

MANAGEMENT AND ACCOUNTING PRINCIPLES

CHARLES E. JOHNSON*

An informed observer of corporate reporting in this country during the last twenty-five years must inevitably conclude that substantial progress is evident in both the quantity and quality of information flowing from the management of publicly held corporations to outsiders. Management has no doubt responded to pressures from regulatory agencies and from an increasingly sophisticated and more broadly based investing public. But managers also have learned that paying heed to their social responsibility for providing information about their companies is likely to be in their own long-range self-interest.¹

Published reports, in which the major corporate attributes of income, fund flows, and financial position are measured, constitute the main picture windows through which outsiders get a view of what is going on in private corporations. But the scope of the total corporate reporting function is broader than this. Much financial data not contained in the annual report reaches individual investors indirectly through the network of investment advisory and statistical services. Prospectuses, stock exchange listing applications, and Securities and Exchange Commission registration statements and annual and other reports are all combed and digested by the major financial services. Accounting and related information having a limited initial circulation thus filters into the hands of the public.

I

THE QUALITY OF ACCOUNTING DATA

Prior to World War II the *quantity* of accounting data made available by corporations was a matter of concern. There is still room for improvement in this area, but this problem is now of secondary importance. A major concern of accountants and investors today is the *quality*—the economic relevance and intercompany comparability—of accounting information.

The main source of the qualitative problem is clear: the measurement of net income and financial position is a highly imperfect process. Accounting measures are inherently imprecise largely because the primary measurement problem is to scale future prospects into a system of future values and then determine their present

* B.A. 1942, M.B.A. 1948, Ph.D. 1952, University of Minnesota. Dean of the College of Liberal Arts and Professor of Accounting, School of Business Administration, University of Oregon. Certified Public Accountant, District of Columbia. Co-author, *ACCOUNTING—THE BASIS FOR BUSINESS DECISIONS* (1962); *INTERMEDIATE ACCOUNTING* (1963); and *ADVANCED ACCOUNTING* (to be published in 1966). Member of AICPA Commission on the Common Body of Knowledge for CPAs. Advisory editor in accounting, McGraw-Hill Book Co. Educational consultant to U.S. General Accounting Office. Contributor to accounting and business periodicals.

¹ See, e.g., A. R. CERF, *CORPORATE REPORTING AND INVESTMENT DECISIONS* ch. 8 (1961).

significance. Unfortunately the crystal balls in accountants' offices and managerial boardrooms are no better than those in the soothsayer's parlor. Theorists who have studied the accountant's measurement problem usually wind up by concluding that the task of measuring corporate income and position objectively is an impossible assignment.² So long as men regard as useful the struggle to provide even rough approximations, however, we are saddled with the financial measurement problem. We need to be continually reminded of the pitfalls to insure that we remain humble in the face of the odds against us.

Finding it essentially impossible to measure what we would like to know about corporations, accountants approached the problem by substituting something they could measure in the hope that this information would at least throw some light on the situation. The term *accounting principles* took root and flourished as a collective title for the assumptions, concepts, procedures, rules, and conventions employed in the measurement system that evolved as a basis for financial statements. Although the word *principles* is still widely used in this conglomerate sense, accountants have become more sophisticated in recent years and have identified three conceptual levels of the framework of accounting: (1) *basic postulates* of accounting, which are the assumptions underlying the measurement process; (2) *broad principles*, which stem from basic postulates, and (3) *rules* for the application of principles in specific situations. Admittedly, this terminological precision has not yet been widely adopted in practice, but it has received substantial authoritative support.³

As might be expected there is far greater accord with respect to the basic postulates of accounting than with respect to its principles and rules. It is always easier to agree on broad general objectives than on the best means of accomplishing these objectives. If accounting principles and rules—like driving on the right side of the road—were purely conventional in nature, the qualitative problem would be less difficult. In the important areas of accounting, however, reason and judgment govern the measurement process. Moreover, there is considerable latitude for differences of opinion as to the best way, or even the acceptable ways, to measure the result of given economic events. Accounting is a man-made art, not a science; it does not enjoy the discipline of natural laws.

