



AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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STUDY ON ESTABLISHMENT OF ACCOUNTING PRINCIPLES

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March 29, 1972

To the Board of Directors

American Institute of Certified Public Accountants

Submitted herewith is the report of our study of the issues and problems involved in the establishment of accounting principles, together with our recommendations for improving the process and making it more responsive to the needs of those who rely on financial statements.

We wish to acknowledge with appreciation the cooperation which we have received throughout the course of our study from the staff of the Institute, including particularly our Administrative Secretary, Michael A. Pinto.

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Establishing Financial Accounting Standards

March 1972

Report of the
Study on Establishment of Accounting Principles

American Institute of Certified Public Accountants

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Introduction

IN MARCH 1971, Marshall Armstrong, then President of the American Institute of Certified Public Accountants ("AICPA" or "the Institute"), acting at the direction of the Board of Directors of the Institute, appointed a seven-man group to study the establishment of accounting principles and to make recommendations for improving that process.

This Report is the product of that assignment. Its conclusions represent the unanimous judgment of the members of the study group.

The decision was made to include in the study group significant representation from outside the practice of public accounting. Consistent with this determination, the following persons (a majority of whom are neither practicing certified public accountants nor members of the Institute) were appointed to the study group (the "Study"):

JOHN C. BIEGLER, CPA, senior partner of Price Waterhouse & Co.

ARNOLD I. LEVINE, CPA, national executive partner, management of J. K. Lasser & Company.

WALLACE E. OLSON, CPA, executive partner, Alexander Grant & Company.

THOMAS C. PRYOR, senior vice-president and chairman of the investment policy committee of White Weld & Co., investment bankers.

ROGER B. SMITH, vice-president—finance, General Motors Corporation.

DAVID SOLOMONS, FCA, professor and chairman of the accounting department, Wharton School, University of Pennsylvania.

FRANCIS M. WHEAT—chairman, partner of Gibson, Dunn & Crutcher, attorneys-at-law; commissioner, Securities and Exchange Commission, 1964–1969.

The prospectus for the Study is contained in Appendix A, pages 87-88, to this Report. The Study was asked to "examine the organization and operation of the Accounting Principles Board and determine what changes are necessary to attain better results faster." In so doing, it was expected that the Study would consider criticisms of the Institute's existing efforts to establish accounting principles. However, it was not intended that the Study should confine itself to the role of the Institute in the standard-setting process. The terms of the Study's prospectus indicated that "entirely new approaches" should also be considered. The scope of the Study's work has been consistent with this broad directive.

It was not within the Study's province to undertake a critical evaluation of the published opinions of the Accounting Principles Board of the Institute (the "APB" or "Board"). The Study was not expected to become involved with technical questions of accounting theory or practice. On the contrary, we were primarily concerned with the processes and means by which accounting principles should be established. A separate study group (the "Accounting Objectives Study Group"), also organized in the spring of 1971, is presently reviewing the objectives of financial statements and the technical problems in achieving those objectives. The task assigned to this companion study, chaired by Robert M. Trueblood, is broader than ours. It was expected from the outset that our study would be the first to be completed.

We wish to acknowledge with appreciation the assistance we received from numerous groups and individuals concerned with improvement in the process of establishing accounting principles. Many of those with whom we met arranged to do so at substantial personal inconvenience. Many briefs and other communications of the highest quality, reflecting a major effort on the part of their authors, were submitted to us and are a part of our public files. The fact that so many undertook to help us in these ways attests to the depth of interest in this country in improving financial accounting. As Leonard M. Savoie, Executive Vice-President of the Institute, said last October: "Never before has there been such a craving for credibility of information given to the public."

Set forth in Appendix B, pages 89-91, to this Report are the names of representative organizations which provided the Study with invaluable help. The individuals who contributed to the work of the Study through these organizations are too numerous for us to list. However, we do wish to acknowledge with special appreciation the contributions made by the persons listed in Appendix B in their individual capacities and not as members of a particular firm or organization.

The work of the Study

Background of the Study

THE LATTER HALF of the decade of the sixties was a period of unprecedented stress for the individual members and institutions of the accounting profession. Problems arising from the rapid expansion of accounting firms, the new issue boom, the development of increasingly complex and innovative business practices, and the corporate merger movement combined to create a wave of criticism of corporate financial reporting. This criticism came both from within and outside the profession, and much of it was focused upon the work of the APB.

Responding to this criticism, the Board of Directors of the Institute in January 1971 called a two-day conference of 35 prominent accountants representing 21 accounting firms. The purpose of the meeting was to consider how the Institute might reappraise its standard-setting role and how that role could be made more responsive to the needs of those who rely upon financial statements. Reflecting the mood of the conference, President Marshall Armstrong observed: "If we are not confronted with a crisis of confidence in the profession, we are at least faced with a serious challenge to our ability to perform a mission of grave public responsibility."

The conference recommended that two studies be undertaken under the Institute's sponsorship to explore ways of improving financial reporting. Our Study and the Accounting Objectives Study resulted from this recommendation.

In a parallel move, the Executive Committee of the American Accounting Association, meeting in February 1971, adopted a report calling

for the establishment of a commission of inquiry into the means of establishing accounting principles. Upon the announcement of our Study, however, the AAA determined to table its own call for action pending a review of the results of our work.

During the progress of our Study, interest in the problems that concerned us continued at a high level. Two examples of this interest deserve mention. In October 1971 a two-day conference on "Institutional Issues in Formulating Reporting Standards" was held under the auspices of the Graduate School of Management of Northwestern University. Three members of the Study attended this conference. At the annual meeting of the Financial Executives Institute in October 1971, attended by one member of the Study, a full session was devoted to the resolution of controversy over accounting principles. Among the principal speakers at this session was Commissioner James J. Needham of the Securities and Exchange Commission.

The many suggestions advanced by critics of the existing state of affairs have been reviewed with great care by the Study. These suggestions have varied widely, as might be expected, in light of the marked differences in vantage point and interest of their proponents. On one point, however, all were in agreement. The task of improving financial accounting standards is urgent in a free enterprise economy such as ours. As the number of people (presently over 30 million) owning stock in publicly held businesses continues to grow, that urgency increases. The task force has by no means been neglected. A dedicated effort has been made by the accounting profession to shoulder its burdens. But the times call for even greater dedication and effort. Failing this, the present system for allocation of capital in our free society could be placed in grave jeopardy.

Procedures followed by the Study

Ours has been an independent study in every sense. The thinking of each of us went through a process of evolution during the course of our work. Our conclusions were reached only after rigorous analysis and debate among ourselves. At no time prior to the completion of this Report were these conclusions discussed with any member of the Board of Directors of the Institute or with the Institute's staff.

Since our first meeting in New York on May 14, 1971, we have met as a group on eight separate occasions for a total of 14 days. In addition, two days were devoted to a public hearing held in New York, the notice

of which is included as Appendix C, pages 93–96. At this hearing, which received wide publicity, the Study heard oral statements from 17 individuals and groups drawn from the public accounting profession, professional organizations, trade associations, universities, and others, all but one of which submitted written statements to us. Twenty-three other position papers were submitted to us and reviewed in connection with the hearing.

In addition to meetings of the full Study, subcommittees of the study group spent many days meeting separately with various individuals and groups. On two occasions the Study met with the SEC and its staff. We cannot, of course, guarantee that everyone with a contribution to make has been heard, but whatever shortcomings may attend the results of our labors, they cannot be attributed to a paucity of advice.

Members of the Study also attended various meetings and public hearings held by the Accounting Principles Board. A great number of published statements concerning the matters before us have been reviewed. Background studies have been prepared for us by our Administrative Secretary and by other persons. Some of this material will be referred to specifically below.

The Study's public record

It was determined that the Study's proceedings, insofar as practicable, should constitute a public record available to anyone interested in the data considered by the Study and the submissions made to it.

Accordingly, a depository of documents available for public inspection has been established at the offices of the AICPA, 666 Fifth Avenue, New York, New York, comprising the following materials pertinent to the Study:

1. A full transcript of the oral proceedings at the public hearing held by the Study on November 3 and 4, 1971.
2. Copies of all written submissions made to the Study in response to the notice of the public hearing.
3. Copies of over 100 additional reports, articles, pamphlets, books, and papers collected for and reviewed by members of the Study during the course of its deliberations.

Copies of any of the foregoing are available for examination on request. In addition, the full transcript of the Study's public hearing may be purchased from the Institute.

Summary of conclusions and recommendations

THE SCOPE and nature of the task of establishing accounting principles must be considered before proposals for improvement can be made. Accordingly, our Report begins by discussing what is meant by “establishing accounting principles.” We trace the effort to formulate a body of fundamental accounting concepts, an effort which went forward concurrently with the setting of more detailed standards to deal with specific problems of financial accounting and reporting. This historical review shows that while the APB and its predecessor, the AICPA’s Committee on Accounting Procedure, have done much to raise the level of financial reporting, many of their opinions have had little to do with “principles” as that word is normally understood. We therefore recommend (in Chapter 4) the use in the future of the term “financial accounting standards” as better describing the nature of the Board’s pronouncements.

In Chapter 5, we consider a threshold question: Should financial accounting standards be formulated by a governmental or a private body? We reach the conclusion that this task should continue to be shouldered in the private sector, subject to appropriate review by the SEC. The present standard-setting arrangements are described in Chapter 6, including the relationships of the APB with the SEC and other governmental agencies. The advantages and disadvantages of these arrangements and a number of possible alternatives are considered in Chapter 7.

The Study concluded, after listening to much evidence and weighing many conflicting points of view, that while the procedures devised at the end of the 1950s for formulating financial accounting standards were prob-

ably appropriate at that time and have brought about notable improvements in financial reporting during the APB's 12-year history, the time has come for a change.

The APB, which has a present membership of 18, was set up in 1959 as a senior committee of the American Institute of Certified Public Accountants. As such, it is the voice of the Institute on financial reporting standards. Nonmembers of the Institute may not serve on it. Board members continue their affiliations with their firms, companies, or institutions while serving without compensation on the Board. Under these arrangements, the accounting profession, in the fullest sense, is performing the self-regulatory function of establishing standards for the guidance of its members in attesting to the fairness of financial statements.

This fact has been an important source of strength for the APB. It has helped to assure acceptance of APB pronouncements. But we cannot ignore the difficulties which have arisen under the present arrangements. In summary, we see these arrangements as falling short of what is needed today in the following respects:

1. A part-time, volunteer APB will continue to be subject to doubts as to the disinterestedness of its members—their freedom from client and other pressures.
2. A part-time APB, however dedicated, cannot devote itself continuously and single-mindedly to the urgent problems confronting it.
3. Formulation of financial accounting standards would benefit from a broader base and perhaps a greater variety of skills than can be supplied by a group chosen from among the members of a single professional organization, all of whom must hold the CPA certificate.
4. The research activities of the APB need more substantial and continuous direction than a part-time Board can provide.

We believe these imperfections call for more than minor modification of the present arrangements. A summary of our proposals (which appear in more detail in Chapter 8) follows:

First, we propose that a new foundation, to be called the Financial Accounting Foundation, be established, separate from all existing professional bodies. It would have nine trustees whose principal duties would be to appoint the members of the Financial Accounting Standards Board and to raise the funds for its operation. One of the trustees would be the President of the AICPA. The other eight would be appointed by the Board of Directors of the Institute for three-year terms (after initially staggered terms

to assure continuity). Four appointed trustees would be CPAs in public practice. Two trustees would be financial executives, one a financial analyst, and one an accounting educator. These four trustees would be chosen, respectively, from names submitted by each of the following organizations: the Financial Executives Institute, the National Association of Accountants, the Financial Analysts Federation, and the American Accounting Association. The trustees would select their own chairman. The trustees would be responsible for appointing the members of the Financial Accounting Standards Board (described below) and the Financial Accounting Standards Advisory Council (also described below), for raising and allocating the funds required for the new structure, and for periodically reviewing that structure. Their actions would require a two-thirds majority of their total number, except when making structural changes in their own organization or that of the Standards Board or Advisory Council, when eight affirmative votes would be necessary.

Secondly, we propose that a Financial Accounting Standards Board be established with seven members, all salaried and serving full-time for terms of five years with a possible renewal for a second term. They would be appointed by the Board of Trustees of the Foundation which would also designate one of them to serve at its pleasure as chairman. The members of the Standards Board would, during their terms of office, have no other business affiliations. Four of the Standards Board members would be CPAs drawn from public practice. The other three should have extensive experience in the financial reporting field but need not hold a CPA certificate. The affirmative vote of five of the seven members of the Standards Board would be required to approve a standard before it could be issued. Interpretations of standards, when deemed necessary, would be issued with the full authority of the new Board. The new Board would, to the fullest extent possible, carry out its functions in public. A history for each pronouncement should be developed and made publicly available. As regards the transition from the APB to the Standards Board, we propose that opinions which have reached the exposure draft stage should be carried through to completion by the APB. Other matters on the APB's agenda should be transferred to the Standards Board. There will doubtless also be some carryover of committee and staff personnel to ease the transition.

Thirdly, we propose that the Board of Trustees of the Foundation establish a Financial Accounting Standards Advisory Council with approximately 20 members to work closely with the Standards Board in an advisory capacity. Members of the Advisory Council would be appointed by the trustees to serve one-year terms which could be renewed indefinitely. They

would be entitled to reimbursement for expenses but no remuneration. They would be drawn from a variety of occupations, although not more than one-quarter of the membership should come from any single sphere of activity. The chairman of the Standards Board would be, ex officio, chairman of the Advisory Council. The Advisory Council would consult with the Standards Board as to its priorities, help it to set up task forces which would aid the Board in detailed investigation of issues under consideration, react to proposed standards, and otherwise assist the Standards Board when called upon to do so.

Finally, we recommend that research projects be more carefully defined and more rigorously controlled than in the past to ensure that they are directly germane to the Board's needs and are carried out expeditiously. As far as possible, research studies carried out for the Standards Board should be worked on full-time, whether the researcher is a paid consultant or a member of the Board's staff.

We estimate that the cost of implementing our proposals will be between \$2,500,000 and \$3,000,000 a year. These figures do not greatly exceed the present cost of operating the APB when one takes into account the approximate value of the time given by APB members and their staffs. We make no recommendation as to how the necessary funds should be raised, preferring to leave to the trustees of the Financial Accounting Foundation as free a hand as possible. However, four alternative methods of funding are considered briefly in our Report. Of these, reliance on the voluntary support of firms, individuals, and companies might initially be the most practical method, even if another method were to be adopted later.

We believe the arrangements embodied in our proposals are superior to the present structure in six important respects:

1. The Standards Board will be, and will be seen to be, free of any private interests which might conflict with the public interest.
2. Because of its compactness and because its members will serve full-time, the Standards Board will be able to devote undivided attention to its tasks and to move expeditiously, when necessary, to deal with urgent problems.
3. The new organizational structure will facilitate participation by a number of important groups in the standard-setting task. It will thus have a broader base of support, and it will be possible to draw upon a broader

range of skills both for the Standards Board itself and for its supporting organizations.

4. It will be possible to seek broader financial support for the work of the new Standards Board.
5. Because of its strong link with the AICPA, the Standards Board should continue to command the support of the public accounting profession. We consider such support essential to effective enforcement of the standards developed by the Board.
6. The new Board will be better able to supervise and monitor the essential research which should precede much of its work and to see to it that such research is performed expeditiously.

It is, of course, a question of judgment whether our proposals will produce the desired results. We believe they will, and we commend them not only to the Board of Directors of the AICPA (to whom this Report is formally addressed) but also to all who think it important to improve financial reporting methods and to increase public confidence in financial information provided to stockholders and others. As an American Accounting Association report on this subject said last year, "while it is too much to say that the survival of the free enterprise system depends on improvements in present methods of financial reporting, it is not too much to say that it can never reach its full potential without them." We share that view and hope that our recommendations will contribute to that goal.

What does "the establishment of accounting principles" mean?

BEFORE A JUDGMENT can be arrived at as to how accounting principles should be established, it is necessary to inquire about the scope and nature of the task. What does "the establishment of accounting principles" mean?

"Accounting principles" has proven to be an extraordinarily elusive term. To the nonaccountant (as well as to many accountants) it connotes things basic and fundamental, of a sort which can be expressed in few words, relatively timeless in nature, and in no way dependent upon changing fashions in business or the evolving needs of the investment community. Yet the APB (despite the prominence in its name of the term "principles") has deemed it necessary throughout its history to issue opinions on subjects which have almost nothing to do with "principles" in the usual sense. For example, Opinion No. 19 ("Reporting Changes in Financial Position") deals with a financial statement considered appropriate for inclusion when the balance sheet and income statement of a business are reported upon; portions of the two Omnibus Opinions (Nos. 10 and 12) deal purely with matters of disclosure; and Opinion No. 15 ("Earnings Per Share") deals with methods of calculating and presenting the net earnings on a per share basis. Projects on the agenda of the APB include matters far removed from the domain of "principles," such as the makeup of interim financial statements and the disclosure of accounting policies followed in the preparation of financial statements. Other

examples of the work of the APB could be given for which the term "principles" is at best inappropriate, but the point has been sufficiently illustrated.

Why has the term "principles" persisted in describing the work of the APB? How could the nature of its task be described with greater clarity and comprehensiveness?

To answer such questions we must go back to the year 1932 when the accounting profession in the United States took a major step toward improving standards of financial accounting for publicly held corporate enterprises. On September 22 of that year, a date which has been described as perhaps the most important in the recent history of accounting, a committee of the American Institute of Accountants (the predecessor body of the AICPA), headed by the late George O. May, recommended to the New York Stock Exchange that audit certificates for listed companies should state that the financial statements were prepared in accordance with "accepted principles of accounting" and recommended five basic principles to be followed in the preparation of such financial statements.¹

Less than two years after the report of the May Committee, Congress adopted the first of the Federal Securities Acts, an event which heralded a period of great expansion for the accounting profession in America. An increased sense of responsibility accompanied this expansion, stimulated by the seminal work of May and his colleagues, and manifested by an increasing effort to develop professional norms. This effort has followed two paths. There has been the attempt to establish a body of fundamental accounting concepts, whether by logical deduction from a few basic premises or by induction from experience, or both. This attempt faltered in the early 1960s. At the same time (and increasingly since the mid-1960s) the profession mounted an effort to develop more specific standards of financial accounting and reporting without reference to any systematic theoretical foundation, but with at least three practical goals in view: (1) to discourage practices in specific areas which experience indicated might be employed in such a way as to mislead public investors; (2) to encourage practices which could be expected to make financial statements more informative; and, (3) to reduce the use of alternative accounting methods not justified by factual or circumstantial differences.

¹ The history of this event and its aftermath are discussed in Dr. Reed K. Storey's *The Search for Accounting Principles* (New York: AICPA, 1964).

