has received thoughtful and extensive consideration. Without at the moment raising a question of the merits of the conclusion, it is the present official position of the Institute that attempts to reflect the declining value of the dollar should, for the present, be achieved by supplementary data and explanations and not through the formal accounts. Thus, an independent certified public accountant whose client would like to compute depreciation on a basis other than historical cost must advise his client that to do so would be contrary to the generally accepted principle involved and would require the accountant to so state in his report. It is my understanding that the SEC would view as deficient financial statements which were accompanied by an auditor's opinion qualified as to their conformity with generally accepted accounting principles.

Where We Now Stand: It seems clear that present processes permit little, if

any, opportunity for sound experimentation of new ideas.

To summarize, this, then, is where I think we stand:

- (1) Although new events have created new differences and inconsistencies in the meantime, there is general recognition that the areas of difference and inconsistency in financial reporting have been narrowed substantially in the last quarter century and that this could not have been achieved except through the acceptance of the concept of a body of generally accepted accounting principles as criteria. *\* = no. itself*
- (2) The Institute has accepted almost exclusive responsibility for the development of research in the field of accounting principles. In many respects this has been helpful but it certainly may not be said to have been ideal. To the extent that research is conducted outside our Institute as, for example, that which finds expression in research statements issued by the American Accounting Association, it is not coordinated with our own.
- (3) Present methods of accounting research give no opportunity to test new ideas - in fact, there is some justification for a belief that they tend to stifle creative thinking.

A New Approach to Research: I propose that the Institute undertake to restudy the research program. As a starter, I suggest:

- (1) Development of accounting principles should be regarded as in the nature of pure research.
- (2) An adequate research organization should be provided. There are reasons which suggest that it would be best if the research

organization were to be an adjunct to and not a formal part of the Institute itself. This is a basic question of policy which should be resolved in the restudy which I think should be undertaken. I am not prepared at this time to advance a detailed organization plan. One possibility is to create a Research Foundation having the same organizational relationship to the Institute as does our present Accountants Foundation.

- (3) The research organization should be staffed with personnel having proper academic and experience backgrounds (we might require as many as five or six men of outstanding ability). There should be no restrictions which would require that the staff be drawn exclusively from people who had been in practice; in fact, it might be preferable if the staff, in part, were composed of those whose background would enable them to contribute the academic and industry points of view.
- (4) Industry and our profession should jointly share the cost of the program in equitable proportions by contributions to the Research Foundation.
- (5) The function of the research organization generally should be to carry on continuous examination and re-examination of basic accounting assumptions and to develop authoritative statements for the guidance of both industry and our profession. In doing so, the research staff should have full power and facilities to consult, as necessary, with representatives of industry, with representatives of the teaching profession,

and with representatives of regulatory bodies. Representatives of such groups should have the privilege of presenting their ideas to the research staff. The functions of the research staff should also include the development and distribution of material designed to improve the understanding of those who rely upon financial reporting as to the nature, value and limitations of financial representations.

- (6) Statements issued by the research organization should be submitted for approval or rejection of basic ideas to the Council of the American Institute of Certified Public Accountants. It would not be expected that Council would concern itself with form or manner of expression but only with the substance of the ideas presented for its approval or rejection. As a practical matter Council might appoint a "screening" committee to review proposals prior to their formal submission for voting.
- (7) Upon receiving approval of two-thirds of the members of Council voting upon any particular bulletin, it should be considered binding upon members of our Institute.

Research is a full-time job and should be recognized as such. Hundreds of the foremost members of our profession have devoted uncounted hours of hard work to the program of the Committee on Accounting Procedure. Many of my own partners have served and I know at firsthand of the tremendous demands on their time and energy. I am sure that all who have had the privilege of service have a well-founded conviction that their efforts were worthwhile. Yet I also believe that all of them at times must have wondered whether the job was not too demanding

for any voluntary group. The necessity of changing the personnel of the Committee from time to time is disruptive of continuity and this, too, is a problem.

In spite of its devotion to its tasks, the ever-increasing complexities of business make it inevitable that we should be faced with the question of whether the Committee can move fast enough to keep up with economic and social changes which affect accounting and financial reporting. The adoption of a program of the type which I suggest should permit an orderly division of the total responsibilities of the research organization and this should do a great deal to enable us to move forward with all necessary speed and the assurance of carefully considered judgments. One of our occasional mistakes has been to place too much emphasis on speed in getting out bulletins. This may strike some of you who are aware of the long periods of deliberation of the Committee on certain problems as an unusual conclusion. Nevertheless, I think it is true that the few bulletins which have been most open to question are those where normal procedures were accelerated in an endeavor to meet a time schedule. Merely to change the organizational form under which research is conducted will not, of course, obviate the need to move with speed when the circumstances require that we should do so but a well-staffed research organization which can devote its full energies to a continuous process of research should be able better to anticipate the needs of the times and do a great deal to improve our capacity for prompt action.