II

THE SOURCES OF NONCOMPARABILITY OF FINANCIAL DATA

Accountants have long been aware of the nature of their measurement affliction. Financial statements for two companies having identical asset and debt positions and engaging in an identical set of transactions during a given period may differ sig-

² See, e.g., W. J. VATTER, *THE FUND THEORY OF ACCOUNTING* (1947); Alexander, *Income Measurement in a Dynamic Economy*, in *STUDIES IN ACCOUNTING THEORY* 126 (Baxter & Davidson, 2d ed. 1962).

³ PAUL GRADY, *INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES* at xi (AICPA Accounting Research Study No. 7, 1965).

nificantly even though each statement is prepared in accordance with generally accepted accounting principles. One who seeks the reason for this apparent inconsistency will find two major explanations:

(1) Uniform accounting measurement procedures may produce different results when applied to transactions that are equivalent in economic reality but different in timing and form. For example, suppose that Firm A and Firm B operate two plants identical in age and operating conditions. Firm A acquired its plant new ten years ago at a price of ten million dollars and has depreciated it to a book value of six million dollars at the beginning of the current year. Firm B acquired its plant recently by buying a ten-year-old facility from Firm C for nine million dollars. Following an identical accounting principle of measuring assets at acquisition cost less the estimated cost of expired asset services, Firm A will value its plant at six million dollars, and Firm B will value its plant at nine million dollars. Differences in asset valuation will also produce material differences in depreciation expense charged in arriving at net income for subsequent periods. The variation in the timing of the two plant acquisitions, coupled with changes in construction costs, combine to produce different accounting results *under the same measurement principle*. Narrowing the range of alternative generally accepted accounting principles will not necessarily obviate this source of noncomparability in financial data.

(2) Different accounting principles, each generally accepted, may produce materially different measures of position and income. To illustrate, suppose that Firm C and Firm D own identical plants acquired at the same price and the same time. Firm C adopts straight line depreciation; Firm D depreciates its plant by using one of the accepted accelerated methods, which results in heavier depreciation in early years of service life. In this case differences in accounting methods adopted by each firm will produce significantly different net income figures and asset values.

One could provide numerous additional examples in each category, but these should suffice to make the point. The source of the noncomparability of reported financial data is more complex than simply the existence of alternative accounting principles. At some risk of oversimplification we may observe that attack on the first source of noncomparability depends largely on changes in the basic postulates underlying the accounting process and perhaps on improvements in our measuring techniques. Attack on the second source of noncomparability depends on narrowing the range of alternative accounting principles and procedures that are given the seal of general acceptance.

III

THE ROLE OF THE ACCOUNTING PROFESSION

The American Institute of Certified Public Accountants has officially recognized its responsibility for assuming leadership in improving the art of accounting in both

of the areas discussed above. The following statement by its Committee on Research was officially approved by the governing Council of the AICPA:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. . . .

Also, the Institute should encourage cooperative study with other representative groups to determine that its understanding and interpretation of (accounting) postulates are valid and to provide a forum which will command sufficient respect to bring about a change in postulates when any of them become outmoded.⁴

In response to this charge the AICPA recently sponsored two notable research studies that attempted to deal with the problem in these terms.⁵ Since the conclusions of neither study have received the official blessing of the AICPA, it is perhaps too early to assess the influence of this research effort on accounting practice. The logic and firm theoretical foundation provided by these studies, however, is a base from which progress may be made in future years, both in improving the assumptions that govern accounting measurement and in narrowing the range of acceptable alternative principles and rules.

IV

MANAGEMENT'S ROLE

Any attempt to narrow the range of acceptable accounting principles used in corporate reporting should take into account management's role in shaping accounting measurements, because managers are initially and primarily responsible for the information contained in corporate reports. The basic assumption that management is responsible for the contents of financial statements has a long tradition and is deeply rooted in the mores of the accounting profession. It is described by the AICPA's Committee on Auditing Procedures as follows:

Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounting for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. . . . [T]he fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. . . . His [the independent auditor's] responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management.⁶

⁴ GRADY, *op. cit. supra* note 3, at x.

⁵ M. MOONITZ, THE BASIC POSTULATES OF ACCOUNTING (AICPA Accounting Research Study No. 1, 1961); R. T. SPROUSE & M. MOONITZ, A TENTATIVE SET OF BROAD ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES (AICPA Accounting Research Study No. 3, 1962).

⁶ COMMITTEE ON AUDITING PROCEDURES, AICPA, AUDITING STANDARDS AND PROCEDURES 10 (Statement on Auditing Procedures No. 33, 1963).