The effort to formulate a body of fundamental concepts

At the time the APB was first organized, it was widely hoped that one of the first results of its labors would be a "grand design" of accounting theory upon which all else would rest. The Charter of the Board states that "pronouncements on financial accounting and reporting are expected to encompass (a) fundamentals of financial accounting, (b) definitions of 'terms of art' used in financial accounting, (c) applications of the fundamentals in specific areas of financial accounting, and (d) the form and content of financial statements, including the nature and extent of appropriate disclosures therein." Primacy was given to fundamentals with applications following along behind. In the 1958 report of the AICPA's Special Committee on Research Program,² which contained the blueprint for the APB, the importance of developing the fundamentals of accounting was given even greater prominence:

The broad problem of financial accounting should be visualized as requiring attention at four levels: first, postulates; second, principles; third, rules or other guides for the application of principles in specific situations; and fourth, research.

Postulates are few in number and are the basic assumptions on which principles rest. . . . The profession . . . should make clear its understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations. . . . A fairly broad set of co-ordinated accounting principles should be formulated on the basis of the postulates. . . . The principles, together with the postulates, should serve as a framework of reference for the solution of detailed programs.

Rules or other guides for the application of accounting principles in specific situations, then, should be developed in relation to the postulates and principles previously expressed. . . .

If these early hopes have not been borne out, it has not been for want of trying. Accounting Research Study No. 1, written by Professor Maurice Moonitz in 1961, and Accounting Research Study No. 3, written by Professors Robert Sprouse and Maurice Moonitz in 1962, were devoted respectively to basic accounting postulates and broad accounting principles. Both were disavowed by the APB as "too radically different . . .

² *The Journal of Accountancy* (December 1958), pp. 62-68.

for acceptance at this time”³ although, in the decade since they were published, they have had a considerable effect on accounting thought.

The failure of this first effort to win support did not signal abandonment by the APB of the attempt to develop a conceptual foundation for its work. Accounting Research Study No. 7, published in 1965 and written by Paul Grady, Director of Accounting Research of the AICPA at the time his study was being prepared, consisted of a compilation of the “principles” which could be deduced from current accounting practice. Because accounting practice is not always consistent, the “principles” compiled by Grady were not always consistent. His inventory was descriptive, not normative. It did not result in a statement by the APB itself.

In the same year, the AICPA’s Special Committee on Opinions of the Accounting Principles Board, commonly referred to as the Seidman Committee, again sought to emphasize the need for a conceptual base for the work of the APB:

Nevertheless, it remains true that until the basic concepts and principles are formulated and promulgated, there is no official benchmark for the premises on which the audit attestation stands. Nor is an enduring base provided by which to judge the reasonableness and consistency of treatment of a particular subject. Instead, footing is given to controversy and confusion. . . .

* * *

What is meant by the expression “generally accepted accounting principles”? . . . Where are they inscribed, and by whom?

The Committee’s first recommendation called upon the Board to set forth its views on the purpose of financial statements and the attest function, to enumerate and describe the basic concepts to which accounting principles should be oriented, to state the accounting principles to which practices and procedures should conform, and to define a number of widely used terms.

The Board’s response to this recommendation is embodied in its Statement No. 4 (“Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises”), issued in October 1970. Like Accounting Research Study No. 7, which preceded it by five years, the Statement analyzes current accounting practice but stops short of asking how well practice serves the objectives of accounting. To quote

³ Statement No. 1 of the Accounting Principles Board (New York: AICPA, April 1962).

the Statement itself, it "is primarily descriptive, not prescriptive. It identifies and organizes ideas that for the most part are already accepted. . . . The description of present generally accepted accounting principles is based primarily on observation of accounting practice. Present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting."

Unlike Paul Grady's "Inventory," which as a research study had only the authority of its author's reputation, Statement No. 4 was a Board pronouncement. It did little to appease the Board's critics; in fact, the Board's present Chairman, Philip L. Defiense, has made it clear that he does not regard it as more than an important step along the road. This aspect of the Board's work, which has proven to be so elusive, has now passed, for the time being, into other hands with the formation of the Accounting Objectives Study Group, the members of which represent a broad cross section of the financial community. This group has been given the challenging assignment of considering the basic objectives of financial statements, the methods or bases of measurement which should be used in their preparation, and the forms of presentation which would be most useful in achieving those objectives.

The effort to establish more detailed standards of financial accounting and reporting

With the passage of the Federal Securities Acts in 1933 and 1934, the work of the May Committee was terminated. The Acts gave a government agency the power to prescribe the financial reporting practices to be followed by a substantial proportion of publicly held businesses. As discussed in greater detail later in this Report, the SEC requires companies subject to its jurisdiction to follow accounting practices certified as generally accepted by independent public accountants. Only rarely has the SEC found it necessary to use its power to prescribe financial accounting or reporting practices.

In 1939, the Institute took the initiative in identifying acceptable accounting practices by appointing a Committee on Accounting Procedure (the "Committee"). The Committee adopted a practical problem-by-problem approach in identifying generally accepted accounting practices to guide those involved in the preparation and certification of financial statements.

The Committee was active for 20 years and issued 51 bulletins. Throughout its existence, the Committee focused its efforts on identifying

accepted practices including alternatives. While some questionable practices were gradually eliminated, the Committee did not make firm choices between "acceptable" alternatives, and it did not seek to proscribe widely used (hence "accepted") methods even though they were in conflict with its recommendations. As a result, there continued to exist a superabundance of "acceptable" alternatives for accounting for specific types of transactions.

Toward the latter part of the 1950s, the accounting profession was subjected to a barrage of criticism—much of it from within the profession itself—for permitting the existence of widely divergent alternative accounting practices, all within the broad framework of "generally accepted accounting principles." It was alleged that financial statements lacked comparability as a result of these alternatives, and that investors and other users of financial statements were thereby in danger of being misled. The response of the profession was to organize the APB to replace the Committee on Accounting Procedure.

During the early years of the APB, when its efforts in the more theoretical sphere were being emphasized, the SEC was encountering increasing practical difficulty with certain financial accounting practices which created problems for public investors. Urged by the SEC to confront these problems, the APB began in 1964 to issue opinions dealing with particular accounting practices considered to be in need of immediate attention. Since that time, work along this path has gained in momentum. In 1964 and 1965 three opinions were issued. In the next three years, six opinions were issued. During the three years ended December 31, 1971, the APB issued nine opinions. At present, there are fifteen projects on the APB's active agenda, each of which could lead to an opinion.

It is worth noting that a number of these opinions dealt with matters of particular concern to the SEC. Prior to the issuance of Opinion No. 9 ("Reporting the Results of Operations") the staff of the SEC had drafted the outline of a Commission rule dealing with the presentation of earnings per share. This draft was aimed at the elimination of potentially misleading "bottom line" calculations not reflective of the potential dilution of per share earnings arising from increasingly complex corporate capital structures. Opinion No. 9 proved in practice to be inadequate as a solution to the problem. A new effort was made which resulted in Opinion No. 15.

The SEC was also known to feel an urgent need for an opinion dealing with accounting for business combinations. Extraordinary efforts were put forth by the APB and its staff to solve this problem—the most difficult, by

far, in its history—culminating in Opinions Nos. 16 and 17. Recently expanded SEC requirements for interim financial reports highlight the need for an opinion (presently on the APB's active agenda) dealing with this subject. Action by the SEC in 1969, dealing with "line of business" financial data in registration statements under the Securities Act of 1933, and again in 1970, requiring similar data in reports on Form 10-K, has stimulated efforts to develop standards relating to these data (the "diversified companies" project on the APB's agenda). Suggestions made years ago by the May Committee regarding disclosure of methods of accounting used in particular financial statements lie behind the "accounting policy" item on the APB's agenda.

Thus, in recent years, encouraged by the SEC and by the 1964 special action of the governing Council of AICPA (discussed on pages 41-42 below), the APB has actively sought to narrow the areas of difference in accounting practice by dealing with pressing issues on a problem-by-problem basis.

Financial accounting standards

The history of the APB's efforts, briefly outlined above, provides background for the Study's recommendation that the name "Financial Accounting Standards Board" be given to the new board proposed in Chapter 8 of this Report. In the Study's judgment, the word "standards" is more descriptive of the majority of the Board's pronouncements as well as the great bulk of its ongoing effort. The term "financial accounting" has become widely accepted as referring to external reporting, as contrasted, for example, with management accounting.

The need for a fundamental conceptual foundation has been much debated in accounting circles for many years. We believe this debate may have produced more heat than light. Financial accounting and reporting are not grounded in natural laws as are the physical sciences, but must rest on a set of conventions or standards designed to achieve what are perceived to be the desired objectives of financial accounting and reporting. We understand the primary work of the Accounting Objectives Study Group to be the development of such objectives and some guidelines for their achievement.

The work of the ongoing standard-setting body should be to develop standards for preparing financial accounting information that will be consistent with these objectives. Such standards will, in some cases, be funda-

mental and cut across all aspects of accounting. In other cases, the standards will be narrow in their application. What is of greatest importance is not whether the standards are fundamental or narrow but whether they contribute to progress in achieving the objectives of financial accounting and reporting.

A threshold question: should the board be public or private?

ONE QUESTION overshadows all others when considering the best way to set accounting standards. Should the task remain a responsibility of the private sector, or should it be taken over by a governmental body? In the sphere of government, the choice probably lies between the Securities and Exchange Commission or a new body created by Congress for this specific purpose. In the private sector, there are several alternatives which we shall consider shortly.

Protagonists on both sides can point to examples which could be followed. In the public sector, standards for air safety are set by the Federal Aviation Administration, for automobile safety by the National Highway Traffic Safety Administration, for foods and drugs by the Food and Drug Administration, for atmospheric and water pollution by the Environmental Protection Agency and by state governments. The setting of standards has not been left to the industries concerned or, in the last case, to industry in general.

More closely related to our own area of concern is the Cost Accounting Standards Board, set up by legislation in 1970 and headed by the Comptroller General of the United States. But before too much is made of this agency as a possible model, we note that it is concerned with the relatively narrow field of setting cost accounting standards for government defense procurement contracts, and that the government is itself a major party to the transactions which the Cost Accounting Standards Board oversees. It

should not be surprising, therefore, that standard-setting in this field is not left in private hands.

Turning to the private sector, the models of so-called self-regulation which come immediately to mind are the stock exchanges and the National Association of Securities Dealers in the investment field. Standard-setting in other fields is carried out extensively by the American National Standards Institute, the Society of Automotive Engineers, the National Fire Protection Association and many other trade and professional associations.

Those who advocate having the primary standard-setting responsibility assumed by a governmental body argue that the public interest at stake in establishing accounting standards is too important for this function to be left to a nonpublic body not directly responsible to Congress, even though subject to SEC oversight. They believe that the protection of investors and other users of financial statements requires that standards be set by a body that is clearly free of any conflict of interest. They argue that the establishment of accounting standards should involve the cross-disciplinary expertise of lawyers, economists, and financial analysts, as well as accountants, and they believe that such skills can be best brought to bear on the problems by an administrative agency of the Federal Government. Finally, it is asserted that accounting standards established by the profession have, as a practical matter, the effect of law and should therefore be established by a government agency following all of the procedures prescribed for agency rule-making.

On the other hand, there are distinct disadvantages to transferring the standard-setting function to the public sector. One very real concern is that government agencies may be more susceptible to political pressures than private bodies. This could lead to accounting standards being designed to accomplish the self-serving objectives of private interest groups rather than solely to meet the needs of those who use financial statements in making economic decisions. The political pressures evident in 1971 when Congressional action was taken to regulate the accounting treatment of the investment tax credit reinforce this concern.

A second concern is that where government agencies have laid their hands on accounting, the result has too often been a tendency toward inflexibility and a lack of responsiveness to the needs of investors. The failure of the Interstate Commerce Commission to take action to modernize railroad accounting is hardly a triumph for government regulation. State regulation of insurance accounting has not been responsive to the needs of shareholders for information relevant to investment decision-making. Other

examples could, of course, be given. While the SEC's record in accounting matters has been generally well regarded, many believe it has held the clock back by consistently opposing the recognition of values as distinct from costs in accounting.

A third argument against transferring standard-setting to a government agency is the belief that such a development would inevitably sap the vitality of the accounting profession. To an increasing degree, through their participation in the work of the APB and in other ways, leaders of the profession have given unstintingly of their time and talent in the search for better accounting standards. We doubt that such men would be willing to contribute to a similar degree if the basic responsibility for accounting standards were shifted to government auspices. On the contrary, it seems likely that practicing public accountants might be largely reduced to the role of advocates on behalf of their clients. This would constitute a serious loss to the public at large.

Finally, most government agencies, including the SEC, oversee a domain which is much smaller in numbers, if not in influence, than that of the APB. There are in this country a vast number of corporations, partnerships, and private businesses which do not report to the SEC, to say nothing of not-for-profit organizations and those businesses, such as most insurance companies and banks, which are regulated by other agencies. Thus, to hand the APB's task to the SEC, even if the latter wanted it, would involve either a considerable extension of the Commission's present powers or the possible coexistence of two or more sets of accounting standards. The SEC can oversee the actions of a private sector standard-setting board without taking over its basic task. Indeed, the SEC's impact has been very real, as outlined more fully at pages 17-19 and 48-52.

It may at some time become clear beyond question that standard-setting cannot be left in private hands. But that time is not yet. Until it is shown without doubt that this task must be entrusted to government, we strongly prefer to keep it where it is. There are two prerequisites for the success of such an undertaking in the private sector. These are the existence of a tradition of standard-setting and the participation, at the core of the process, of a well-organized profession anxious to make the process work. In the field of accounting, these two prerequisites are satisfied.

We also believe that the success of a standard-setting board in the private sector depends in the final analysis on acceptance of its standards by the business community, practicing accountants, the SEC, and the public. We are satisfied that such acceptance will be forthcoming provided:

1. The standard-setting body possesses unassailable independence and objectivity in fact and in appearance.
2. There is significant participation by the financial reporting community in the process by which standards are set.
3. Standards are promulgated only after a public procedure which insures that all interested parties are heard and their views are considered.
4. The quality of pronouncements is high—there must be persuasive logic and supporting reasoning, consistency with agreed-upon objectives, room for professional judgment in appropriate circumstances, and perceived usefulness to investors and the public.
5. The members of the accounting profession support the standards in attesting to the fairness of financial information.

We believe these criteria can be met by a private sector standard-setting group structured as proposed in this Report. Future events may possibly dictate more radical changes in the standard-setting process than we are now recommending; but such changes are not called for now, and they would not now be in the public interest.

Our preference for keeping the standard-setting function in the private sector is shared by the great majority of the organizations and individuals who gave evidence before us, including the New York and American Stock Exchanges and the SEC itself. Their view, in which we join, is that a continuing, dynamic relationship between a private standard-setting board and the SEC offers the greatest potential for future progress in financial accounting.

Present arrangements for formulating financial accounting standards

Operation and funding of the APB

AT PRESENT, the issuance of authoritative pronouncements on financial accounting standards is virtually exclusively in the hands of the Accounting Principles Board, subject to oversight and, historically, occasional intervention by the SEC. Other accounting bodies and trade organizations have committees or task forces which are concerned with these matters. They have conducted research on various aspects of financial accounting but hitherto they have been largely content to cooperate with the Board, to respond to its initiatives, and to accept its leadership in the field. As described in more detail below, the SEC has also looked to the Board to take the initiative in setting standards, while reserving its right to reject or modify APB pronouncements. This right, however, has not been overtly exercised since 1963 when, in Accounting Series Release No. 96, the SEC overruled the Board's hotly contested Opinion No. 2 by permitting both deferral and flow-through methods of accounting for the investment tax credit.

The APB consists of 18 members, all of whom must be members of the AICPA. At the present time, 14 are in public practice, two are academic accountants, one is engaged in industry, and one is a financial analyst. Of the 14 public practice seats, eight have been traditionally occupied by partners of the eight largest firms in the profession. The APB is set up as a senior committee of the AICPA, responsible to the Institute's governing

Council through the Board of Directors and has vested in it by Council "the primary responsibility for establishing professional standards in the area of financial accounting and reporting. . . ." The Board has the authority to issue pronouncements in its own name and is "responsible through its chairman for reviewing all statements on financial accounting and reporting to be published by any committee of the Institute, in conformity with policies adopted by the Board of Directors with respect to senior committees." (The quoted passages in this paragraph are taken from the APB Charter.)

Members of the APB are appointed by the President of the Institute, with the approval of the Board of Directors. Each serves a three-year term with possible reappointment for a second three-year term. Written approval by at least two-thirds of the members is required before a pronouncement may be issued. This voting rule covers the two types of pronouncements issued by the Board, namely, "statements" and "opinions." The essential difference between them is that only opinions are covered by the Council's Special Bulletin of October 1964, quoted below, which requires that departures from opinions in financial statements be disclosed either in footnotes to the statements or in the audit report.

The Board held its first meeting on September 11, 1959. Down to the end of 1971 it had held 68 meetings lasting 175 days and occupying approximately 3,350 man-days. From only two days of meetings in 1960 it had increased its activity to 27 full days of meetings in 1971. It has had five chairmen during its 12 years of existence and 63 other members of the Institute have served on it. In addition, 19 nonmembers of the Board have served on its subcommittees, all but two of them CPAs. Five of these 19 were former Board members.

All members of the APB, including its chairman, serve in a part-time capacity. Most members appear to devote from one-half to two-thirds of their time to the Board's work. Most members of the Board are supported by an advisor, who normally also attends Board meetings, and other support is provided by their firms. None of this work is compensated by the Institute. Out-of-pocket expenses of members and their staffs are defrayed by the Institute if reimbursement is requested. Usually, it is not.

The staff support provided by the AICPA is drawn from the Accounting Research Division and the APB Administration Division of the Institute.

The Accounting Research Division is headed by a director (the incumbent, Reed Storey, Ph.D., CPA, has held office since 1964) and the staff consists of four project managers and one assistant project manager with four clerical assistants. In addition, in a typical year, there will usually be from eight to ten consultants working on a variety of research projects.

The director of accounting research is responsible for the Institute's accounting research program. He initiates, assigns, and supervises research projects. He participates with the chairman of the APB and the executive vice-president of the AICPA in planning the research program and appointing project advisory committees and their chairmen. He conducts special studies as requested by the chairman and provides drafting assistance in the preparation of opinions, reports, and advisory documents for the Board's consideration.

The APB Administration Division was established in 1965. Its first director, Richard C. Lytle, M.B.A., CPA, formerly director of the Institute's Technical Services Division,¹ has held office since that time. He is aided by an assistant director, two managers, a research associate whose principal function is to prepare the interpretations of APB opinions, an administrative assistant, and two secretaries. The administrative director provides staff assistance to the Board and its chairman, including the preparation of agenda and other background material for meetings of the Board and its committees, and minutes. He makes arrangements for meetings, provides drafting assistance in consultation with the director of accounting research, maintains contact with the large number of organizations who are kept informed of the Board's work, makes arrangements for the publication and distribution of Board pronouncements, and carries out other duties assigned to him by the chairman.