Almost since its reorganization the Committee has had the assistance of Carman Blough as Director of Research. His guidance and his judgments have been of immeasurable value to the Committee and have greatly enhanced the prestige of the profession. He has filled his post with great distinction. What he has been able to do and the way in which he has accomplished it

emphasize the desirability of entrusting the whole function of research to a professional group whose characteristics I could define no better than in terms of what Carman Blough has brought to the job. It will not be easy if, in fact, it is possible for us to find five or six Carman Bloughs. Yet I am convinced that is what is needed and we must set about it and do the best we can.

Another problem for our present method of operation is the difficulty which exists in reversing positions previously taken. At best, the need for doing so gives rise to awkward questions of procedure and protocol; at worst, it tends to encourage procrastination. I believe a research organization which, in a sense, would be independent of the Institute would have less difficulty with problems of this kind. X X

Something to Start on: The January, 1957 issue of the Journal of Accountancy includes an article entitled "An Executive Looks at Accountancy" which contains some constructive criticisms of present-day accounting. It is a pity that this fine article was published when so many of us were busily engaged in trying to keep up with year end problems. If you have not read it you should do so.

The author, Mr. Oswald W. Knauth, is a distinguished businessman who has had ample opportunity to appraise the values and weaknesses of financial reporting. His views are important to all of us. Incidentally, in my earlier discussion of the activities of the Special Committee on Cooperation with Stock Exchanges, I pointed out that the Committee was concerned with the widespread misunderstanding of the function and nature of financial statements and of the work of the independent public accountant, even among sophisticated groups. In this article, Mr. Knauth observes "In their attempt to portray accurately the position of a corporation to an uninformed group of investors or potential investors, accountants to me face an almost impossible, perhaps impossible, task."

I am confident that no group of responsible independent public accountants would deliberately encourage the impression that one of its objectives was to achieve an accurate portrayal of financial position. For at least a quarter of a century our opinions have sought to do no more than to state whether we believe the balance sheet fairly presented position with full recognition that accuracy in the generally accepted sense of the word was not necessarily desirable but, even if desirable, was certainly unobtainable. The very choice of words by Mr. Knauth constitutes an indictment of the adequacy of our educational efforts.

Mr. Knauth reminds us that strong reasons exist for challenging certain assumptions which are basic to the accounting function and concludes his article with six recommendations for our consideration. We cannot seek today to resolve the questions raised by Mr. Knauth. All of them are important and worthy of serious thought. Many of them re-emphasize the necessity for further educational efforts. All of them, I believe, are matters which should have the attention of some group, such as the research organization which I have suggested.

THE INDISPENSABILITY OF INDEPENDENCE:

Independence is the foundation of our profession - without it our names would add little, if any, value to the credibility of financial reporting. Whether he practices as an individual, as a member of a small firm, or as a member of a larger firm, I am thoroughly convinced that every member of our Institute recognizes that he must do so with complete objectivity and independence of judgment if he and the profession are to survive. Instances of record where the independence of the certifying accountant has been challenged are so few as to raise question as to whether they are a fair reflection of the prevailing level of practice. We know that in our profession or in any other

profession there will always be those who will yield to expediency and whose views will be colored by personal, rather than the public, interest. We do not have the capacity to change human nature but we can take pride in the fact that we have done everything reasonably possible to establish high standards of practice and to investigate cases of malpractice which are brought to our attention and to deal with offenders. It is my personal belief that, in matters of ethics, competence, and performance, practice today stands at a higher level than ever before. Criticisms which suggest that the profession on any widescale basis has lost its independence or that high standards of ethics, competency, and independence are the exclusive characteristics of any particular group in the profession are baseless. Preservation of high standards of practice is something about which we can never permit ourselves to become complacent. I think that there is small risk of our ever doing so.

SUMMARY:

In summary, I believe that, as a profession, we can best meet the demands and challenges of financial reporting if we keep these things in mind:

- (1) We must re-emphasize our faith in the concept of generally accepted accounting principles as necessary to an objective determination of the fairness of financial representations.
- (2) We must continue to accept our fair share of responsibility for the identification of those principles which should be generally followed, and devise new methods which will take into partnership with us others whose roles in the economy invest them with parallel interests in the process of identification.

- (3) We must recognize that accounting principles must be sufficiently rigid to give meaning to financial reporting and sufficiently flexible to permit of change when circumstances require.
- (4) We must increase our efforts to educate those who depend upon financial reporting as to the nature of financial statements and their unavoidable limitations and of our function as independent certified public accountants.

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