The combination of private and social responsibility inherent in the publicly held corporation requires that managers function as trustees of economic resources, accountable to stockholders, employees, customers, creditors, government agencies, and the public in general. Corporate stewardship, however, is concerned not with the conservation of resources but with growth through engaging in profitable endeavors. Thus the information contained in financial statements constitutes not only an accounting for fiduciary responsibility, but more importantly is a measure of management's performance. In a very real sense, accounting statements are an index of managerial success and thus a report *on* management.

Because corporate managers, and the various outside interests to which they are accountable, have important and sometimes conflicting interests in the current status and progress of corporations, a number of forces are at work trying to influence management to shape accounting measurements to particular ends. Let us examine some of these pressures.

A. Reflection on Managerial Performance

The most obvious pressure, though not necessarily the most influential, is management's interest in having a favorable performance report. Accounting statements are a major element of the scorekeeping process that attests to managerial success or failure and reveals the current standings of corporations in economic competition, reflecting glory (or ignominy) on the managerial stars of the team. Apart from managerial status, the compensation of corporate managers is strongly influenced by earnings reports, particularly when stock options are an important element in the compensation structure.

Managers would scarcely be human if they did not pay some attention to the scoreboard in setting accounting policy. To the extent that this kind of bias is operative against conflicting pressures, it favors accounting methods that will increase short-run earnings. Management may resist proposals to adopt the LIFO inventory method, for example, because of a short-run adverse effect on reported profits. Arthur Wyatt, in a study of corporate combinations, concludes that the managerial predilection toward the pooling-of-interests approach in accounting for mergers and consolidations stems largely from a desire to avoid the consequences of amortizing increased asset values and thus depressing reported earnings after the combination.⁷

B. Tax Implications of Particular Accounting Methods

Without question the most forceful pressure influencing the choice of accounting methods is the Internal Revenue Code. Income taxation, if not the mother of accounting understatement, is certainly a doting godfather. The ghost of the obvious

⁷ A. R. WYATT, A CRITICAL STUDY OF ACCOUNTING FOR BUSINESS COMBINATIONS 60 (AICPA Accounting Research Study No. 5, 1963).

tax advantages that stem from an understatement of assets and income sits at the shoulder of management whenever accounting policies are at issue. For example, base stock and LIFO inventory accounting methods were proposed in the accounting literature for a variety of alleged nontax reasons, but their use languished until the 1940s when LIFO gained income tax acceptance. A similar effect is evident in the choice of depreciation methods. The allowance of more liberal accelerated depreciation methods in the Internal Revenue Code of 1954 acted as a strong encouragement to the adoption of these methods for accounting purposes. Accounting for exploration and development expenditures in extractive industries is strongly influenced by the option to charge these expenditures to current expense for tax purposes. Tax factors play a major role in keeping goodwill, lease rights, and other intangibles off the financial statements even in cases where there is reasonably objective evidence of their existence and value.

The Internal Revenue Code provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."⁸ There is also a specific requirement that LIFO adopted for tax purposes must also be used in published accounting statements.⁹ A growing number of accountants and managers argue, however, that taxable income and accounting income are two different concepts and that divergence between the two is not only to be expected but to be encouraged. It is management's responsibility to adopt for tax purposes accounting methods which will legally minimize the present value of future income tax liabilities. This objective, however, is not pertinent in the choice among accounting principles for reporting on corporate performance. Fortunately for this view, those who administer the tax law (with the exception of the LIFO provision cited above) have not made use in corporate reporting a necessary condition for the adoption of any given authorized accounting method for tax purposes.

The growing divergence between taxable income and reported income is evidenced by the tax allocation controversy. Tax allocation is an accounting procedure designed to make provision in the accounts, as both a charge to expense and a liability, for estimated future income taxes on income reported currently in financial statements but not subject to inclusion in taxable income until later years. Logically the procedure is also applicable but not widely used in the opposite case; that is, when income is currently taxed but not reported in financial statements until later years. The admission of tax allocation to the list of generally accepted accounting principles suggests that differences between taxable income and reported income exist and are significant.

There is an obvious conflict between management's inclination toward favorable performance reports and the desire to understate and postpone the recognition of in-

⁸ INT. REV. CODE OF 1954, § 446(a).