The two directors are at a coordinate level, each is autonomous within the scope of his authority, and each has the privilege of the floor at meetings of the Board and its committees.

An analysis was prepared at our direction of the full cost of the Board's work. This has risen steadily since 1965, partly because of inflation, and partly because of increased administrative support and the increasing level of activity of the Board. Details of the AICPA's outlay for accounting research and APB administration since September 1, 1960 are given in Appendix D, page 97. In the Institute's last full fiscal year ended August

¹ Now called the Auditing and Reporting Division.

31, 1971, the expenses of the two APB support divisions were as shown below:

	Accounting Research Division	APB Administration Division	Total
Salaries, fees and related expenses	\$215,639	\$171,327	\$386,966
Administration expenses	28,096	55,287	83,383
Meeting and travel expenses ..	7,927	35,978	43,905
	<u>\$251,662</u>	<u>\$262,592</u>	<u>\$514,254</u>

The budget for 1971/72 projects expenditures of \$277,000 for the Research Division and \$319,000 for the Administration Division. To this must be added estimated net charges of \$72,000 to these activities from other divisions of the Institute, giving a total projected cash expenditure by the Institute for the APB for the current year of \$668,000.

The foregoing, however, is only a small part of the cost of the Board's work. The greater part of that cost is borne by the Board members' firms. Our estimate puts it at \$2,000,000 for the value of time contributed and \$125,000 for meeting and travel expenses, or an aggregate of \$2,125,000 for the value of time and expenses of Board members. The estimate of the value of time contributed is based on a total of 40,000 hours per year for the 18 members and their staff assistants, priced at \$50 an hour (a figure which includes an estimate of compensation plus the indirect cost of fringe benefits and secretarial support).

Putting these figures together gives a total of approximately \$2,793,000 as the annual cost of the Board's work, before crediting some \$260,000 earned by the Institute from publications relating to the work of the Board. This still leaves out certain important hidden costs, notably those borne by firms whose partners or staffs work on Institute research projects. For studies such as ARS No. 10 on goodwill and ARS No. 11 on accounting for extractive industries, where the researchers were practitioners working without compensation from the AICPA, it is estimated that the value of the time contributed by the firms concerned may have been between \$125,000 and \$225,000.

The research program of the APB

The AICPA committee report which can be said to have brought the APB into existence, the Powell Report of 1958, was entitled "Report to Council of the Special Committee on Research Program." The committee's title makes it clear that research was to be one of the main activities, if not *the* main activity, of the APB. "The accounting research program," said the committee, "should be one of the most important activities of the Institute"; and the APB, together with the accounting research staff, is described as "the organization for carrying out the proposed accounting research program and related activities of the Institute. . . ."

The Institute's Accounting Research Division was established in 1959 and has had four directors. Their names and dates of appointment are:

PERRY MASON—appointed November 1959
MAURICE MOONITZ—appointed July 1960
PAUL GRADY—appointed August 1963
REED STOREY—appointed September 1964

Paul Grady was formerly a practitioner. The other three directors came from the academic world.

At our direction, a detailed examination of the history and results of the Institute's research program was made. By no standard that we can think of can this program be called a striking success. The outcome of 24 studies authorized down to August 1967 is summarized below. (See table on page 30.) Several significant facts emerge:

1. No new studies have been authorized since August 1967.
2. Of the 24 separate studies authorized between September 1959 and August 1967, only 11 had resulted in publications before the end of 1971. Ten will probably be published at a later date, and three were terminated.
3. Of the 11 published studies, four were in gestation for more than 50 months. Three of these took 65 months or more.
4. For the as yet unpublished studies, the elapsed time since authorization down to the end of 1971 ranges from 54 months to 139 months.
5. No study authorized since the end of 1964 had resulted in a publication by the end of 1971; and only five studies authorized after 1959 had done so.

**Outcome of Accounting Research Studies Authorized
Since September 1959**

Year of authorization	No. of studies authorized ¹	Published				Distribution by interval between authorization and publication (months)				To be published after 12/71	Terminated without publication
		before 12/71	24 or less	25-50	51-75	76 or more					
1959	7	6	1	3	1	1	1			1	
1960	3	1	1	—	—	—	—	—	2	—	
1961	1	1	—	1	—	—	—	—	—	—	
1963	3	2	1	—	1	—	—	—	1	—	
1964	3	1	—	—	1	—	—	—	1	1	
1966	4	—	—	—	—	—	—	—	4	—	
1967	3	—	—	—	—	—	—	—	2	1	
	<u>24</u>	<u>11</u>	<u>3</u>	<u>4</u>	<u>3</u>	<u>1</u>	<u>1</u>	<u>10</u>	<u>3</u>	<u>3</u>	

¹ Studies launched separately and subsequently merged are counted here as a single study.

A marked change has taken place in the assignment of research studies during the years since 1959. Of the 11 studies authorized during the program's first 12 months (including one which was merged into another study), six were assigned to academics, one to a practicing CPA, and four to staff members of the Accounting Research Division. Of the 15 authorized since then (including one which was subsequently merged into another project), only two were assigned to academic authors. The rest were divided almost equally between practitioners and staff members. Thus the reliance on practitioners has increased notably since 1960.

It cannot be said that this change has raised the program's productivity. If one looks at the average elapsed time for completed studies between the appointment of an author and completion of his study, the results look like this:

	<u>No. of studies</u>	<u>Average elapsed time</u>
Staff authors	3	22 months
Academics	5	39 months
Practitioners	3	48 months

These averages, however, are influenced by a single protracted academic study and a single rapidly completed practitioner study. Without these two studies, the averages would have been 29 months for academics and 62 months for practitioners.

Practitioners also seem to take longer not to complete a project than academics. Of the ten projects still in process at the end of 1971, the two assigned to academics had an average elapsed time of 47 months since the author was assigned, compared with 63 months for practitioners and 66 months for staff authors.

It seems likely that research projects in the past would have come to fruition faster if they had been assigned under contracts which required the researcher to devote his full time to the work. Teaching and committee assignments are as distracting for academics as client responsibilities are for practitioners. Research, like most other activities, suffers when the researcher's attention is divided. The research studies carried through most expeditiously bear this out. Only in exceptional cases should two years be required to complete a research study when it is worked on full-time. Normally one year or less should be enough. Full-time research should, we believe, be the normal pattern for the future.

It might be supposed that members of the Accounting Research Division's staff would be able to devote all their time to projects to which they are assigned, and that their research productivity would be correspondingly higher. Unfortunately, there have been many demands on their time which have had the effect of drawing them away from their primary research activity. These demands have included drafting for the APB, work on special projects, or, in the case of the Director himself, supervision of other projects within the Division while he continued to carry the burden of research on one project himself.

When the APB's Administration Division was established in 1965, it was intended that the Research Division would be released from day-to-day involvement in the work of the Board. This independence has not been achieved. Indeed, the distinction between the two divisions has become increasingly blurred. It appears that in the past two years some 30-40% of the Research Division's effort has been devoted to routine drafting and other work for the Board which could not be called research. This in part explains why academics and practitioners to whom projects have been assigned have been allowed to proceed at their own pace. It is clear to us that tighter control could have reduced some of the inordinate delays which have afflicted several projects. There have also been regrettable delays in the selection of authors for important projects. It took 26 months after authorization to select an author for a study of inventory pricing, 27 months for a study of depreciation and 22 months for a project on working capital. This is hardly indicative of a sense of urgency.

Since 1959, when the Powell Report was implemented, a striking change has taken place in the importance attached to research in the standard-setting process. Though still important, it has lost its primacy in the Board's thinking. Several recent opinions were not preceded by a published research study nor were several of the matters now being actively considered by the Board. The Board's research arm has not moved fast enough or effectively enough to keep up with the needs of a Board constantly under pressure to deal with the urgent items on its agenda. The men who are promulgating standards have outrun those who are doing the research.

Looking at the 21 opinions published down to the end of 1971, if one eliminates those minor ones for which no preparatory research was needed and groups the others according as they were or were not preceded by published research studies, the following picture emerges. Of the seven major opinions published to the end of 1968, five were preceded by published

research studies and two were not,² whereas of the eight published since 1968, three were preceded by published research studies and five were not. Moreover, of the three opinions since 1968 which were preceded by published research studies, one of them rested on research published 111 months earlier (and authorized 21 months before that) and a second on research published 85 months earlier (and authorized 43 months before that). The details are given below.

Major APB Opinions Preceded By Published Research Studies

APB Opinion No.	Topic	Prior published ARS No.	Date of ARS	Date of Opinion
3/19	Funds Statement	2	1961	1963/71
5/7	Leases	4	1962	1964/66
8	Pensions	8	1965	1966
11	Income Taxes	9	1966	1967
16	Business Combinations	5	1963	1970
17	Intangible Assets	10	1968	1970

Major APB Opinions Not Preceded By Published Research Studies

APB Opinion No.	Topic	Date of Opinion
2/4	Investment Credit	1962/64
9	Reporting the Results of Operations	1966
14	Convertible Debt	1969
15	Earnings per Share	1969
18	Investments in Common Stocks—Equity Method	1971
20	Accounting Changes	1971
21	Interest on Receivables and Payables	1971

The contrast between the early research hopes and the consequent achievement is even more striking if one looks at the items on the APB's active agenda at the beginning of 1972. Eliminating minor items and amendments to prior opinions, there are 12 other items that might have been expected to be preceded by AICPA published research studies; yet, only two of them will have been so preceded. The other ten will result in standards not based on prior AICPA published research studies.

² For this purpose, Opinions Nos. 2 and 4 are treated as a single opinion, since No. 4 simply countermanded No. 2.

The activities of the Accounting Research Division have had a relatively greater impact on the Board's statements than on its opinions. Of the four statements issued by the end of 1971, two (No. 3 on price level changes and No. 4 on basic concepts) were based in part on research studies. Statement No. 2 (on diversified companies) had no prior AICPA research study; and Statement No. 1 was a short statement disavowing Accounting Research Studies Nos. 1 and 3.

Of course, the fact that an AICPA-sponsored research study has not been published does not necessarily mean that the APB must act without the benefit of any research. In some subject areas, an abundance of theoretical and empirical research has been performed by academics, practitioners, and/or professional associations which is available for consideration by the Board. In such cases, a further research effort by the AICPA may not add measurably to the fund of knowledge and may, in fact, delay consideration of areas where standards are urgently needed.

It should also be noted that other professional associations have shown an increasing interest in sponsoring research on subjects under consideration by the APB. When competent research is expected to be forthcoming, the AICPA has indicated a willingness to await the results of research sponsored by other organizations rather than have its Accounting Research Division take on a project which might duplicate the work of others. An example is the research study on financial reporting by diversified companies prepared by Professor R. K. Mautz and sponsored by the Financial Executives Research Foundation.

In general, if one excludes Opinions Nos. 16 and 19, Board action has followed quite promptly on the completion of a research study—generally within two years. It seems to be a reasonable hypothesis, therefore, that if the Board's research arm had been more productive, the Board's effectiveness might have been greater.

The productivity of accounting research, of course, depends not only on the quantity of output but also the quality of research performed and the extent to which the research is related to the needs of the pronouncing body. We shall not attempt any evaluation of the quality of the Accounting Research Division's output. It is our impression, however, that research projects have not always been initiated with a clear statement of the issues before the Board and an indication of the types of evidence that the Board would consider persuasive in formulating an accounting standard. As a result, the Board has acted contrary to AICPA published research studies in a number of instances. We come to the inescapable conclusion that

much of the work of the Accounting Research Division has not been related closely enough to the needs of the Board.

Our review of the research program prompts a number of recommendations for the future which appear in Chapter 8 of this Report at pages 77-78 below.

Involvement of outsiders in the work of the APB

Although made up exclusively of members of the AICPA, the APB has been at pains from the beginning to involve others in its work. Exposure drafts of opinions are now circulated very widely to the business community, government agencies, academics, and professional and trade organizations; about 10,000 copies are sent to nonmembers of the Institute and to organizations other than accounting firms. In addition, some 90,000 copies are sent to individual members of the Institute and to accounting firms. It is not uncommon for the Board to receive 500 to 1,000 letters of comment on exposure drafts.

In 1966, the first of a series of financial writers' seminars was held by the Institute to help raise the level of understanding of the Board's problems. In the following year, the first of a series of symposia was held at which invited organizations were asked to give their opinions on pre-exposure drafts. The purpose of the symposia was to help the Board to reach conclusions and not merely to invite reactions to conclusions already reached.

The first public hearings were held by the Board in 1971 on the valuation of marketable securities and on accounting for extractive industries. These were a natural outgrowth of the symposia at which attendance had been by invitation only. The public hearings, which can now be expected to be a permanent feature of the Board's procedures for sounding opinion, invited the expression of views from anyone who wished to appear.

However, many remain unsatisfied with these efforts. They assert either that the Board has already made up its mind before it holds a public hearing, in those instances when it does not respond to pressure, or that it is vacillating and spineless when it does. Well might the Board's Chairman say in his opening statement at our public hearing that "in its 12-year history the Accounting Principles Board has produced four statements, 21 opinions, and a thousand critics."

Another input, in a sense external to the Board, has been obtained by bringing nonmembers, and even non-CPAs in one or two cases, onto

subcommittees of the Board. We think input of this sort could be greatly expanded and we shall have more to say about this matter below.

The output of the APB

Since its inception in 1959, the Board has issued 21 opinions and four statements. These are listed in Appendix E, pages 99–102, together with information about their periods of gestation. A list of projects on the Board's active agenda at the beginning of 1972 is also given. In a few cases, opinions of the Board have reversed or greatly modified earlier pronouncements so that the list of pronouncements slightly overstates the Board's productivity. On the other hand, a simple tally of opinions and statements takes no account of the weight or quality of these pronouncements. For example, Statement No. 4 ("Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises") is a substantial document representing years of work. Opinion No. 13, on the other hand, consists of two short paragraphs extending Opinion No. 9 ("Reporting the Results of Operations") to commercial banks.

There have been tremendous variations in the elapsed time between the initiation and completion of APB projects. A project can be said to have been initiated when a research study is authorized, although (as previously shown) not all Board opinions have been preceded by formal research studies. An examination of Appendix E shows that Statement No. 4 holds the record (if Accounting Research Studies Nos. 1 and 3 can be said to be part of its gestation process) with an elapsed time of 133 months. Statement No. 3 ("Financial Statements Restated for General Price-Level Changes"), published in June 1969, began with a research study authorized in April 1961; its elapsed time was therefore 98 months.

Among opinions, No. 16 ("Business Combinations") had the most protracted history, beginning with a research study authorized in December 1959 and concluding with the issuance of the Opinion in August 1970, an elapsed time of 128 months. Second in duration was Opinion No. 11 ("Accounting for Income Taxes"). The relevant research study was authorized in December 1959 and the Opinion was issued in December 1967, an elapsed time of 96 months. On the other hand, Opinion No. 6 ("Status of Accounting Research Bulletins"), which was not the subject of a research study, took only 11 months between the appointment of a Board committee and the issuance of the Opinion. Opinion No. 10 ("Omnibus Opinion—1966") and Opinion No. 12 ("Omnibus Opinion—1967") took

only 12 months and 11 months, respectively, from the appointment of a committee to the date of issuance of an opinion.

The quality of the Board's output is much more difficult to evaluate and any evaluation must be highly subjective. Many would agree with the judgment of Marshall Armstrong, President of the AICPA in 1970-71, that "the Board has a significant record of accomplishment." On the other hand, Robert Trueblood, himself a former member of the Board, appraised the first decade of the Board's work and concluded that the value of the Board's accomplishments "has not been proportionate to the human and monetary resources that have been expended."³

In discussions of the quality of APB pronouncements, a common form of disparagement is to liken many of them to a "cookbook." Professor Paton refers to "the unfortunate tendency of the Board to explore details and endeavor to take a positive position on all sorts of minor points."⁴ Like many critics who have chosen this point of attack, he focuses on Opinion No. 15 ("Earnings Per Share") as his main target. "Of course," he says, "obscurity and unnecessary detail are not all that is wrong with this particular Opinion. The basic objection to it is that the subject should never have been tackled in the first place." He goes on to complain that "the Board is no longer content to express opinions; it is now issuing hard-and-fast rules and directives."⁵

But there is another side to this question. It is virtually certain that, if the Board contented itself with broad generalizations, it might placate some critics but would provoke others, for it would then be accused of uttering platitudes. It is extremely doubtful that broad generalizations would satisfy the needs of public investors as seen by the SEC. The detailed prescriptions of Opinion No. 15 were, in fact, prompted by what appeared to be the ineffectiveness of the broader standards for reporting earnings per share in Part II of Opinion No. 9 ("Reporting the Results of Operations") which were, in turn, prompted by the serious concerns of the SEC. In a recent address to the National Association of Accountants, Commissioner James J. Needham of the SEC referred to Opinion No. 15 in these words:

³ "Ten Years of the APB: One Practitioner's Appraisal," an address by Robert M. Trueblood before the annual meeting of the American Accounting Association, August 27, 1969.

⁴ W. A. Paton, "Earmarks of a Profession—and the APB," *The Journal of Accountancy* (January 1971), p. 42.

⁵ *Ibid.*

I know many of you believe that only a "Philadelphia lawyer" could possibly interpret Opinion 15. Certainly, it's not easy. But to put an end to all the abuses conceived by very resourceful people in the computation of earnings per share required a comprehensive and necessarily complicated opinion.

If attempting to narrow the wide range of alternative financial accounting methods applicable in like factual situations is a proper function for the Board, it is difficult to see how effective standards can be formulated at the level of broad generalization. Good cooks do not sneer at cook-books; and they would not think much of a recipe which called for "a fair amount of flour" or "an appropriate number of eggs." However, in setting standards the Board ought to avoid attempting to deal with their application under every conceivable set of circumstances, no matter how rare or obscure.

The Board's opinions have been criticized for giving too little explanation and justification of the conclusions reached and too little discussion of the alternatives which the Board rejected. We believe this criticism is valid. In the interests of brevity—a quality we do not deplore—the Board seems to us to have missed opportunities to educate the accounting profession as well as the entire financial reporting community.

Moreover, by giving more attention to rejected alternatives in drafting an opinion, it would be practicable for the Board to dispense with the publication of dissenting views as a part of the opinion. The attachment of dissents to opinions doubtless has some educational value but the practice can also create both uncertainty and confusion. Perhaps for this reason, almost all agencies of government and other authorities which issue rulings do not include dissenting opinions as part of such rulings, although dissents are of course properly a part of the public record of agency action. The Hanson Committee, which reported to the Institute's Executive Committee⁶ in 1969 on the APB's operations, said "it is the feeling of many that the provision for public dissent in the opinion has done more to damage the image of the APB, and therefore the profession, than almost any other single item."

The Hanson Committee recommended that "dissents not be printed in those cases where an APB Opinion receives the necessary two-thirds majority." This recommendation was not adopted. We agree with the

⁶ What was formerly the Executive Committee has, since 1969, been known as the Board of Directors.

Hanson Committee and offer a recommendation on this matter below at page 74. The better way to give minority views the attention they deserve is by explaining in the discussion section supplemental to an opinion why the majority of the Board did not accept them.

The status of APB opinions

Departures from APB opinions. To understand the present status of Board opinions, it is necessary to go back to the year 1948 when the membership of the AICPA approved a special report of the Committee on Auditing Procedure laying down certain standards of reporting. In 1962, these standards were incorporated into the Committee's codification of its work to that time as Chapter 2 of Statement on Auditing Procedure No. 33 ("Auditing Standards and Procedures"). The first standard of reporting, as it there appears, reads: "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting."

This reporting standard is given force by Article 2 of the Institute's Code of Professional Ethics. Rule 2.02(e) reads:

In expressing an opinion on representations in financial statements which he has examined, a member or associate may be held guilty of an act discreditable to the profession if . . .

(e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

In his historic address to the AICPA's annual meeting in New Orleans in October 1957 in which the concept of the Accounting Principles Board was first presented, Alvin Jennings, the Institute's President, proposed that "statements issued by the research organization [he was here referring to what became the APB] should be submitted for approval or rejection of basic ideas to the Council of the American Institute of Certified Public Accountants. . . . 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."⁷ This suggestion did not commend itself to the Special Committee on Research Program (the Powell Committee) to which Mr. Jennings' proposals were referred by Council. That committee proposed the establishment of an Accounting Principles Board, expressing its own view in the following words:

⁷ *The Journal of Accountancy* (January 1958), p. 32.

We have concluded that only rarely should a pronouncement be given the degree of finality represented by adoption of the principle by the Council or possibly by the membership of the Institute. The Board would be expected to review its past pronouncements from time to time, and in a few instances might decide that a particular statement was of such great significance and had received such general support and acceptance, that it should be given formal recognition and become mandatory upon the membership of the Institute. In such cases the Board would include recommendations for such action in its report to the Council. We feel that the best method of enforcing most of the Board's pronouncements would be to secure their acceptance as high authority by professional accountants in advising clients and in preparing reports on financial statements.

It is worth mentioning that the Chairman of this committee, Weldon Powell, was soon to become the APB's first chairman; three other members, Carman Blough, formerly Chief Accountant of the SEC, Arthur Cannon and Leonard Spacek, were among the Board's original members; another, Paul Grady, was for a short time the Institute's Director of Accounting Research; and two other members, William Werntz and Andrew Barr were successively Chief Accountant of the SEC. Such an array of talent gave the Powell Committee's report unusual authority.

The course recommended by the Powell Committee was adopted when the APB came into existence in 1959. The Board's pronouncements were "expected to be regarded as authoritative written expressions of generally accepted accounting principles," to quote from the Board's original Charter; but, as the Executive Committee said in its Special Report to Council in March 1964, "there is at present no means of assuring either that they will be universally followed or that departures from them will be disclosed by independent auditors."

Alvin Jennings was one of the APB's original members; he took over the chairmanship from Weldon Powell in 1963. In June 1963, by a vote of eleven to eight, the Board proposed to the Executive Committee of Council that the auditing standard and rule of ethics cited above should be amended "as may be required to provide that in addition to the obligation of members to report departures from generally accepted accounting principles they shall also be required to include a report as to departures from opinions of the Accounting Principles Board." This proposal was rejected by the Executive Committee, because it appeared to recognize two sets of standards, "generally accepted accounting principles" and the opinions of the Board. In its place, in its Special Report of March

1964, the Executive Committee put to Council a much stronger proposal, the essential part of which was that

when a pronouncement of the Accounting Principles Board has become effective, that pronouncement shall be considered as constituting the only "generally accepted accounting principle" in the subject area covered for purposes of expressing an opinion on financial statements, within the meaning of Rule 2.02(e) of the Code of Professional Ethics and the first standard of reporting . . . unless and until the Council rescinds such pronouncement of the Board.

* * *

The effect of adoption of this proposal would be that a member of the Institute, in expressing an opinion on financial statements in which a material item was dealt with in a manner different from that recommended in a pronouncement of the Accounting Principles Board which had become effective, would be required in his report to "direct attention" to the fact that this item was not presented in accordance with generally accepted accounting principles.

This proposal was too restrictive in its meaning of "generally accepted accounting principles" to commend itself to a majority of Council, but a substitute motion was carried to the effect that "it [was] the sense of this Council that audit reports of members should disclose material departures from Opinions of the Accounting Principles Board," and the question of implementation was referred to a special committee to be set up by the President for the purpose. This committee, the Seidman Committee, worked on the problem through the summer of 1964 and came forward with a set of recommendations which Council accepted at its fall meeting, and which are still in effect. These were promulgated in a Special Bulletin issued by Council to the members in October 1964. The essential passages are as follows:

The Council of the Institute, at its meeting October 2, 1964, unanimously adopted recommendations that members should see to it that departures from Opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, either in footnotes to financial statements or in the audit reports of members in their capacity as independent auditors.

* * *

"Generally accepted accounting principles" are those principles which have substantial authoritative support.

Opinions of the Accounting Principles Board constitute "substantial authoritative support."

"Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

* * *

If an accounting principle that differs materially in its effect from one accepted in an Opinion of the Accounting Principles Board is applied in financial statements, the reporting member must decide whether the principle has substantial authoritative support and is applicable in the circumstances.

If he concludes that it does not, he would either qualify his opinion, disclaim an opinion, or give an adverse opinion as appropriate. . . .

If he concludes that it does have substantial authoritative support:

- (1) he would give an unqualified opinion and
- (2) disclose the fact of departure from the opinion in a separate paragraph in his report or see that it is disclosed in a footnote to the financial statements and, where practicable, its effects on the financial statements.

The Special Bulletin instructed the APB to include in each opinion a notation that members should disclose a material departure therefrom. Accordingly, every opinion from No. 6 onwards has carried a notation in line with Council's recommendation, together with the warning that the burden of justifying departures from Board opinions must be assumed by those who adopt other practices. Disclosures in accordance with the Special Bulletin of such departures from APB opinions have been rare.

The Special Bulletin of October 1964 described a failure to disclose a material departure from an Accounting Principles Board opinion as "substandard reporting." This phrase is explained in a footnote to mean "reporting practices not in conformity with recommendations of the Council" and the Practice Review Committee was instructed to give its attention to this area. Infractions of Council's recommendations were not considered at the time to be a breach of the Code of Ethics. However, after further study of this question, the Seidman Committee, in a second report to Council in the spring of 1965, recommended that, after an interval for education and adaptation to the Special Bulletin, the Code of Ethics should be changed.

There is a rule of professional ethics dealing with failure to observe generally accepted accounting principles. Likewise, there should even-

tually be a rule of professional ethics dealing with failure to disclose departures from Opinions of the Board.

* * *

The public posture of the profession should be supported by the highest ethical standards. Certainly, Council's resolution gains more authority with a corresponding ethics rule than without one.

The Committee thought that an interval of three years should be allowed before asking Council and members of the Institute to vote on an amendment to the Code of Professional Ethics. Council approved such a change in 1969; but in a mail ballot of the members, the proposal narrowly failed to obtain the necessary two-thirds majority.

We understand that a complete revision of the Code of Ethics is presently under consideration and will, if approved by Council, come before the membership for a vote late in 1972. Included in the revised Code is a new Rule 203 which provides:

A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an Opinion of the Accounting Principles Board which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the departure is necessary to a fair presentation. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the Opinion would not result in a fair statement.

Rule 203 differs from the earlier proposal in that it sanctions departures from an opinion on the basis of "unusual circumstances" and "fair presentation" rather than "substantial authoritative support." However, it would make adherence to the opinions under normal circumstances enforceable under the profession's Code of Ethics. We think such a change in the Code of Professional Ethics is highly desirable, as evidence of the profession's commitment to the development of effective standards of financial reporting. In light of the recommendations in this Report, we suggest that proposed Rule 203 be revised so that opinions of the new Financial Accounting Standards Board would be enforceable under that Rule.

Susceptibility of APB opinions to legal attack. There are possibly four legal avenues by which actions of the APB, or of the new Financial Accounting Standards Board which we propose in Chapter 8, might be sub-

jected to attack, namely, arguments that such actions (a) inflict tortious injury upon a company whose reported financial position or results of operations are affected thereby, (b) violate the antitrust laws, (c) flow from an unconstitutional or otherwise improper delegation of power by the SEC, or (d) violate the Federal Administrative Procedure Act.

Only the first of these avenues has been the subject of a court case. In 1959 the Committee on Accounting Procedure of the AICPA (the predecessor of the APB) announced a proposal to interpret the phrase "deferred tax account" appearing in Accounting Research Bulletin No. 44 to mean a liability and not an equity account. Certain subsidiaries of American Electric Power Company had previously taken the position that deferred tax accounts should be classified as a part of stockholders' equity. Unhappy with the prospect that their aggregate balance sheet liabilities would increase (with potential adverse effects upon bond indenture ratios and the like), they sued to enjoin the issuance of the pronouncement on the ground of prima facie tort, or the intentional infliction of injury without just cause.⁸ The suit was unsuccessful. Absent a showing of actual malice or its equivalent, the Second Circuit said, courts "may not dictate or control the procedures by which a private organization expresses its honestly held views." Indeed, in the court's opinion, a professional body "accepts a public obligation for the unfettered expression of its views."

As previously pointed out, the APB's membership is made up solely of CPAs who are members of the Institute. Our proposal for a Financial Accounting Standards Board (Chapter 8) contemplates that a minority of the Board may consist of persons who are not CPAs although they must be well versed in the problems of financial reporting. Would such a change weaken the force of the *Appalachian Power* decision as a shield against legal attack on the Board's pronouncements? Based on a careful reading of the Second Circuit's opinion and a review of its reasoning, we think not. The essence of a successful defense lies in the freedom of the private body from any motive, economic or otherwise, to do injury to anyone. That freedom is best assured by the elimination of even the appearance of conflict of interest and by the fact of independent sponsorship. Our proposals, we believe, will strengthen the Board's status in this vital respect.

⁸ *Appalachian Power Co. v. AICPA*, 177 F. Supp. 345 (S.D.N.Y. 1959), *aff'd per curiam*, 268 F.2d 844 (2d Cir. 1959), *cert. denied*, 361 U.S. 887 (1959).

Freedom from economic motivation is also a key element in protecting the Board and its pronouncements from attack on antitrust grounds. Private and professional organizations are not immune from the antitrust laws and a number of cases have been successfully brought in the past against private standard-setting bodies. These cases demonstrate that it is where superficially objective standards have been utilized for the purpose of reducing competition or injuring others who are differently situated economically that antitrust principles clearly apply. By contrast, in the absence of such economic motivation, and given a rational basis and procedures adequate to avoid patent unfairness, collaborative action in developing standards has not been held subject to antitrust liability.

It has been urged by some, although not as yet in litigation, that certain opinions of the APB are vulnerable on antitrust grounds because they are, assertedly, "inherently unreasonable" or have a discriminatory impact upon certain businesses. In our view, these arguments must fail so long as the particular pronouncement of the Board is one as to which reasonable men can honestly differ, and so long as the men who voted it are unmotivated by commercial self-interest. We cite as illustrative authority *United States v. Johns-Manville Corp.*, 259 F. Supp. 440 (E.D. Pa. 1966); *Structural Laminates, Inc. v. Douglas Fir Plywood Ass'n*, 399 F.2d 155 (9th Cir. 1968), *cert. denied*, 393 U.S. 1024; and *cf. Marjorie Webster Junior College, Inc. v. Middle States Ass'n of Colleges and Secondary Schools, Inc.* (C.A.D.C. 1970), 432 F.2d 650.

It is conceivable that an argument might be advanced to the general effect that opinions of the Board are the result of an improper or unconstitutional delegation of the powers reposed by Congress in the SEC. To this argument there are several answers. Although to a major extent the APB exercises its function in an area which the Commission could preempt if it chose, nevertheless the APB's authority does not in any sense derive from the Commission. The APB could issue its opinions even if there were no Federal Securities Acts. Moreover, as has previously been pointed out, there are large numbers of firms and corporations over which neither the SEC nor any other Federal agency has authority in matters of accounting, but as to which the pronouncements of the APB apply so long as the financial statements of such companies are audited by members of the AICPA.

Nothing in either the language or legislative history of the Federal Securities Acts suggests that Congress intended to preempt the establishment of financial accounting standards. Moreover, there has been nothing

approaching an explicit delegation of authority by the SEC to the APB. At most, the Commission has left the initiative to the APB, reserving its own right of contrary decision and also letting its views, and those of its staff, be known for the guidance of the APB. We are aware of no judicial pronouncement indicating that such a procedure would be equivalent, for legal purposes, to delegation of authority in the constitutional sense.

Finally, the considerations which have been discussed immediately above would appear adequate to dispose of the argument that actions of the APB or its successor might be susceptible to an attack based on the principles of the Federal Administrative Procedure Act (the "APA"). This Act has no direct application to the APB or any other body operating in the private sector. Even assuming that the issue turned solely on the operating procedures of the APB, irrespective of legal technicalities, it should be a sufficient answer that the APB's procedures (including public notice of its proposed opinions, the opportunity for submission of written views by interested persons, and the holding of public hearings on topics of substantial importance) have evolved to the point where they are superior in some respects even to the specific requirements of the APA.

Interpretation of APB opinions

Since 1969, the Administration Division of the APB has been responsible for preparing and issuing what at first were called "unofficial accounting interpretations" of APB pronouncements. These are published in *The Journal of Accountancy* and in the looseleaf service and bound volumes of *APB Accounting Principles*. Over 50,000 copies of the longest interpretation, a substantial booklet on Opinion No. 15 ("Earnings Per Share"), have been issued. In addition to the booklet, 144 interpretations were published down to the end of 1971 and many more were under consideration at that time.

Most of the research and drafting for interpretations is done by a research associate in the Administration Division. Topics to be covered are sometimes suggested by questions raised by CPA firms, sometimes by persistent questions coming into the Institute's Technical Information Service, and sometimes by the APB's Planning Committee as a way of getting narrow points disposed of pending a fuller review of an already issued opinion. The interpretations are designed to clarify and amplify

language in an opinion which is thought to be too vague or to apply the opinion to circumstances that were not contemplated at the time it was written.

Before an interpretation is issued, it must be approved by the administrative director of the APB, by the executive vice-president of the Institute, and by the chairman of the APB. More recently, some interpretations have been reviewed by the full Board prior to issuance and have been the subject of informal votes.

In the summer of 1971, accounting interpretations ceased to be "unofficial" simply by deleting this adjective from their title. They did not by this act become "official" for they are still not pronouncements of the Board. Their status is described in a statement which now accompanies each interpretation as follows:

The Institute staff has been authorized to issue interpretations of accounting questions having general interest to the profession. The purpose of the interpretations is to provide guidance on a timely basis without the formal procedures required for an APB Opinion and to clarify points on which past practice may have varied and been considered generally accepted. These interpretations, which are reviewed with informed members of the profession, are not pronouncements of the Board. However, members should be aware that they may be called upon to justify departures from the interpretations.

When the interpretation service started in 1969, it was thought of by those most directly concerned with it as a staff function in which the APB itself would not be much involved. Gradually, however, it begins to look more and more as though the Board is developing a second, more informal brand of opinion which can be issued in a hurry without the formality of obtaining a two-thirds vote of the Board. The Chairman of the Board, in his oral statement at our public hearing, said: "When events create an urgency to move faster, the Interpretation route is taken and the effect [is] immediate, as in the case of computer leasing. This procedure is a recent development in the Board's operations, and many critics have not yet digested the full significance of it." Critics of this procedure can be excused if they take these words to mean that the Board is indeed now issuing "two classes of authoritative pronouncements, one called Opinions and one called interpretations and attributed to other authority."⁹ It seems to us that this recent development might possibly jeop-

⁹ From the statement submitted to us by Arthur Young & Company.

ardize the deliberative process which the Board in general has been at great pains to preserve.

At the same time, it is easy to sympathize with an over-burdened part-time Board when it seeks to avoid delay in getting expressions of view by the full Board. It would be easier for a full-time board to have interpretations prepared and to issue them expeditiously with its full authority. This is one of several reasons which have led us to favor a full-time board.

Government agencies and the APB

The SEC and the APB. Since 1934, the SEC has been empowered to prescribe the form and content of financial statements filed by reporting companies¹⁰ and to specify the methods to be followed in their preparation.

Early in its administration of the Securities Exchange Act of 1934, the Commission adopted Regulation S-X setting forth the required form and content of financial statements. With certain limited exceptions, certification of all financial statements by independent public accountants was required. The matters to be covered by the accountants' opinion were specified. Standards of independence were formulated. Requirements for disclosure of the effects of changes in accounting principles or practices were promulgated.

However, despite the acknowledged breadth of its powers to prescribe accounting principles and practices, the Commission has elected not to preempt the field. Instead, it has encouraged the accounting profession to take the lead in developing financial accounting and reporting standards, reserving to itself, for the most part, the role of overseer to "criticize and prod."¹¹ This policy has continued to the present day. It is based on several important considerations.

First, a role of great importance in carrying out the disclosure philosophy of the Federal Securities Acts is assigned to the independent public accountant. Under the statutory scheme, substantial reliance is placed

¹⁰ Under the Securities Exchange Act of 1934, all nonexempt companies with over \$1,000,000 of assets and 500 shareholders of record must file periodic reports, including financial statements, with the SEC.

¹¹ Statement of the SEC to the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, February 19, 1964.

upon him for a painstaking review of the financial statements, which are the heart of the registration document. To perform such a responsibility adequately requires a high sense of dedication to a professional ideal. Early leaders of the Commission may well have sensed that if accountants were to maintain such dedication, it would be wise to give them the primary responsibility for improving the usefulness and reliability of financial statements. Otherwise, in the long run, the public interest might suffer.

Secondly, the Commission has long recognized that the task of improving financial accounting standards is one of great complexity, demanding large expenditures of time and talent. It has chosen to use its small accounting staff to meet the pressing demands of day-to-day administration. Little likelihood has existed of obtaining the additional appropriations necessary to hire a substantially larger accounting staff which could be devoted to research on accounting standards. The alternative has been to insist that the institutions of the profession take the initiative in this vital area.

Moreover, with few exceptions, opinions of the APB have been followed voluntarily by accountants practicing before the Commission, however vigorous the debate which preceded their adoption. The Commission's decision to leave the initiative to the APB has been influenced, beyond doubt, by the marked degree to which the Board's opinions commanded acceptance by the profession without the exercise of explicit enforcement power.