⁹ INT. REV. CODE OF 1954, § 472(c).

come for tax purposes. This pressure is reinforced by the fact that the choice of one accounting approach for reporting and another for tax purposes imposes on management a considerable burden of proof in arguments with Internal Revenue agents about the justification for its tax accounting. The general inability to amortize goodwill for tax purposes is a strong deterrent to its appearance on the balance sheet. Management is strongly motivated to assign maximum values to depreciable property rights in joint acquisitions because a different assignment for reporting purposes would jeopardize the tax treatment.

If the view that taxable income and accounting income are two different things were widely accepted, corporate managers would in effect be able to have their tax cake and enjoy its eating in the pages of their financial reports. Nevertheless, the trend toward recognizing the different objectives of corporate reporting and income tax administration may be an important factor in improving accounting reports, since it provides an escape hatch from tax pressures that operate against a fair reporting of corporate performance. It is unrealistic to assume, however, that tax pressures on corporate reporting will ever become insignificant.

C. Effect on Stock Prices

A third factor influencing corporate accounting policy is pressure from stockholders and potential investors to report results that will favorably affect stock prices. This pressure reinforces management's own self-interest in favorable earnings and position reports. Management may resist a change in accounting policy because they are unwilling to face stockholder reaction to the resulting unfavorable effect on reported income.

Since stockholders like higher earnings per share there is often a conflict between investor pressure and income tax pressures on accounting policies. The conflict is well illustrated by the following quotation from a recent issue of a business publication:

A debate on accounting methods is going on within the paper industry. West Virginia Pulp and Paper is switching from accelerated to straight line depreciation write-offs in fiscal 1965. This will lower depreciation charges and boost profits by some 60¢ per share. Though most paper companies have switched to the straight line method, International Paper and St. Regis Paper are notable holdouts. International says that having fought for faster write-offs, it is obliged to show them in annual reports. St. Regis has been pressured by stockbrokers to switch. Analysts say the change could mean an extra 40¢ a share in 1964.¹⁰

It is clear that management, in wrestling with the choice of accounting methods under these circumstances, will find it difficult to concentrate on the important issue: which method results in a fairer presentation of income and financial position as measures of corporate performance?

¹⁰ Business Week, Dec. 19, 1964, p. 108.

D. Public and Labor Relations

Financial statements are an important part of management's case in debates over corporate policy in the arena of public opinion. The kind of income figures that emerge during important labor negotiations are a matter about which managers are understandably sensitive. Here the desire to spray performance reports with the fragrance of prosperity and success is in sharp conflict with the inclination to approach labor negotiations with an air of abject poverty. This conflict leads to attempts to argue that corporate performance is not as favorable as financial reports suggest because of rising price levels and replacement costs. The argument over the effect of changes in price levels and specific prices on accounting measurements has engaged accounting theorists for over a century, with no generally accepted solution yet in sight. In the 1930s, labor used falling replacement costs to support its case that companies were better off than accounting reports suggested, while management extolled the virtues of original investment. In the 1950s, their positions and arguments were for the most part reversed in the face of rising prices.

President Kennedy's entrance into the steel pricing issue in 1962 provided dramatic evidence that prices charged for products in major nonregulated industries may be influenced by accounting reports. An increase in the price of steel today may depend less on the economic ability of the steel companies to sell their product at a higher price than on their ability to convince the public that a price increase is justified in maintaining a proper balance of equity among the various segments of our society having an interest in the steel industry.

E. Internal Accounting Needs

A fifth pressure on accounting principles is the internal uses of accounting information. The accounting system of any firm is a major element in the general information system that provides data to management as a basis for decision making. Marginal and differential costs, for example, are often relevant to management's decisions, and progressive managers will find it useful to have these kinds of measurements incorporated in the general reporting system. The direct-costing controversy stems from this factor. The decision-making advantages of marginal inventory costing are well recognized by managerial accountants, but the effect on position and earnings is, in the minds of the public accounting profession, in conflict with the objectives of periodical performance reporting. On the other hand, the need for objectivity in published measurements keeps out of corporate reports information generated internally for managerial purposes that outsiders might find extremely useful. In making investment decisions, management often develops data in detailed capital budgeting analyses that are relevant to the accountant's valuation problem.¹¹ The accountant's objectivity requirement at present constitutes a strong

¹¹ For examples see Davidson, *The Day of Reckoning—Managerial and Accounting Theory*, 1 J. ACCOUNTING RESEARCH 117 (1963).

bar against the incorporation of this kind of data in financial statements, although management may circulate such information informally.

F. Conclusions on Influences Affecting Management

The biases reflected in these five kinds of pressure on management to mould accounting reports in particular ways do not, of course, operate in one direction. In making accounting policy decisions, management must often feel a strong kinship with the employee who approaches his boss for a raise and tries to appear poverty-stricken and unusually competent at one and the same time.

Recent testimony of a senior partner of a prominent accounting firm has been quoted frequently as evidence that the net directional bias of management is toward overstatement of earnings. Mr. Spacek observed that in ninety-nine out of 100 arguments over alternative accounting methods the accountant is "arguing for a procedure that would show a lower profit than the procedure the client wants to follow."¹² In interpreting this statement, however, one must remember that the independent accountant himself has a strong bias that he carries around in a little bag labeled "the principle of conservatism."¹³ Independent public accountants have a much higher tolerance for understatement than overstatement, and one suspects that Mr. Spacek's firm simply did not raise any serious objections over accounting methods in another ninety-nine cases where substantial understatement was present in financial reports.

Where obvious bias and conflicting pressures are present, it is not reasonable to assume that some natural law of countervailing forces will operate to keep the measurement process on an objective course. The inherent weakness of a situation in which the choice among alternative accounting principles and methods lies for the most part in the hands of the group whose performance is judged by the resulting financial statements is an important consideration in the current controversy over the need for greater uniformity in accounting measurements.

V

MANAGERIAL INFLUENCE ON ACCOUNTING PRINCIPLES

There is nothing particularly sinister in the fact that outside pressures and self-interest create a managerial bias in setting accounting policies. Bias is a ubiquitous human characteristic and thus an important social phenomenon. We customarily institute checks and balances in our public and private institutions to provide a framework within which bias and conflicting social pressure can work effectively. The managers and players in professional sports, for example, have a considerable

¹² Spacek, *The Need for an Accounting Court*, 33 ACCOUNTING REV. 368, 371 (1958).

¹³ Most authorities deny that conservatism is a principle of accounting, or at least define it in such a way that it loses status as a principle. For an excellent discussion of this issue, see Devine, *The Rule of Conservatism Reexamined*, 1 J. ACCOUNTING RESEARCH 127 (1963).

personal and financial stake in the scoring process by which their performance is judged. In accordance with the best principles of countervailing power, we incorporate into the game a retinue of timers, scorekeepers, umpires, and field judges who make the measurements and report on the performance statistics and the outcome of the contest.

Our scoring system in the case of publicly held corporations is in striking contrast. Management is allowed to set accounting policy and to make accounting measurements. When the results are compiled management then hires an umpire, the professional accountant, who reviews the measurement process and renders an opinion on the fairness and consistency of the reported results.

The umpire in this situation limits himself to expressing an opinion on managerial representations and perhaps amplifying or qualifying his opinion with explanations, additional disclosures, or expressions of disapproval as he deems appropriate. The sole source of the CPA's influence on the measurement process is his persuasive ability, backed by his ultimate right to withhold his opinion. Not only is arguing with the umpire permitted, but management has a far greater chance of influencing the auditor's decision than we would tolerate in any sports contest.

Management's ultimate control over accounting measurements has a number of sources. The first is that the rulebook of accounting measurements, titled *Generally Accepted Accounting Principles*, has never been officially codified. This in itself allows management and the auditor a wide latitude in deciding on the principles that are acceptable as a fair representation of corporate performance. Statements having the weight of authority, such as the SEC's Accounting Series Releases, the AICPA's Accounting Research Bulletins, and the Opinions of the Accounting Principles Board came into being largely in response to fire alarms, as the importunate and clarion calls for rulings were heard in the central station. Various comprehensive attempts to state the generally accepted principles of accounting have only unofficial status. The most recent attempt by Paul Grady is frankly called an inventory¹⁴ and is essentially an organized compilation of past statements by various authorities plus a description of methods extant in current practice.