Summarizing its policy in connection with Congressional hearings in 1964, the Commission observed:

Much improvement in financial reporting practices has occurred since the enactment of the first Federal securities law in 1933. The Commission believes that its policy of working with and supporting the accounting profession in the development of accounting principles has directly influenced this progress and is the best means of assuring continuing improvement of accounting practices.¹²

In accordance with this policy, the Commission has in fact worked with the accounting profession in the development of accounting principles in a number of ways. Through the years, an AICPA Committee on Relations with the SEC and Stock Exchanges has met from time to time with

¹² *Ibid.*

the accounting staff of the Commission to discuss areas in need of attention in financial accounting. The staff has not hesitated to suggest that items it considers important be placed on the APB's agenda. Where resolution of a particular matter might otherwise have been delayed, both the Commission staff and individual members of the Commission have pressed the APB for action. The staff has regularly submitted comments on exposure drafts of proposed APB opinions after clearing such comments with the Commission. We believe this useful interchange could be strengthened without injury to the role and responsibility of the private standard-setting body. A recommendation along these lines appears on pages 75-76.

It has often been observed, somewhat loosely, that the Commission "enforces" observance of the APB's opinions by issuers of securities who must file registration statements. This observation may lead to a misconception of the relationship between the Commission's administrative functions and improvements in financial accounting. In reviewing registration statements, particularly those filed under the Securities Act of 1933, the Commission's staff necessarily exercises a large measure of discretion. Registration statements and prospectuses are required to contain the disclosures specified in various registration forms officially adopted by the Commission, but these forms describe areas of required disclosure only in general terms. Over the years, the character and quality of prospectus disclosure has been largely shaped by staff comments on individual filings, often preceded or followed by informal conference between the staff and lawyers or accountants for the registrant, rather than by formal administrative proceedings.¹³ The process has been an evolutionary one, as it applies both to the text and to the financial statements contained in prospectuses.

What are the sources of experience which contribute to this process? They are many: the observed results of particular offerings, complaints of investors, internal staff studies on particular subjects, conferences with registrants and their advisors, and such products of outside research and analysis as the bulletins of the AICPA's Committee on Accounting Procedure and the opinions of the APB. All of these may contribute new insight as to those types of disclosure which may be more informative, on

¹³ Two important Commission rules are pertinent to this process: Rule 408 under the Securities Act of 1933 and Rule 3-06 of Regulation S-X. These rules are similar in their import. Referring specifically to the financial statements, Rule 3-06 says: The information required with respect to any statement shall be furnished as a minimum requirement, to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

the one hand, or which may possess the potential for misleading investors, on the other, in contrast to previously permitted disclosure patterns. Pronouncements of the APB—a competent professional body dedicated to improving financial reporting—obviously bear great weight with the SEC, even though, on occasion, it has permitted or required registrants to follow practices contrary to APB opinions.

Several critics, notably Professor Homer Kripke,¹⁴ have questioned whether, by making use of opinions of the APB in the course of administering disclosure policy, the SEC may have engaged in what amounts to rule-making in violation of the Federal Administrative Procedure Act (the “APA”).

The pertinent provisions of the APA appear to be those of 5 United States Code Sec. 553 requiring, as to agency rule-making, that general notice of a proposed rule be published in the *Federal Register*; that this be done at least 30 days prior to the proposed effective date; that there be furnished an opportunity for interested persons to submit written data, views, and arguments (although not necessarily an oral presentation); and that the agency provide a right of interested persons to petition for the issuance, amendment, or repeal of a rule. These formal requirements are not applicable to “interpretative rules” or “statements of policy.” It may be noted that most of the pronouncements the Commission has made with respect to matters of accounting practice have not been by way of formal rule-making, but rather by Accounting Series Releases or opinions of the Chief Accountant, presumably because the Commission has considered them to be “interpretative rules” or “statements of policy.”

We doubt that the APA was intended to prevent the sort of evolutionary progress in disclosure policy which has been described earlier in this Chapter of our Report. Indeed, no one has ever challenged the SEC on such grounds. The Study discussed Professor Kripke’s point with Philip A. Loomis, Jr., formerly General Counsel and now Commissioner of the SEC. Mr. Loomis advised us that in his opinion the Commission’s administration of the disclosure requirements of the Federal Securities Acts in regard to financial statements has not been in conflict with the APA.

The role of the SEC in assuring high standards of financial reporting to public investors is a crucial one. The Commission has been sensitive

¹⁴ Homer Kripke, “The SEC, The Accountants, Some Myths and Some Realities,” *NYU Law Review* 45, No. 6 (December 1970), pp. 1151–1205. See particularly pp. 1151 and 1181.

to the need for greater coordination between the registration process under the Securities Act of 1933 and the periodic reporting process under the Securities Exchange Act of 1934. Among other events, the recently adopted Rule 144 and Form S-16 show that increasing reliance will be placed on the 1934 Act reporting process to provide the public with up-to-date and informative financial data. Careful review of such periodic filings by a highly competent staff is important, and in the view of many, the present accounting staff of the Commission is not adequate for this task.

Other governmental agencies and the APB. The interest of governmental agencies (other than the SEC) in the accounting area varies among agencies depending principally on their statutory purposes. Most agencies have statutory authority to prescribe the accounting and reporting procedures of companies subject to their jurisdiction. Many agencies have in fact established uniform systems of account designed to meet their particular regulatory needs, which include rate-making, awarding of franchises or operating rights, approving the issuance of securities, passing upon mergers of regulated companies, and the like.

No governmental agency except the SEC is primarily concerned with financial reporting to investors. Such agencies as the Federal Communications Commission and the Civil Aeronautics Board have in general permitted companies under their jurisdiction to follow generally accepted accounting principles, including opinions of the APB, in reporting to shareholders, despite the fact that their own accounting procedures and rules may be inconsistent with those principles or opinions. In 1962, the Interstate Commerce Commission adopted an order permitting carriers under its jurisdiction which desired to do so to publish financial statements in reports to their shareholders based on generally accepted accounting principles at variance with the ICC's prescribed accounting rules. However, many railroads continue to report to their shareholders in accordance with the ICC's rules rather than generally accepted accounting principles.

Most agencies take the position that they have the power, under their statutes, to require reports to shareholders to conform to their own accounting procedures. In the case of the Federal Power Commission, that power has been judicially confirmed.¹⁵ There are indications today that

¹⁵ *Appalachian Power Company v. Federal Power Commission*, 328 F.2d 237 (4th Cir. 1964); *cert. denied* 379 U.S. 829.

governmental agencies other than the SEC may in fact become more involved in financial reporting, particularly in view of the Congressional criticism of the ICC for alleged failure to protect the shareholders of the Penn Central, and the concern of some regulated companies that presently accepted (or proposed) accounting practices may affect their ability to finance their operations.

Early in its history, the APB issued an "Addendum" to Opinion No. 2 which is still in effect and which permitted accounting methods prescribed by a regulatory agency in the course of the rate-making process to be used in financial reports to shareholders, even though these methods ordinarily would not be in accordance with generally accepted accounting principles. For example, such principles would not normally permit a casualty loss to be capitalized; but if a regulatory agency will permit recovery of such a loss in establishing future rates, the "Addendum" to Opinion No. 2 permits capitalization of such a loss for reporting purposes. This approach is necessary to match costs and related revenues in these circumstances. However, when a governmental agency imposes accounting requirements for financial reporting to investors which are not directly related to the rate-making process, the effect may be to accomplish a regulatory purpose at the risk of misleading present and potential investors. Unless government agencies are careful to avoid such procedures, the process of improving financial accounting in the public interest could be jeopardized.

One other agency of the Federal Government, not concerned with regulation, has a substantial interest in financial accounting standards. We refer to the U.S. Treasury Department which is responsible for administering the Federal income tax laws. Taxable income may differ substantially from the income reported to shareholders in accordance with generally accepted accounting principles. This follows from the fact that the tax laws and the regulations of the Treasury Department have economic or social objectives not necessarily consistent with the most informative reporting of the results of operations. In such instances, it has generally been Treasury Department policy not to insist that the financial accounting followed by a taxpayer conform to the tax accounting used. Where policy objectives do not supervene, however, and two or more alternative accepted methods of accounting are available (one of which may produce substantial tax benefits whereas the other would produce the most informative statements to investors) the Treasury Department has indicated a desire to secure conformity of income determination methods used for

tax and financial statement purposes, i.e., to require that a particular method may be used for tax accounting only if that same method is also used in preparing the financial statements.

Fortunately, the Study gained the impression from conferences with Treasury Department officials that the Department is aware of the problems which could be created by unwise conformity requirements. Although some divergences are inevitable, the basic objectives of tax and financial accounting are essentially the same insofar as the accurate measurement of business income is concerned. The Study hopes that it will be the policy of the Treasury Department to work toward narrowing the gap between tax and financial accounting, wherever possible, by embracing accepted financial accounting standards for tax purposes. That policy will be easier for the Treasury Department to implement if more rapid progress can be made in reducing the number of unjustified alternatives available in financial accounting.

Generally speaking, we do not believe that government officials desire to inhibit the development in the private sector of sound financial accounting standards. Most recognize the public interest implications of such standards. In one or two recent instances, government agencies may have concerned themselves with reporting to shareholders partly because they were confronted with urgent accounting issues which they believed the APB would not resolve on a sufficiently timely basis. We believe that the new Standards Board proposed in Chapter 8 of this Report will reduce the pressure for government agencies (other than the SEC) to become involved in financial reporting to investors.

The Study's inquiry into this area prompts two other conclusions. First, it is essential that the private sector standard-setting body become more actively and intimately involved with the concerns of agencies of government which may possess the power to override its standards in areas of their jurisdiction, demonstrating to them, in turn, that usefulness to investors must be the basic consideration in financial reporting. Secondly, in the long run, the present jurisdictional patchwork in the area of financial reporting ought to be reduced. One agency, the SEC, charged solely with protecting the interests of investors, should have the ultimate power over all financial reporting for the benefit of public investors. A step in that direction was taken last year with the introduction of legislation¹⁶ to eliminate the existing exemptions in the Federal Securities Acts

¹⁶ See H.R. 12128, introduced December 8, 1971 by Congressman Harley Staggers of West Virginia. The Chairman of the ICC has stated publicly that he favors the changes which would be brought about by such legislation.

for carriers regulated by the ICC. Even without legislation, progress is possible. For example, over many years banks and trust companies (which possess complete exemption from SEC rules regarding financial disclosure) reported to their shareholders in a manner at variance with generally accepted accounting principles. However, in July 1969, representatives of the SEC, the three Federal bank regulatory agencies, and the American Bankers Association agreed upon a form for bank income statements which followed in large measure the audit guide for banks published by the Institute the previous year.

Advantages and disadvantages of the present arrangements: possible alternatives

TWO CENTRAL ISSUES confronted us, once the choice was made to keep the standard-setting process in the private sector. These were:

1. Should the responsibility for setting accounting standards continue to be exclusively the province of the AICPA or should that responsibility be shared with others?
2. Whoever bears the responsibility, should the work be done by a fairly large, volunteer, part-time group or by a smaller, full-time board?

These two issues can be considered separately although at several points, as on financing, they come together. We shall consider them in the above order.

Should the AICPA share responsibility for standard-setting with others?

The Accounting Principles Board, as was explained earlier, is a senior committee of the AICPA. It is responsible to the Council of the AICPA through the Board of Directors, and its members are appointed from the ranks of the AICPA by the President of the Institute with approval of the Board of Directors. It is thus an integral part of the largest organization of accountants in this country.

There are advantages to the present arrangement. Under this arrangement the accounting profession, in the fullest sense, is performing the self-regulatory function of establishing standards for the guidance of its members in attesting to the fairness of financial statements. Members of the APB maintain their professional affiliations while devoting much of their time to the Board's work; this fact might well be viewed as strengthening the connection between the profession and the work of the Board.

Moreover, the continuing contact that APB members have with their firms, companies, or universities protects them from the charge that they dwell in ivory towers. While the demands of Board membership make it virtually impossible for a practitioner member to have extensive client responsibilities, he continues, nevertheless, to have contact with his partners. He is not withdrawn from the problems of everyday professional life. Consequently, he can be expected to bear in mind matters of practicability in the development of Board opinions.

From the Board's inception, each of the eight largest public accounting firms has had one of its partners on the Board. Medium-sized and smaller firms have provided some outstanding men, including two of the Board's five chairmen. CPAs from the industrial, financial, and academic worlds have also served on the APB, although only in small numbers. This representative feature of the Board's present organization has given it a broad constituency within the profession which has, in turn, generally helped to assure acceptance of its pronouncements without the need for cumbersome enforcement procedures. Whether the present Board can be said to be fully representative of the public interest in matters relating to financial reporting is perhaps more controversial. Despite the doubts which have been expressed on this score, we think there is *prima facie* reason for believing that members of a profession with many clients drawn from different sectors of society, with a sense of loyalty to their profession, will generally find it easier to adopt a public interest stance than men of equal integrity regularly employed by private business.

As we have already pointed out, public accountants have a special position and responsibility under the Federal Securities Acts. The audit of financial statements which they are required by law to perform, and the standards of independence which they are required by SEC regulation to meet, are designed to furnish added protection to the public in carrying out the statutory policy of full and fair disclosure. Such considerations have weighed heavily in our deliberations. They lead up to the conclusion that if the time has now come for a change in the composition of the Board, it is

essential that at least a majority of the new Board's members be public accountants. The tie between the Board and the public accounting profession must remain strong. Public accountants must see the new Board as fulfilling the essential duty of their profession to establish and improve the standards by which their activity advances the public interest. Such a duty has long been regarded as the hallmark of a true profession.

Nonetheless, we believe that the work of the standard-setting body would be improved if a more direct share of responsibility were given to the three principal groups in the financial reporting community who, together with auditors, have a substantial concern with the setting of financial accounting standards. These three groups are: financial executives of corporations who prepare reports to their stockholders, financial analysts who distill essential facts and trends from available financial data for dissemination outside their own organizations, and accounting educators. (We do not include in this financial reporting community those who merely use financial information for their own purposes.) Not only are these groups concerned with the standard-setting process, but they include individuals possessed of skills and experience of a high order which could be useful to the standard-setting body.

To facilitate such broader participation in the standard-setting process, we would eliminate the present requirement that all members of the APB be members of the AICPA. As to three of the seven persons making up the new standard-setting body, we would remove the requirement (subsumed by membership in the AICPA) that they hold a CPA certificate. We believe that for a standard-setting body such as we have in mind, one which is not wholly within the structure of the AICPA, these two requirements would unnecessarily exclude persons in all three of the fields mentioned—financial executives, academics, and financial analysts—who are not CPAs, or who are not members of the Institute, but who could nonetheless make a substantial contribution to the work of the body. We note that if the one financial analyst now on the APB had not also been a CPA he would have been disqualified from serving. There are senior financial executives outside the ranks of the Institute and academics knowledgeable about accounting who are not CPAs. We also note that of the roughly 125,000 CPAs in this country, some 40,000 or almost one-third do not belong to the AICPA at the present time and so are presently not eligible for membership on the APB. Of course, the more than two-thirds who do belong include virtually all the partners of the leading firms in the practicing part of the profession.

Many well-informed persons believe that financial executives of corporations should play no part in standard-setting. One member of the APB has put it to us that "there is an inherent conflict between their role as managers and the task of measuring their own performance. An analogy might be having the baseball batter calling the balls and strikes."

To this argument there are several answers. First, the present Board already has two seats for business executives (though one is now occupied by a financial analyst), so that the principle which is being questioned has already been conceded—unless a distinction is to be drawn between those executives who belong to the AICPA and those who do not, a distinction which, as we have said, we think should not be perpetuated. But more fundamentally, we think the Board member quoted above invokes the wrong analogy, since the role of the Board is not that of enforcing standards, but of developing them. True, the baseball batter should not call the balls and strikes; but there is no reason why he should not have some say in developing the rules of the game.

Secondly, insofar as the objection to financial executives having a role in standard-setting rests upon apprehension of a conflict of interest, we believe that the full-time service on the Standards Board which we propose should be a sufficient answer. On such a board, the board member, for the time he serves on it, would have no other loyalty. He would be serving because of the contribution he could make to the board's work, drawing upon the special perspective and expertise he has developed in the role of a financial executive.

An important objection which might be raised against our proposal to broaden the base of the standard-setting body concerns the problem of enforcement. Can the disciplinary machinery of the AICPA be used to enforce, as to its members, the pronouncements of a standard-setting body which is not a committee of the Institute? It is an essential part of our proposals that the new Standards Board, and the Financial Accounting Foundation on which it rests, shall have a separate identity of their own. But under our proposals, the AICPA is given a role in the establishment and maintenance of the Foundation sufficient to provide a strong continuing sense of participation in its work and thereby to insure that the support of the profession will not be seriously diminished. In these circumstances, it seems to us, the answer to the question posed above about the use of the Institute's disciplinary machinery to enforce standards under the new regime can and will be yes.

Should the board be part-time or full-time?

Whatever the composition of the board as regards the professional allegiances of its members, the choice between a part-time or a full-time body must still be made.

The virtues of a part-time board are implicit in what has already been said about the present arrangements. The members of the present Board, by continuing to be partners of their firms or, if not in practice, by continuing to perform their other functions, are kept aware of the problems faced by their professional brethren. In most cases, their firms can provide research support to complement that provided by the AICPA. The heavy cost of setting financial accounting standards is thus largely hidden. The relatively large number of persons who can be brought onto a part-time board bring a diversity of views greater than could be found in a smaller group. Perhaps most important, a large part-time board has a representative character, at least in relation to members of the AICPA. In theory, therefore, it has a ready-made constituency to look to for support.

We are impressed by these considerations. When the Board came into existence twelve years ago, the model which was used was probably right for the time. Though the APB's predecessor, the Committee on Accounting Procedure, had been issuing accounting research bulletins since 1939, the idea of enforceable accounting standards was not firmly established. Now it is. The arguments for a smaller, full-time board are much more persuasive now than they would have been in 1959.

The major positive arguments for a full-time board are independence and efficiency. It is the doubts cast on the disinterestedness of a part-time board which trouble its critics the most. They assert that Board members having a continuing affiliation with their firms or companies must inevitably find their loyalties divided. It is difficult to assess the seriousness of the risk that clients exert pressure on Board members to vote one way or another on specific issues. In large firms, APB members can be more easily shielded from direct client contacts. Moreover, it has been argued that, to some extent at least, competing pressures from numerous clients serve to neutralize each other. Yet doubts remain. Partner pressure rather than client pressure may well be a greater danger. The proponents of a part-time board must confront this dilemma. The more importance they attach to the continuing professional contacts of board members, the more difficult it is for them to argue that such men can maintain undivided loyalty to the board.