The second reason for management's control over the selection of accounting principles is more fundamental. Even if there were an official restatement of generally accepted principles as they are understood today, we would still be far from the uniformity of reporting standards necessary to achieve anything like the comparability we seek. A wide variety of alternative measurement methods, allowing for material variations in reported results, exists even in areas covered by official pronouncements. Why does the accounting profession tolerate this kind of variety? Accountants in general are reluctant to accept collective judgment that would narrowly prescribe acceptable measurement procedures. They believe such a move would mean giving up their freedom to exercise professional judgment and would

¹⁴ GRADY, *op. cit. supra* note 3.

reduce their function to that of a clerk. Furthermore, accountants argue that there are significant differences in the circumstances within which different companies operate that justify the use of different accounting procedures. Finally, there is faith in the values of experimentation. Where alternative approaches exist without a clear indication that one method is superior, accountants appear to have implicit faith that there is some yet undiscovered measurement principle that will resolve the difference of opinion. The solution is to allow experimentation with alternative methods until this principle is discovered, at which time everyone will recognize its undeniable merit and uniformity will be achieved without the necessity of an enforced compliance.

The Securities and Exchange Commission has the power to state, and require adherence to, specific accounting procedures,¹⁵ but it has not exercised this authority to any significant extent. Instead the SEC has relied upon and supported the accounting profession in its attempts to place lighthouses at the most pressing danger spots in the sea of accounting principles.

A third aspect of managerial influence over accounting measurements is related to the first two. The lack of unequivocal criteria for judging the merits of varying accounting policies undoubtedly weakens the CPA's ability to exercise what authority he has. But that authority is itself considerably weakened by the fact that the CPA is hired and paid by the corporation on whose statements he renders an opinion. It is true that some corporate charters require the election of public accountants by stockholders, but the force of this requirement is extremely doubtful. Except in unusual cases, stockholders ratify management's choice of auditors as a routine matter.

The upshot of all this is that where alternative accounting procedures are available and can be rationalized as "generally accepted" it is management that makes the choice. This is the major implication of management's primary responsibility for financial reports. The accountant who has strong convictions that alternative procedures would result in a better presentation of position and operating results can, according to Spacek, "swallow his convictions, or he can qualify his opinion on the basis of his own convictions, or he can resign. Usually the latter two courses are one and the same."¹⁶ Management's power to choose the umpire strongly suggests that, if one umpire's decision does not please, another may be found who can honestly agree that an alternative accounting method is generally acceptable, in some sense of that term.

The essential problem in management's present role in corporate reporting of accounting measurements is clear. We have two important elements conducive to a reporting bias: a conflict of interest and the ability to influence results in terms of self-interest. The problem appears sufficiently serious to warrant some attention.

¹⁵ Securities Act of 1933, § 19(a), 48 Stat. 85, as amended, 15 U.S.C. § 77s(a) (1964).

¹⁶ Spacek, *supra* note 12, at 371.

VI

CHOOSING THE AUDITOR

An important step in any concerted move to narrow the range of accounting principles and procedures is to give the independent accountant greater authority over their choice. One possible move toward this objective would be to devise a different method of selecting independent auditors. If auditors were chosen by someone other than management, this would strengthen the hand of the CPA who is called upon to render an opinion on managerial representations. The principle seems clear, but a practical means of applying it is not so apparent.

Stockholders are logical candidates for such a role. In theory they employ management and have important interests not entirely coincident with those of corporate managers. If financial reports are statements of managerial performance, and if management is accountable to stockholders, why not put the choice of the expert who renders an opinion on management's reports in the stockholders' hands? One weakness of this suggestion is that it is difficult to devise a scheme to make stockholder selection of auditors effective. We have already noted that, where such a provision now exists in corporate charters, stockholders routinely ratify management's choice of CPAs. The effectiveness of choice could be strengthened by requiring management to present two candidates for stockholder selection, but the question arises whether stockholders as a group are sufficiently informed to make an intelligent choice. A more attractive approach would be to put the selection of the independent CPA in the hands of a committee of stockholders composed of persons not associated with either management or the board of directors. This stockholders' committee might be elected at the same time as the directors. Under this arrangement, management should be free to choose a different public accounting firm for management-services engagements if it desires. This latter separation of engagements would provide some auxiliary advantages from the viewpoint of the accounting profession in its serious attempts to retain audit independence in the face of a growing demand for management consulting activities.

A possible objection to strengthening the stockholders' role is that publicly held corporations have growing social responsibilities and stockholders as a group have their own self-interest and potential biases. On these grounds one might propose that the selection of auditors for large publicly held corporations be made by a public body, such as the SEC. In theory, at least, this approach would provide the accountant with the greatest degree of independence from pressures by management and stockholders. The thought of having a quasi-political body choose professional firms to perform engagements for which substantial fees are to be paid, however, is not very attractive. Assuming the corporation would continue to pay the audit fee, this opens up the whole difficult business of judging whether a fee is reasonable when the employer and the payer are two different parties. The suggestion that standard

fees be set by a governmental body for professional engagements in which advice is rendered to a nameless public falls in the category of cures that are likely to be worse than the disease. On principle, any arrangement that divorces the hiring and compensating of professional firms from the most direct beneficiary of the services is difficult to defend. The basic difficulty in this case is that the ultimate beneficiaries of good corporate reporting are a number of diverse groups difficult to identify except in terms of the general investing public.

On balance, the most attractive avenue for modifying our present system of hiring and paying the CPA is to strengthen the role of the stockholder, particularly through the use of executive committees composed of relatively well-informed stockholders who are not a part of management. In this connection it is interesting to note some developments in this direction in the Scandinavian countries. In a recent study, Bomeli reports that the most significant difference between American and Scandinavian practice in this area is the much closer relation of Scandinavian auditors to shareholders.¹⁷ Any stockholder or group of stockholders owning more than ten per cent of the outstanding shares may appoint an independent accountant to consult with auditors designated by management and to report to the appointing group. Mr. Bomeli does not specify who pays the fee of the stockholder-appointed auditors, but one may infer from his discussion that the corporation foots the bill.

One additional means of strengthening the CPA's independence of both management and stockholders would be to increase the seriousness of the CPA's withdrawal from an engagement. A provision for fairly widespread notice of withdrawal might well tip the scales a bit in favor of the auditor in arguments over accounting policy, since notice of withdrawal would automatically raise questions that would bring to light the nature of the controversy. A requirement that the fact of a withdrawal from an audit engagement be reported immediately to the stock exchange and the SEC, and noted in the corporation's annual report and in any prospectuses used in connection with securities offerings, would add force to the independent accountant's control over accounting policies. The SEC could probably implement a disclosure requirement along these general lines under current law.

VII

CHANGING MANAGEMENT'S ROLE

Another approach in a program of mitigating management's influence on accounting principles is to alter the roles of management and the CPA. Perhaps we should take a hard look at the traditional premise that published financial statements are managerial representations on which the auditor's opinion is sought. Herbert Miller, in a recent article, questions the usefulness of this premise.¹⁸ Miller points

¹⁷ Bomeli, *Management Reviews by Scandinavian Accountants*, J. Accountancy, July 1964, p. 33.

¹⁸ Miller, *Audited Statements—Are They Really Management's?*, J. Accountancy, Oct. 1964, p. 43.

out that accounting conventions, income tax rules, SEC regulations, and the independent auditor all have some influence on accounting policies. Despite these restraints, he concludes, management has a significant ability to shape accounting measurements. Miller then suggests that management's responsibility be limited to the adoption and maintenance of an adequate accounting system and that the independent auditor be given greater responsibility for determining the accounting principles to be followed. This idea is worth examining more closely in relation to the objective under discussion.

Shifting primary responsibility for accounting policies to the CPA would not alone, of course, automatically narrow the range of alternative accounting procedures falling under the shelter of general acceptance. The CPA would have open to him as many alternatives as has management, unless professional accountants as a group chose to grant acceptance to a smaller number of alternative methods. The impact of such a shift in roles on accounting measurements, however, would be significant.

The most important implication of altering the responsibility of the CPA lies in the area of choosing among available alternative accounting policies. Where alternative accounting procedures exist, we may assume that the CPA would then have the responsibility for selection, subject to persuasion by management. The burden of proof, in a sense, would be shifted. The auditor would be expected to have a preference and to state it rather than simply to review the preferences of management. Having the burden of setting accounting policy should not only strengthen the CPA's ability to stand firm on his convictions but should also encourage him to formulate responsible convictions, since he could no longer limit his function to that of merely passing on the general acceptability of managerial representations.