At all events, it is perhaps the appearance of nonindependence rather

than its reality which poses the more significant problem. If there is a widely held supposition—even an erroneous one—that the present Board is too responsive to client or industry pressure, then its position is weakened. We see no way of avoiding this difficulty except through a full-time board.

Judged also on grounds of efficiency, the drawbacks of the large, part-time board are formidable. It takes a great deal of time for all members of a large body to make their views known. It is far from certain that the quality of group decisions is enhanced as the number of persons in the group increases, once it has grown beyond a modest size. There is no satisfactory way to measure the efficiency of groups of different sizes. We can only express our judgment, which is shared by many who talked with us, that the present Board is too large. It is worth recalling that when the Seidman Committee recommended a reduction in the size of the Board in 1965 from 21 to 18 members, it expressed the view that “it may very well be that the Board will find that even further reduction in its size is desirable and possible, say to 15.” Our own proposals go much farther.

We might note, at this point, the controversy which surrounds the Board’s voting rule. The requirement of a two-thirds majority can be defended as ensuring relatively wide acceptability for the Board’s pronouncements, an advantage which decisions taken by bare majority might not enjoy. Hence, the problem of enforcement has been minimized. The other side of this picture, as both critics and friends of the Board have pointed out, is that the two-thirds rule has led to compromise and may have caused the Board in some instances to sacrifice decisiveness and principle to acceptability. What seems to some to be a source of strength appears to others to be a defect.

We believe the greater merit lies with a larger-than-majority voting requirement in the case of the seven-man Standards Board which we propose. Other considerations may well apply in the case of a larger volunteer board, but we have not undertaken to make a recommendation on the point, in view of the nature of our proposals.

The APB itself is on record as having “a strong majority view” in favor of a full-time chairman.¹ We believe that if all members of the APB were able to devote themselves fully to the work of the Board, a substantial gain in efficiency would result. Consideration of a problem could be more continuous, more concentrated. If time were needed for reflec-

¹ Report of the APB’s Committee on Board Operations, November 24, 1970, to the Board of Directors of the AICPA.

tion, a full-time board could still take time (as the Supreme Court does) consciously, and not because of the intrusion of other activities, as is the case with the present APB. Direction of the board's staff and its subcommittees could be more continuous. Finally, a full-time board could deal expeditiously with new problems of accounting as they emerge.

We therefore recommend a full-time board with seven members. Before describing our proposals in detail, it is appropriate here to explain why we think that such a board may enjoy the advantages which are claimed for the present Board (or one like it) by its proponents, while avoiding its shortcomings. By being full-time, the new Standards Board can give undivided attention to the business before it. It will not constantly lose momentum, as a part-time group must do. The diversity of views which enriches the present Board can be obtained through the relatively large advisory council which we propose, through the board's subcommittees or task forces (which will not be confined to board members) and through public hearings and other contacts with the business world. Though withdrawn from public practice or other nonboard activity, board members will serve limited terms so that there is no serious danger of their getting too far out of touch with "the real world." Above all, they will have no ties except to the board and thus will be seen to have no private interests which might come between them and the public interest; in these circumstances, their disinterestedness should not be seriously questioned.

Should there be two boards dealing, respectively, with fundamentals of financial accounting and the application or interpretation of such fundamentals?

A proposal has been made to us by several highly experienced accounting firms and individuals that the work of the Board should be divided between two bodies—one concerned with basic concepts and standards, and the other devoted solely to the application of those standards in particular areas of accounting practice.

We have given this proposal careful consideration. One obvious analogy to support such a division of functions is that of the constitutional convention, on the one hand, and the legislature, on the other. This analogy, and others which we have reviewed, are somewhat far afield from the subject at hand, but perhaps serve a purpose in analysis. The analogue of the constitutional convention might well be the Accounting Objectives Study Group. When its work is done, it will presumably go out of exist-

ence, as does each constitutional convention. Hopefully, it will have provided a chart of objectives and basic concepts which will enable the day-to-day work of the board to be more firmly grounded than before.

On the practical side, it seems to us preferable that actual drafting of basic standards and consideration of their application and interpretation be in one set of hands. To divide this responsibility is to open up the possibility of conflict between the two bodies as to whether a particular question is one involving a basic standard, on the one hand, or its application, on the other, and also as to whether an interpretation drafted by one body is consistent with the intentions of the other. The disadvantages of the two-tier system, which include its added complexity, seem to us to outweigh its advantages.

A thoughtful comment on this issue, with which we agree, was made by the present Chairman of the APB in his statement to the Study at its public hearing:

Some say that the top rule-making authority should limit itself to formulating broad principles and leave their implementation to a lesser group. One suggestion would require the senior group to approve pronouncements of the lower group. This sounds fine—but it won't work. Under this system, broad pronouncements would need to be delayed until it became clear that their implementation was sound, practical and feasible. The Board has frequently gone down a wide path only to back away when it was realized that practice could not follow. Once the Board unanimously issued an Opinion embodying a very fine theoretical concept requiring allocation of the proceeds of convertible debentures between debt and conversion features, only to rescind it when the Board found that it was impractical and, in some instances, produced bizarre results.

Should there be a separate appellate body?

Several commentators have urged upon us the possible need for some procedure for appeal from APB pronouncements. The issue has been raised both by companies and independent accountants wishing to adopt some reporting procedure at variance with a Board opinion. They could be satisfied, presumably, only by the establishment of an appellate body separate from the APB.

We found that those who call for a new appellate body are not all talking about the same thing. Some are looking for a means of modifying or repealing standards issued by the APB. To achieve this end, they would

cause a proposed standard (which is certain to be less than satisfactory to some who would be affected by it) to go through two complete processes of review, modification, and adoption or rejection. It is obvious that this would impose serious delays on the process of improving financial accounting. Moreover, it would necessarily require substantial duplication of effort. We question the wisdom of such a procedure.

Those who do not like a standard promulgated by the APB have the right to press for its reconsideration. Several of the APB's opinions have revised earlier opinions in the light of changed circumstances or changed views. We endorse the continuance of that procedure. Continuous review of its past pronouncements is a proper function of the Standards Board itself. To create a separate appellate body for this purpose would introduce confusion and uncertainty into the system.

The need for relief from a standard because of a company's peculiar circumstances is a different ground on which it is asserted by some that an appellate body is necessary. As an example, a company might think that, because of special circumstances, rigorous adherence to APB Opinion No. 15 might misrepresent its earnings per share. At the present time, the normal procedure would be to ask the Chief Accountant of the SEC to accept an accounting method not fully in accord with the Opinion. We have seen no evidence that this procedure is unsatisfactory, except in one respect. It has been urged that the SEC ought to publish information regarding those instances in which its staff has made important rulings of this character. We agree. If such information were more readily available, there would probably be less demand for an appeal procedure separate from or beyond the SEC.

Companies and unincorporated businesses which do not come under the jurisdiction of the SEC have a different problem. It is a matter between themselves and their auditors as to whether an accounting procedure not fully in accordance with a standard issued by the APB or its successor is acceptable to the auditor. The AICPA's Special Bulletin of October 1964, referred to at pages 41-42 above, provides that "'substantial authoritative support' can exist for accounting principles that differ from Opinions of the Accounting Principles Board" and that when such a principle is applied in financial statements, "the reporting member must decide whether the principle has substantial authoritative support and is applicable in the circumstances." Thus an escape hatch has been provided. The proposed new Rule 203 of the Institute's Code of Professional Ethics, referred to at page 43 above, provides a different, and

in our opinion a better, escape hatch. Moreover, the worst sanction which can be imposed on a business not required to report to the SEC is a qualified or adverse auditor's opinion or a disclaimer of opinion on the financial statements.

We have not been convinced of the merits of an appellate body separate from the Standards Board itself, either for reporting companies or for those which do not report to the SEC. Our proposals, therefore, make no provision for such a body. This conclusion is in accord with the great weight of opinion expressed to us.

Should board opinions be officially adopted as rules of the SEC?

At least two able critics raised the question whether it would be an improvement over present procedures if opinions of the APB (or its successor) were to take effect only after they had been officially adopted as rules of the SEC. The Study gave careful consideration to this question. There is at least one marked advantage to the suggested procedure. If it had been in effect, the unfortunate episode involving APB Opinion No. 2 (see page 25 above) could not have occurred.

Several possible disadvantages of the suggested procedure weighed heavily in the minds of members of the Study. It might well be extremely unwise on policy grounds for the Commission to permit an entirely separate group to draft its proposed rules in a given area. Moreover, many, if not most, of the opinions of the APB are ill-adapted to the standard format of administrative rules. Such opinions may provide for alternative treatment of a transaction or factual situation depending on the judgment of the accountant as to the applicability of a number of stated factors. Opinion No. 18 on accounting for long-term investments is an example. Administrative rules, on the contrary, must be as precise as possible. They are usually formulated with great care by lawyers. Understandably, such rules tend toward the creation of a rigid policy framework. Similar considerations apply to those pronouncements issued by the SEC which bear upon standards of financial accounting. It is partly for this reason, we suspect, that with rare exceptions such pronouncements have been made by way of Accounting Series Releases or opinions of the Chief Accountant rather than by formal rules.

Even if formal rule-making were practicable in the area of financial accounting standards, however, we would be troubled by its potential im-

pact. It can be assumed that if the APB or its successor should adopt an opinion after much study and debate, and thereafter that opinion should be published for comment by the Commission as a proposed rule, the outcome of the process could be quite different from the initial opinion. Repetition of all of the elements which went into the making of the original opinion would necessarily be involved, including preparation of an exposure draft, receipt of comments and alternative proposals, debate upon the form and substance of the opinion, decision, and final drafting. In this process, unless the subject matter is entirely noncontroversial, substantial change is probable. It is not change as such that concerns us, but the fact that when men of high ability and experience have labored on the form and substance of an opinion, only to see it revised or rejected by a separate authority, they will necessarily view their roles as downgraded. We see a clear danger that this may lead to a lessening of commitment by those leaders of the accounting profession who have, to date, been willing to devote themselves wholeheartedly to the service of the Board.

Another consequence of the suggested procedure which troubles us is the inevitable delay which it would interject into the standard-setting process.

On balance, therefore, the Study believes that it would be unwise, as it is unnecessary, to attempt to institute an arrangement by which opinions of the APB (or its successor) would be proposed for adoption as formal rules of the SEC. It should be borne in mind that the SEC presently has power to overrule the Board and to reverse or amend its opinions, as it did in the episode involving APB Opinion No. 2.

Should the board be established by law as an official self-regulatory agency?

Some have suggested to us that the APB, or its successor in the standard-setting field, should be realigned under an arrangement similar to that of the National Association of Securities Dealers ("NASD") under Section 15A of the Securities Exchange Act of 1934 (commonly referred to as the Maloney Act) as an official, governmentally sanctioned, self-regulatory agency.

There are several areas in which it could be argued that such a step might represent an improvement over present arrangements. However, none of these arguments has seemed to us to be particularly persuasive.

First, it might be thought that a realignment of the functions of the APB under express statutory authority would decrease the risk of lawsuits by those aggrieved over a particular opinion. However, as previously discussed (see pages 43-46), we believe the risk of such suits is presently slight.

Secondly, one objective of such a realignment might be to enhance the authority of the opinions of whatever private body succeeded to the functions of the APB. As we have indicated, however, the opinions of the APB already possess a considerable degree of authority.

Thirdly, an official self-regulatory alignment would provide a means, beyond that available today, for disciplining accountants who fail to comply with the opinions of the standard-setting board. The statutory self-regulatory mechanism under which the NASD and the stock exchanges operate enables those agencies to make binding rules. The disciplinary power behind these rules is substantial and is founded on the severe economic consequences of suspension or expulsion from NASD or exchange membership. For an analogous disciplinary power to exist in the area of financial accounting, it would presumably be necessary to require all accountants practicing before the SEC to be members in good standing of a single organization (possibly the AICPA) and for that organization to have the power of suspension or expulsion. As is the case with the NASD, this disciplinary power would undoubtedly be accompanied by appellate review on the part of the SEC and, in general, by administrative and judicial supervision over the affairs of the Institute, or whatever new organization was set up for the purpose, of an order far more stringent than now applies. Moreover, it is doubtful that the Commission would confine its attention to financial accounting standards. By analogy to the NASD example, supervision might well be extended to areas such as rules of ethics and statements of the Committee on Auditing Procedure, with express power in the Commission to modify or rescind such opinions, rules, and statements at its discretion.

We are concerned by the potential impact on the accounting profession of such arrangements. They might affect adversely the development of that high sense of responsibility on the part of the financial reporting community which is vital to further improvement of financial accounting standards. Moreover, as has been noted, the gains to be obtained from such a realignment are open to question. On balance, we do not believe that establishment of an official self-regulatory agency for the purpose of formulating financial accounting standards would be in the public interest.

The Study's recommendations

A Financial Accounting Foundation

We propose that a new foundation, to be called the Financial Accounting Foundation, be established, separate from all existing professional bodies. It would be governed by a Board of Trustees composed of nine members, whose principal duty would be to appoint the members of the Financial Accounting Standards Board and to raise the funds for its operation.¹

The President of the AICPA would be, ex officio, a trustee of the Foundation. The other eight trustees would be appointed by the Board of Directors of the Institute for three-year terms. The initial terms would need to be staggered to assure continuity. Four of the appointed trustees would be CPAs in public practice. Two trustees would be financial executives, one a financial analyst, and one an accounting educator. These four trustees would be chosen, respectively, from short lists of names submitted by each of the following organizations: the Financial Executives Institute, the National Association of Accountants, the Financial Analysts Federation, and the American Accounting Association. The trustees would select their own chairman. Their actions would require a two-thirds majority of their total number, except as stated in (4) below.

The trustees would have four important duties:

1. To appoint the members of the Financial Accounting Standards Board.

¹ See Appendix F, page 103, for a chart of the proposed organizational structure of the Foundation, the Standards Board, and the Advisory Council.

2. To appoint the Financial Accounting Standards Advisory Council, described below.
3. To raise and allocate the funds required to support the new structure.
4. To review periodically the basic structure of the standard-setting organization, including the size, composition, and functions of the Standards Board and the Advisory Council referred to below. Changes in these arrangements, fundamental in nature, would require an affirmative vote of eight trustees.

The trustees should not have any day-to-day operating responsibilities, and they would be expected to serve without remuneration. They would, however, be entitled to reimbursement for their expenses.

A Financial Accounting Standards Board

We propose that a Financial Accounting Standards Board be established with seven members, all fully remunerated and serving full-time. The function of the Standards Board would be to establish standards of financial accounting and reporting. The Board of Trustees would appoint members of the Standards Board and would also designate one of them to serve as chairman at the Trustees' pleasure. During their terms of office, the members of the Standards Board would have no other affiliations. Four of them would be CPAs drawn from public practice. The other three would not need to hold a CPA certificate but should possess extensive experience in the financial reporting field.

It is implicit in this proposal that the Foundation and the new Standards Board, while they may depend on existing organizations for financial support, have a separate existence of their own. This would be marked by their having separate premises and staff. The financial implications of this separation are considered below.

But the separation has other implications. Even under the present arrangements, care has to be taken to maintain a clear line between the areas in which the Accounting Principles Board and the AICPA's Committee on Auditing Procedure have authority. Since they are both committees of the Institute, liaison between them has been easy. Only rarely have the formal pronouncements of the Committee on Auditing Procedure contained statements on accounting matters which needed to be cleared with the APB, and where they have, no serious difficulties have arisen.

The Committee has retained jurisdiction over matters relating to the auditor's report, since that is the end-product of the auditor's procedures. We think it proper that the Institute's Committee on Auditing Procedure should continue to be responsible both for audit procedures and the auditor's report. The reconstituted Standards Board that we are proposing will not, or at least may not, be composed wholly of CPAs. Some of its members in the future may not have had direct experience in auditing and they should not be asked to pass judgment on matters concerning the auditor's responsibilities. However, the Standards Board may have need to be concerned with the impact of its pronouncements on the position of the auditor, and it will be essential to maintain continuing close cooperation between the Standards Board and the Institute's Committee on Auditing Procedure.

Another activity of Institute committees which interfaces with that of the APB is the preparation of audit guides. Their purpose is to supplement the pronouncements of the APB and the Committee on Auditing Procedure with respect to a particular industry (such as *Audits of Banks*, issued in 1968) or an area of professional practice (such as *Audits of Personal Financial Statements*, issued in 1968). The preparation of each audit guide is the responsibility of a specially appointed committee working within the Auditing and Reporting Division (formerly the Technical Services Division) of the Institute.

Under existing procedures, in order to avoid inconsistency between an audit guide and pronouncements of the APB and the Committee on Auditing Procedure, the guide is informally reviewed by the two chairmen before it is publicly exposed. After incorporation of the revisions resulting from the exposure, the guide must obtain the approval of at least two-thirds of the committee which prepared it. It is then resubmitted to the chairmen of the APB and the Committee on Auditing Procedure, whose approvals are necessary before it can be published. As far as the APB is concerned, this is in accordance with the general provision in the Board's Charter that "the Board is responsible through its chairman for reviewing all statements on financial accounting and reporting to be published by any committee of the Institute, in conformity with policies adopted by the Board of Directors with respect to senior committees."

Under the new arrangements, audit guide committees should confine themselves to auditing questions. As a safeguard, the Institute should impose upon audit guide committees a corresponding responsibility to clear an audit guide with the Financial Accounting Standards Board before it

can be issued. It is essential that financial accounting standards be in only one set of hands—the Standards Board's. Where the Institute has a committee working on an industry audit guide, it may be useful for the Standards Board to have a small task force, with industry experts on it, to maintain contact with the Institute committee, so that any difficulties can be resolved before they become acute.

The seven-man Standards Board that we are recommending seems to us to be small enough to be efficient and large enough to provide for a variety of views and backgrounds. If experience with a seven-man Standards Board suggests that a smaller or a larger board would be better, it could be changed under the power of review given to the Board of Trustees of the Foundation.

As for the qualifications of the members, we have intentionally provided that a majority of them would be CPAs drawn from public practice. We think it essential at this time, in the interests of enforcement of the new Standards Board's pronouncements by the public accounting profession, that its composition should not be such as to endanger its acceptability to the profession. The other three members of the Standards Board should be well versed in the problems of financial reporting in order to be effective. To satisfy this requirement, a CPA certificate is not necessary, but neither is it a disqualification. Men and women of the caliber and with the qualities we have in mind to fill these three seats on the Standards Board can be found among financial executives, financial analysts, academics, economists, and lawyers—but this list is not meant to be exhaustive.

Rather than bringing specially designated "public interest" representatives onto the Board, we contemplate that it will be the obligation of all members of the Standards Board to represent the public interest. They would have no other function.

The full-time nature of the appointments to the new Standards Board is an essential element of our proposal. Of course, as in all such cases, this does not preclude writing, lecturing, or similar activities, but it does preclude any continuing association between a Standards Board member and any firm or company. It also precludes any continuing association with any other institution unless this restriction is specifically waived by the Board of Trustees. An appropriate policy to prevent conflicts of interest arising from personal investments or other personal activity should be adopted by the Board of Trustees of the Foundation. There must be no conflict, real or apparent, between the member's private interest and the public interest.

To get the talent which these appointments call for, we think that the level of remuneration will have to be between \$75,000 and \$100,000 a year, with appropriate fringe benefits. We have heard much argument as to whether persons of the right caliber can be found to devote themselves exclusively to the Standards Board's work at these salaries. We are confident that they can. Service on government commissions, though perhaps sometimes more prestigious, is much less well paid, yet able men can be found to serve. After a limited term on the Standards Board (see our next recommendation), a member might be expected to return to public practice, to industry, or to academic life with enhanced reputation and status. From time to time, there will be members whose service on the Standards Board will be immediately followed by retirement. There will always be room on the Standards Board for such older men, but we do not contemplate that this will be the normal pattern of appointment.

Members of the Standards Board would be appointed for a term of five years, with a possible renewal for a second term. A member would be removed from office before the end of his term only for permanent disability, malfeasance in office, or like causes. Appointments would be staggered, so that not more than two persons would retire in any one year.

With terms limited to five or, at most, ten years, there would seem to be no reason to fear that members of the Standards Board will become too far removed from everyday business life, nor that service on the Standards Board need jeopardize a man's subsequent career. Indeed, as we have already suggested, it might be expected to enhance it.

In order to secure continuity and a smooth rotation, initial terms would have to vary, as follows:

- one appointment for two years
- two appointments for three years
- one appointment for four years
- two appointments for five years
- one appointment for six years

With this plan, one or two members would retire or be reappointed at the end of each year after the second year.

An affirmative vote of five of the seven members of the Standards Board should be required to approve a standard before it can be issued.

By requiring something more than a bare majority to authorize the issuance of a standard, the proposed voting rule would reduce the likelihood of controversial rulings which may not enjoy wide support outside the Standards Board. (See page 62 for further discussion of this point.)

When a standard is adopted by the requisite majority, it should be published without dissents.

When a standard is published, its authority should not be weakened by the attachment to it of dissenting opinions. Accompanying the standard should be a full discussion of the arguments both for and against the conclusions of the Board. In addition, the Standards Board's minutes should disclose the results of all votes that are taken, and should include dissenting opinions; these will be open for public inspection. It is not our wish to hide any dissent which may develop within the Standards Board but simply to insure that standards, when they are issued, are unequivocal. (For an expanded discussion of this matter, see pages 38-39 above.)

The Standards Board should, to the fullest extent practicable, carry out its functions in public.

We expect the Standards Board to use every means available to it to inform the accounting profession and the business world about its activities, actual and prospective, through circulation of exposure drafts, public hearings, discussions with special groups, and so on. A history for each of its pronouncements should be developed and made publicly available. This would include transcripts of hearings, minutes of meetings, copies of briefs and position papers submitted to the Standards Board, and any other relevant documentation.

We have already mentioned the need, as we see it, to explain more fully than has been done in the past why certain views were adopted and others were rejected. If the logic of the Standards Board's position is clear as well as sound on a particular matter, this should enable it to win the necessary support. There is a sense in some quarters that the APB does not give sufficient attention to views put to it at public hearings, or as reactions to exposure drafts, if such views do not agree with the conclusions it has already reached. We do not agree with this criticism. However, in any case, it would lose much of its sting if the Standards Board devoted more space, perhaps in an appendix to a standard, to the grounds on which one position was upheld and another was rejected.

Though the Standards Board will hold public meetings, it must also have

the right to meet in executive session. Action taken by the Standards Board at any meeting will be part of the public record.

Interpretations, when necessary, should be issued with the full authority of the Standards Board.

The Standards Board would no doubt find it necessary, as the APB has done, to provide interpretations of its standards from time to time when their application has been tested in practice and gaps or ambiguities have come to light. Work on an interpretation should be carried out by the Standards Board's staff with the help, where necessary, of a small task force familiar with the topic in question. But the interpretation, when ready, should be issued by the Standards Board in its own name and with its full authority. Until such action is taken, we see no reason why the staff of the AICPA (or, for that matter, of any other body) should not feel free to offer unofficial advice to its members by way of interpretation of a standard. If, subsequently, an official interpretation is issued by the Standards Board, the unofficial interpretation would be deemed to have been superseded.

A Financial Accounting Standards Advisory Council

We propose that the Board of Trustees of the Foundation establish a Financial Accounting Standards Advisory Council, with approximately 20 members, to work closely with the Standards Board in an advisory capacity. Members of the Advisory Council would be appointed by the trustees to serve one-year terms which could be renewed indefinitely. They would be entitled to reimbursement of expenses, but no remuneration. They would be drawn from a variety of occupations, although not more than one-quarter of the members should be drawn from any single sphere of activity. The chairman of the Standards Board would also be, ex officio, chairman of the Advisory Council.

The Advisory Council would be the Standards Board's permanent instrument for maintaining contact with the business and professional world. It is our intention that the Advisory Council be made up of persons conversant with and involved in the problems of communicating financial information, including knowledgeable users of such information. The only qualification for membership on the Advisory Council should be a capacity to make a contribution to the work of the Standards Board. In making appointments, the trustees of the Foundation would be expected to obtain

suggestions from a number of organizations. The following list is illustrative only:

American Accounting Association
American Bar Association
American Economic Association
American Institute of CPAs
Financial Analysts Federation
Financial Executives Institute
National Association of Accountants
Securities Industry Association

In addition, names would be sought from the stock exchanges and from appropriate government agencies. We contemplate that staff members of the SEC might work on the Advisory Council to convey the concerns of the Commission and to help in setting priorities.

Members of the Advisory Council would be expected to serve without remuneration, but would be reimbursed for their expenses on request. They would, of course, continue to devote most of their time to their professional or business activities. Because the balance of skills and knowledge required on the Advisory Council will change from time to time, and perhaps fairly rapidly, appointments to it should be for one year at a time. The trustees of the Foundation can be left to use their judgment as to how long an individual should serve and we make no recommendation as to any limitation on reappointments. However, we think it should be unusual for any person to serve for more than four years. We have recommended that the Advisory Council have approximately 20 members. There is no need to be more precise than this. The size of the Advisory Council, like its composition, might vary somewhat from time to time as the needs of the Standards Board for advice vary.

The functions of the Advisory Council would include providing advice to the Standards Board as to its priorities, helping it to set up task forces, reacting to proposed standards, and otherwise assisting the Standards Board when called upon to do so.

The Advisory Council we contemplate would have three main functions. First, it would assist the Standards Board from time to time in determining its priorities and drawing up its agenda. It should be the eyes and ears of the Standards Board in identifying, if possible before they become acute, the problems to which the Standards Board should turn its attention.

The Advisory Council's second function would be to help the Standards Board set up task forces to investigate and develop draft standards on matters on the Board's agenda and to give advice on the selection of persons to serve on such task forces (which would be comparable in function to the "subcommittees" of the present APB). The actual selection would be made by the chairman of the Standards Board. Members of the Advisory Council might themselves be selected to serve on task forces where the subject matter made this appropriate. When they did so, their membership on a task force would not terminate with termination of their membership on the Advisory Council.

No limitation need be placed on the persons who might be selected to serve on task forces or on the qualifications they should have. All that is necessary is that they should be able and willing to make a contribution to the solution of the problem under discussion. The APB successfully used an actuary on the subcommittee considering the opinion on pension costs. An appraiser or an economist might be expected to have something to contribute to a discussion of depreciation. Where accounting standards relating to a specific industry are being considered, industry experts are indispensable. Knowledgeable users of financial statements might also serve a useful role.

The third function of the Advisory Council is to act as a sounding board and to express its views on proposed standards issuing from the Standards Board. The Standards Board will of course be listening to views put to it from many other quarters, but it can be expected to listen especially carefully to what the Advisory Council has to say.

It is to be expected that the Standards Board will have other matters on which it will seek the advice of the Advisory Council. It is of course not precluded from seeking advice in other quarters, nor is it bound to accept the Advisory Council's advice when tendered. In particular, it may wish to set up task forces without consulting the Advisory Council, and must feel free to do so.

Financial accounting research

We urge that the Standards Board structure its research activity with its needs and objectives clearly in mind. It must first determine the type of research needed to complement the public testimony and position papers which the Board will receive in the course of its proceedings, as well as the abundance of published research prepared by academics, professional

and business associations, and the like. In our view, research performed by the staff of the Standards Board should be analytical, empirical, evaluative, and directed toward systematically dealing with the topics before the Board. For example, it should deal with such questions as:

What are the issues?

What are the alternatives?

What theoretical and practical support exists for alternative solutions?

What are the practical effects and implications of the alternatives?

We do not believe that the Board's staff should be expected to conduct a broad, fundamental research program dealing with basic concepts on an ongoing basis, since we believe that this type of research is best left to those in the academic field.

Based on our review of the existing research program, we put forward the following recommendations in addition to those previously offered:

1. Projects should be rigorously controlled by the Standards Board and by its research director.
2. Projects should be carefully defined to assure that what needs to be researched is researched.
3. Full use should be made of task forces established with the cooperation of the Advisory Council.
4. Authors of research studies should be fully consulted in drafting proposed standards and their related history.

Budget and funding

A budget of the projected costs of operation of the proposed Financial Accounting Foundation, the full-time Financial Accounting Standards Board, and the Advisory Council for which it will be responsible, is presented in Appendix G to this Report, page 105. It shows cash expenditures which are likely to range between \$2,500,000 and \$3,000,000 per year. These figures explicitly include some of the costs presently borne by public accounting firms and other organizations which have personnel serving on the APB or engaged on research projects for it. However, it should not be supposed that such costs to firms and organizations will

fall to zero under the new arrangements. There will still be the expense of preparing position papers for submission to the Standards Board. Firms and companies with men serving on the Board of Trustees and the Advisory Council will still be put to the expense of supporting them during the time they devote to these duties.

The principal financial responsibility of the Foundation's Board of Trustees will be to raise the funds needed to cover the projected expenditures. Several offers of financial support have already been made as gestures of goodwill toward the kind of standard-setting organization which we are proposing. These offers encourage us to believe that the support of the standard-setting function which the public accounting profession has provided in the past will not be less readily forthcoming from it and from others in the future. There are several ways by which such support might be obtained.

One possibility, which many favor and which may initially be the most practical, is to continue to rely on voluntary contributions of firms, companies, and individuals throughout the business world to support this work. An offer by Haskins & Sells to contribute \$1,000,000 over a five-year period was made at our public hearing. The relatively long-term commitment implied by this generous offer is important if the Foundation is to be firmly established.

The Accounting Research Association, membership in which is voluntary, provides an example of systematic fund-raising within the accounting profession. Presently limited to members of the AICPA, the ARA has a minimum scale of contributions, based (for firms) on the numbers of professional staff. The approximately \$550,000 it raises each year covers the cost of operating the APB, including its research activities. Not all members of the AICPA belong to the Accounting Research Association, and not all of them, therefore, bear the financial burden of the APB's work.²

The new Standards Board will be able to call upon a wider constituency. In particular, it is to be hoped that the importance of its work may appeal to large business enterprises as a worthy object for support.

If voluntary contributions are thought to be too uncertain as a method of financing the Foundation, four other methods might be considered.

² In 1971, the Accounting Research Association had a membership of about 3,000 individuals and about 2,800 firms and sole practitioners.

1. Contributions might be made to the Foundation by each of the professional organizations which would nominate its trustees, as proposed on page 69 above. In view of the special position given to the AICPA by our proposals, extra weight might well be given to the Institute's membership in any formula based on total membership to be agreed upon by the cooperating organizations.

To obtain some idea of the magnitude of the contribution per member that would be called for, it may be noted that at the end of 1971 the membership of the five organizations, including student members paying reduced subscriptions, was as follows:

American Accounting Association	14,000
American Institute of CPAs	85,000
Financial Analysts Federation	13,100
Financial Executives Institute	7,300
National Association of Accountants	63,000

2. An alternative form of this proposal would assess the contribution of each organization as a percentage of its dues income. The approximate dues income of the five organizations for their respective fiscal years ended in 1971 was:

American Accounting Association	\$ 164,000
American Institute of CPAs	4,400,000
Financial Analysts Federation	235,000
Financial Executives Institute	750,000
National Association of Accountants	2,820,000

These first two proposals have the advantage of freedom from possible legal difficulties. They confine negotiation to organizations which would participate in setting up the Foundation. Implementation would doubtless require an affirmative vote by the members of each of the cooperating bodies.

3. One way of spreading the burden broadly would be to have the AICPA levy a surcharge on member firms as a percentage of each firm's audit fees. To protect the confidential character of information about firms' income, such a levy could be handled by the Institute's attorneys or some other neutral party, as certain contributions paid to the Accounting Research Association are now handled. The surcharge would normally be passed on to clients. We do not expect an arrangement of this kind to appeal strongly to Institute members.

4. A surcharge might be levied by the New York and American Stock Exchanges, and possibly by other stock exchanges, on listed companies as a percentage of the value of their listed securities. This arrangement could work, of course, only with the cooperation of the exchanges. Unlisted companies would escape having to make a contribution.

We doubt whether such an arrangement has much chance of adoption at the present time. Apart from possible legal difficulties, we think that the exchanges, even though well disposed towards the improvement of financial accounting standards, might regard a surcharge for this purpose as a dangerous precedent, to be followed by requests for charges for other worthy causes. Accordingly, we have no cause for optimism as to the viability of this proposal.

We hesitate to make a firm recommendation on the method or methods by which the Board of Trustees of the Foundation should raise the necessary funds. Much will depend on how our proposals in general are received by the professional and business communities. The trustees will know the climate of opinion in which they will have to operate, while we can only conjecture. We therefore think it wise to leave to them the utmost freedom in a matter which is vital to the success of their work.

Transitional arrangements

In the transition from the APB to the Standards Board, opinions which have reached the exposure draft stage should be carried through to completion by the APB. Other matters on the APB's agenda should be transferred to the Standards Board.

Once the new Foundation, the Standards Board, and the Advisory Council have been set up, there will have to be an orderly transfer of responsibility for establishing financial accounting standards to them from the APB. Experience of the somewhat similar transfer which took place from the Institute's Committee on Accounting Procedure to the APB in 1959 can be drawn on, although that was much simpler since both bodies were AICPA committees.

It would be unfortunate if the present momentum of the APB were to be lost in the transition, though it is inevitable that some will be. To minimize this loss, we recommend that the issuance of an exposure draft by the APB, which implies that it has reached an advanced stage in its consideration of a problem, should determine which matters it is to carry

through to completion in the form of an opinion. Other matters on its agenda, together with the benefits of committee drafts, research studies and other inputs, should be turned over to the new Standards Board and its research staff.

We also think that there should be some carryover of personnel from the old organization to the new. Thus, the break will not be a clean one and the loss of momentum can to that extent be reduced.

Conclusion

THE RECENT PAST has been marked by contention approaching rancor among those outside the government who are involved in the financial reporting process. Such a state of affairs cannot continue. Either the contending forces must find common ground for cooperation or the opportunity to cooperate will be lost. We have attempted to suggest such a common ground.

We have listened with great care to many people. The criticisms of the APB commanded our particular attention. We attempted a thorough analysis of the workings of the APB. As a result, we are satisfied that few, if any, other groups of part-time volunteers in business or the professions presently devote greater personal efforts to the tasks they have undertaken. Widespread changes have characterized the APB's twelve-year span. Among other things, it has greatly improved its procedures for giving interested parties the opportunity to present their views and concerns. To an increasing extent, it has operated in an arena where conflicting views are strongly held and where contention is fueled by powerful interests. In the circumstances, one might say that the vigor of the criticism of its performance is as likely to signify that it is doing its job as that it is failing.

Nevertheless, we recommend substantial changes in the present structure for the establishment of financial accounting standards. We have attempted to give a reasoned explanation of how we arrived at such recommendations. Their acceptance would mark a new spirit of accommodation arising from a common need. The common need we see is for a bold new effort to insure public confidence in the ways in which financial information is reported.

Public interest in business and in informative financial reporting by business has expanded greatly since 1959 when the Accounting Principles

Board came into being. At that time, the accounting profession recognized, in the words of the Special Committee on Research Program, a responsibility "to narrow the areas of difference and inconsistency in practice." Many accounting problems of long standing remain to be dealt with. New and extremely difficult problems are constantly arising in the wake of innovative business techniques. In our judgment, a major new effort to solve these problems is required. The accounting profession has a vital stake in this effort. So has enlightened business management.

As our Report indicates, we believe that much can be gained from greater involvement on the part of financial executives, financial analysts, and accounting educators in the standard-setting process. We have turned to four organizations of national scope and importance, the Financial Executives Institute, the National Association of Accountants, the Financial Analysts Federation, and the American Accounting Association, to aid in the selection of trustees for the proposed Financial Accounting Foundation. We hope these organizations and their members will agree with two conclusions we reached after the most careful deliberation: namely, that it is essential for CPAs in public practice to continue to bear the laboring oar on the standard-setting Board, and that it is equally important to preserve the self-regulatory character of the standard-setting process through an organizational interlock between the new Foundation and the AICPA.

The tasks facing a full-time Standards Board would be formidable. Its maintenance would involve an out-of-pocket cost substantially greater than that of the present APB. However, acceptance of a challenge of this sort is in the American tradition. A practicing accountant who has been a leader of the profession told the Study Group that the CPA "assumes as his ultimate client the general public." We do not minimize the difficulties attending such a responsibility. It requires the strongest possible underpinning. We hope that the sort of Standards Board we have recommended may be able to supply that underpinning.

APPENDICES

Prospectus*

A study of how accounting principles should be established

THE MAIN PURPOSE of the study is to find ways for the American Institute of Certified Public Accountants to improve its function of establishing accounting principles. The study should consider how the Institute's standards-setting role can be made more responsive to the needs of those who rely on financial statements.

The study should examine the organization and operation of the Accounting Principles Board and determine what changes are necessary to attain better results faster. This will involve study, for example, of all the many changes that have been suggested, ranging from minor procedural suggestions to complete replacement of the part-time volunteer Board by a full-time paid Board with a court-like appeal mechanism. It will also involve consideration of entirely new approaches.

The study should consider which elements in society should participate in the establishment of accounting principles and how that participation can be best achieved. But of even greater concern to the study should be the public interest. The function of setting accounting principles importantly affects the public, and therefore the body performing the function should be responsible to the public.

The study should make recommendations as to the size and composition of the body that establishes accounting principles. The study should also consider major operating procedures for communicating with the public, for dealing with the SEC and other regulatory agencies, for maintaining an early warning system on developing problems, and for interpreting pro-

* Issued by the AICPA to the Study.

nouncements and answering questions. The study should consider the division of responsibility for accounting principles between the public sector and the private sector and how they interrelate. Specifically, the acceptance and enforcement of accounting principles should be considered.

The study should obtain the views of as many interested parties as possible and should make sure that views are obtained which are representative of all segments of our society. One or more public hearings should be held. A public record should be maintained of significant proceedings of the study and of comments received from interested parties in order that background information will be available to everyone. The conclusions of the study should be explained in the light of the entire public record.

Major attention should be devoted to research needs and methodology.

The study should report its conclusions to the Board of Directors as soon as possible.

March 29, 1971

1. Organizations which assisted the Study:

Accounting Principles Board of the AICPA
American Accounting Association
American Bar Association
American Institute of Certified Public Accountants
American Stock Exchange
Arthur Andersen & Co.
Arthur Young & Company
Caterpillar Tractor Co.
Central National Insurance Group of Omaha
Civil Aeronautics Board
Committee on Auditing Procedure of the AICPA
Corporate Accountability Research Group
Cost Accounting Standards Board
CPA Associates
Ernst & Ernst
Federal Power Commission
Financial Analysts Federation
Financial Executives Institute
General Accounting Office (United States)
Haskins & Sells
Hospital Financial Management Association
Hurdman and Cranstoun, Penney & Co.
Independent Natural Gas Association of America
Interstate Commerce Commission
Laventhol Krekstein Horwath & Horwath
Louis Sternbach & Company
Lybrand, Ross Bros. & Montgomery
Machinery and Allied Products Institute
Main Lafrentz & Co.
National Association of Accountants
National Association of Independent Insurers
National Society of Controllers & Financial Officers of Savings Institutions
New York Stock Exchange
Peat, Marwick, Mitchell & Co.
Robert Morris Associates
Savings Associations Financial Executives

Securities and Exchange Commission
Securities Industry Association
Touche Ross & Co.
Treasury Department of the United States
TRW Inc.
United Aircraft Corporation

2. Individuals who assisted the Study in their individual capacities and not as members of a particular firm or organization:

Marshall S. Armstrong, CPA
Kenneth Axelson, CPA, Vice President and Director of Finance and Administration, J. C. Penney & Co.
Professor Herbert K. Bell, Jr., CPA
M. F. Blake, CPA
Professor Abraham J. Briloff, CPA
Edward P. Brunner, CPA, Vice President-Accounting, Monumental Life Insurance Company
E. Leo Burton, CPA
Allan Craig, CPA, Director, Bureau of Accounts and Statistics, Civil Aeronautics Board
Dean Sidney Davidson, CPA
Professor Robert I. Dickey, CPA
Dean James Don Edwards, CPA
J. F. Forster, CPA, Chairman, Sperry Rand Corporation
Professor George Gibbs, CPA
Clifford V. Heimbucher, CPA
Professor Charles T. Horngren, CPA
David B. Isbell, Esquire
Herbert C. Knortz, CPA, Senior Vice President and Comptroller, International Telephone and Telegraph Corporation
Professor Homer Kripke
Professor Fred Lang, CPA
Professor Spencer J. Martin
Professor Maurice Moonitz, CPA
Professor Gerhard G. Mueller
David Norr, CPA
Arthur Okun, former Chairman, Council of Economic Advisors
Walter E. Schirmer, Chief Executive, Clark Equipment Company
Charles Schultz, former Director, Bureau of the Budget
Professor William G. Shenkir, CPA
Honorable Ezra Solomon, Council of Economic Advisors
Professor Robert T. Sprouse

Marvin Stone, CPA

James F. Strother, Esquire

A. Carl Tietjen, CPA

Professor Richard Vangermeersch

John V. van Pelt III, CPA, Vice President-Finance, Vulcan Materials
Company

William L. Wearly, Chairman, Ingersoll-Rand Company

Professor Stephen A. Zeff

Study on Establishment of Accounting Principles

Notice of Public Hearing

General information

In April, 1971 Marshall Armstrong, President of the American Institute of Certified Public Accountants, announced the formation of a special committee to "consider how the AICPA's standards-setting role can be made more responsive to the needs of those who rely on financial statements."

Members of the committee are:

JOHN C. BIEGLER, CPA, senior partner of Price Waterhouse & Co.

ARNOLD I. LEVINE, CPA, national executive partner, management of
J. K. Lasser & Co.

WALLACE E. OLSON, CPA, executive partner of Alexander Grant &
Company.

THOMAS C. PRYOR, senior vice-president and chairman of the invest-
ment policy committee of White Weld & Co.

ROGER B. SMITH, vice-president—finance, General Motors Corporation.

DAVID SOLOMONS, FCA, professor and chairman of the accounting de-
partment, Wharton School, University of Pennsylvania.

FRANCIS M. WHEAT, attorney-at-law, Chairman.

In his charge to the committee, President Armstrong said:

The study should examine the organization and operation of the Accounting Principles Board and determine what changes are necessary to attain better results faster. This will involve study, for example, of all the many changes that have been suggested, ranging from minor procedural sugges-

tions to complete replacement of the part-time volunteer Board by a full-time Board with a court-like appeal mechanism. It will also involve consideration of entirely new approaches.

The Committee is anxious to consider the views of all persons interested in this subject, and for this purpose, will hold a public hearing in accordance with the detailed particulars set forth below. All interested persons are invited.

Detailed information

Date: Wednesday and (if needed) Thursday, November 3-4, 1971.

Time: 10:00 A.M. to 5:00 P.M. each day.

Place: Offices of the American Institute of Certified Public Accountants, 1700 Broadway at 53rd Street, (11th Floor), New York City.

Purpose: To provide an opportunity for the Study on Establishment of Accounting Principles to hear (either in writing, or both in writing and orally) from those who are interested in this subject and who wish to present views critical of, or in support of, the procedure whereby financial accounting standards are presently established.

Memorandum questions: A memorandum of the major questions with which the Study Committee is particularly concerned is attached hereto as an appendix.

Requests to participate: Individuals or groups wishing to participate should notify the Administrative Secretary of the Study Committee, Michael A. Pinto, CPA, American Institute of Certified Public Accountants, 666 Fifth Avenue, New York, N. Y. 10019, in writing not later than October 1, 1971, indicating whether (a) they plan to submit a written statement and (b) they wish to make an oral presentation.

Written statements: The Study Committee strongly urges participants to provide the Committee with a written statement of their views. All such statements will be made a part of the public record of the hearing. Written statements may be submitted without requesting time for oral statements. All written statements will receive the careful attention of the Study Committee.

Written statements should be submitted on 8½" × 11" paper (25 copies) by October 15. Copies of such statements will be available for inspection at the AICPA offices after October 20. The Study Committee

cannot undertake to distribute copies among participants. However, the Committee's Administrative Secretary will, on request, supply the names and addresses of those who have indicated an intention to participate. Participants may, of course, bring extra copies of their statements to the hearing for distribution.

Oral presentations: It would be extremely helpful to the Study Committee to have a written statement in advance from any person or groups who desire to make an oral presentation at the hearing, and it urges that this be done. In general, oral presentations should be limited to summation or elaboration of such statement, or comment on statements (written or oral) of other participants. Oral presentation should not be used to read written statements into the record—it can be presumed that the Study Committee will previously have read them.

The Study Committee will allot time to each participant. The amount of time allotted will depend, at least in part, on the number of persons who request time for oral presentations and the extent of elaboration on the written statements, summation and rebuttal the committee believes will be helpful to it.

A stenographic record of the proceedings will be made. Transcripts will be made available to interested parties upon payment of a reasonable fee designed to cover stenographic and duplication costs.

Further information: All communications relating to the hearing should be addressed to the Administrative Secretary of the Committee:

Mr. Michael A. Pinto, CPA
American Institute of Certified
Public Accountants
666 Fifth Avenue
New York, New York 10019

Study on Establishment of Accounting Principles— memorandum of pertinent questions

1. **Establishing accounting principles—scope of the task.** What is meant by the term “accounting principles”? Would it be more accurate and useful to refer to “financial accounting and reporting standards”? Should the body with primary responsibility for formulating such standards limit itself to fundamentals, should it develop detailed standards, or should it undertake to do both?

2. Should the primary responsibility for establishing accounting standards reside in a governmental body or a nongovernmental body? Should the SEC, or another government agency, take over the basic task? Or should it remain with a nongovernmental body, such as the Accounting Principles Board? If a nongovernmental body, what should be its relationship to the AICPA? To the SEC? What is the nature of its authority and by what means can its pronouncements be enforced?

3. Composition of a nongovernmental standards board. Who should serve on the board? Should they all be CPAs? Members of the AICPA? What is its optimum size? In lieu of the present volunteer board, would it be preferable if the Chairman or the Chairman and some of the members, or all of the members, were paid and served full-time? If so, what should be their terms of office? What needs to be done about staffing? How should the board be financed?

4. Methods of operation of a nongovernmental standards board. The procedures of the Accounting Principles Board have evolved to the point where the Board now holds public hearings on subjects for proposed opinions. Are these proceedings satisfactory? How could they be improved? By what vote of its members should a nongovernmental standards board act? Majority? Two-thirds? Other? What procedures would enable such a board to take swift action on developing problems? Is the present procedure for obtaining unofficial interpretations of APB Opinions satisfactory? If not, how should it be changed? Should there be an appeal procedure? To whom?

5. Accounting research support for a nongovernmental standards board. What sort of research is necessary as a prelude to the establishing of financial accounting standards? Who should conduct it? What guidelines for research studies would improve their quality and shorten the time for their completion? How should accounting research be financed?

Appendix D

Expenses of Accounting Research and APB Administration Divisions of AICPA

Year ended August 31	Accounting Research	APB Administration	Total
1961	\$ 142,270		\$ 142,270
1962	170,675		170,675
1963	156,937		156,937
1964	140,032		140,032
1965	125,218	\$ 25,169 ¹	150,387
1966	142,198	80,778	222,976
1967	161,898	111,363	273,261
1968	181,955	142,766	324,721
1969	213,937	151,583	365,520
1970	234,977	257,118	492,095
1971	251,662	262,592	514,254
	\$1,921,759	\$1,031,369	\$2,953,128

¹ The APB Administration Division was established on April 1, 1965. Consequently, the fiscal year ended August 31, 1965 includes operations for five months.

Appendix E

Progress of APB Projects That Resulted in an Opinion

APB Opinion No.	Title	Accounting Research Study		APB Active Agenda Dates		
		No.	Date	Committee appointed	First substantively discussed	Opinion published
1	New Depreciation Guidelines and Rules				10/1962	11/1962
2	Accounting for the "Investment Credit"				10/1961	12/1962
3	The Statement of Source and Ap- plication of Funds	2	1961		6/1962	10/1963
4	Amending APB Opinion No. 2				3/1964	3/1964
5	Reporting of Leases in Financial State- ments of Lessee	4	1962	mid-1962	10/1962	9/1964
6	Status of Account- ing Research Bulletins			11/1964	11/1964	10/1965
7	Accounting for Leases in Fi- nancial State- ments of Lessor	4	1962	11/1964	1/1965	5/1966
8	Accounting for the Cost of Pension Plans	8	1965	6/1965	2/1966	11/1966
9	Reporting the Re- sults of Opera- tions			9/1965	12/1965	12/1966

APB Opinion		Accounting Research Study		APB Active Agenda Dates		
		No.	Date	Committee appointed	First substantively discussed	Opinion published
No.	Title	No.	Date			
10	Omnibus Opinion—1966			12/1965	4/1966	12/1966
11	Accounting for Income Taxes	9	1966	12/1965	2/1966	12/1967
12	Omnibus Opinion—1967			1/1967	3/1967	12/1967
13	Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks			1/1967	9/1968	3/1969
14	Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants			8/1967	10/1967	3/1969
15	Earnings per Share			8/1967	10/1967	5/1969
16	Business Combinations	5	1963	9/1968	1/1969	8/1970
17	Intangible Assets	10	1968	9/1968	1/1969	8/1970
18	The Equity Method of Accounting for Investments in Common Stock			7/1968	3/1969	3/1971
19	Reporting Changes in Financial Position	2	1961	11/1969	10/1970	3/1971
20	Accounting Changes			3/1967	1/1968	7/1971
21	Interest on Receivables and Payables			11/1969	9/1970	8/1971

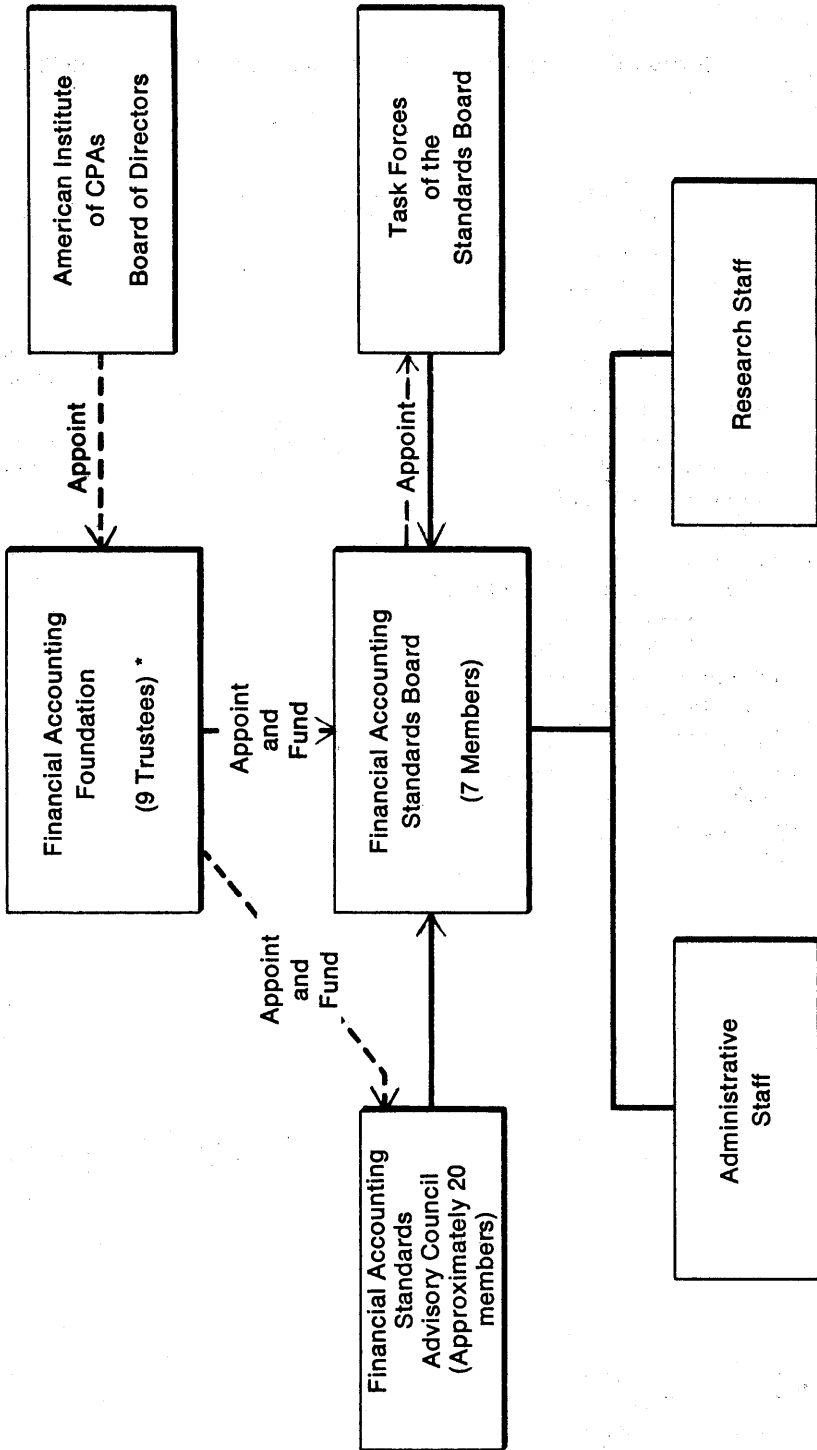
Progress of APB Projects That Resulted in a Statement

APB Statement		Accounting Research Study		APB Active Agenda Dates		
				Committee appointed	First	Statement published
No.	Title	No.	Date		discussed	
1	Statement by the Accounting Principles Board (re ARS Nos. 1 and 3)	1	1961			
		3	1962		4/1962	4/1962
2	Disclosure of Supplemental Financial Information by Diversified Companies			9/1966	9/1966	9/1967
3	Financial Statements Restated for General Price-Level Changes	6	1963		6/1964	6/1969
4	Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises	1	1961			
		3	1962			
		7	1965	6/1965	9/1965	10/1970

Projects on the APB Active Agenda at January 1, 1972

Topic	Accounting Research Study		APB committee appointed
	Actual	Planned	
Translating foreign operations		1972	10/1971
Part 1—U.S. devaluation			
Part 2—general project			
Income taxes—special areas			5/1969
Accounting policy			10/1968
Stock compensation			1/1971
Marketable securities			5/1969
Retirement of debt			9/1969
Amending APB Opinions Nos. 5 and 7			2/1967
Extractive industries	1969		mid-1968
Part 1—oil and gas industry			
Part 2—minerals			
Noncash transactions			11/1969
Interim financial reporting			1/1968
Diversified companies			9/1966
Components of an enterprise			6/1965
Capitalization of interest			10/1971
Opinion No. 9—extraordinary items			12/1971
Self-insurance provisions			12/1971

Financial Accounting Foundation
Organizational Structure



* Four of nine trustees are to be appointed from lists of nominees submitted, respectively, by the FEI, NAA, FAF & AAA.

Appendix G

Financial Accounting Foundation Projected Net Expenses*

	<u>Minimum</u>	<u>Maximum</u>
Salaries and related payroll costs:—		
Standards Board	\$ 725,000	\$ 900,000
Professional staff:		
Research, including consultants	500,000	650,000
Administration	400,000	525,000
Clerical staff	250,000	325,000
Fringe benefits, including payroll taxes	250,000	350,000
Total salaries and related payroll costs	<u>2,125,000</u>	<u>2,750,000</u>
Other expenses:—		
Space, including rent, utilities and equipment	200,000	275,000
Communication and distribution	100,000	150,000
Meetings	75,000	100,000
Legal, accounting and miscellaneous	75,000	100,000
Total other expenses	<u>450,000</u>	<u>625,000</u>
Total expenses	<u>2,575,000</u>	<u>3,375,000</u>
Estimated revenues from sale of publications	250,000	200,000
Projected Net Expenses	<u><u>\$2,325,000</u></u>	<u><u>\$3,175,000</u></u>

* The projected revenues and expenses include the activities of the full-time Financial Accounting Standards Board, and the expenses, primarily for meetings, of the Foundation's Board of Trustees and the Advisory Council.