Furthermore, the authority to choose the measurement technique implies the responsibility to make the choice on the basis of a judgment as to which accounting policy results in the best measure of the performance and position of the corporation. This would require accounting expertise and judgment of a higher order than the responsibility now imposed upon the profession and would challenge public accountants as never before to face up to the major objectives lurking behind the opinion in their certificate that the statement "presents fairly the financial position of the _____ Company and the results of its operations for the period covered in accordance with generally accepted accounting principles."

The goal of absolute uniformity in accounting procedures is probably neither attainable nor particularly desirable. The argument that significant differences in economic circumstances justify alternative accounting measuring approaches is not merely specious. However, there is little assurance in our present system that choices will actually be made on the basis of real differences in economic circumstances. One may well question whether the choice between inventory pricing methods or depreciation methods, or between similar alternatives, is ever significantly influenced by differences in economic circumstances that make one approach more

appropriate than the other in measuring corporate progress and performance.¹⁹ Management chooses on the basis of the kind of pressures previously mentioned; the auditor simply determines whether the method has general acceptance and finds the road to an unqualified opinion clear if the answer is "yes." If the public accounting profession really means business in its announced program of spelling out the different circumstances that call for alternative accounting measurement approaches and specifying how these circumstances can be identified and the appropriate tests for determining when one particular measurement method is better than another, it still faces the problem of enforcement. Granting responsibility to the CPA for making the initial choice places on his shoulders the burden of defending his selection on these grounds and increases materially the prospect of getting better financial data.

Some administrative problems are involved in the role reversal of management and CPAs, but they do not appear to be insuperable. There would be strong advantages in selecting a CPA at the beginning of a fiscal year so he could be consulted whenever questions of accounting policy arose. Most firms follow this practice at the present time. It is true that a change of auditors or the appointment of a CPA near the close of an accounting period might require changes in accounting policies. However the major areas of differential accounting treatment are not such that the measurement principle is irrevocable once the system is set in operation. Asset valuations and cost determinations can be recomputed after the fact, and, while the difficulties should not be minimized, they are not beyond the powers of the accounting art.

A more serious question may be whether placing the initiative for accounting measurements in the hands of the CPA would stifle the development of new (and hopefully improved) measurement methods. The auditor inevitably stresses those qualities of information that command universal confidence—objectivity and authenticity. Management, on the other hand, cherishes those qualities that make information useful for internal decision making. One might argue that management is more strongly motivated to experiment with different kinds of measurements since they have the incentive to seek new methods of manipulating data to produce new kinds of information they find desirable for one reason or another. Whether the net results are good or bad, there is little question that managerial accountants have initiated a great deal of accounting experimentation.

One can only speculate as to the CPA's receptiveness to new ideas under the alteration of roles we are considering. The CPA, his reputation at stake, is likely to be more cautious and less willing to put his stamp of approval on a new measuring approach until it has passed the screening of substantial accounting authority. The

¹⁹ A recent study of managerial decisions on depreciation policy is pertinent. See Lindhe, *Accelerated Depreciation for Income Tax Purposes—A Study of the Decision and Some Firms Who Made It*, 1 J. ACCOUNTING RESEARCH 139 (1963).

pressures to adopt new accounting methods and procedures would not disappear, but they would be shifted from management to the independent public accountant. Furthermore, the CPA's criteria for adoption would be more stringent than simple general acceptability, since he would then face the burden of choosing the most appropriate measure of corporate performance.

If managers retained the power to select auditors they would still be in a position to exert pressure if they disapproved of the auditor's choice of accounting policies. Management, for example, might well investigate the convictions of various CPA firms on particular accounting policies before appointing an auditing firm. If management had a particular interest in LIFO, or accelerated depreciation, or tax allocation, or keeping leases off the balance sheet, they could presumably find independent accountants with appropriate convictions on these points. Changing the responsibility for financial representations is not likely to nullify these sources of management's influence unless it is reinforced with a system of auditor selection that is relatively free of managerial influence.

CONCLUSION

In any serious attempt to increase uniformity and intercompany comparability in corporate reporting we cannot ignore management's role in setting corporate accounting policies. Management is primarily responsible for the choice among alternative accounting principles used in compiling financial reports. Yet accounting statements are essentially reports on managerial performance. Apart from the obvious conflict of interest in such a situation, there is little assurance that management, beset by a variety of pressures to mould accounting results purposively, uses the best measurement criteria in reaching its accounting policy decisions.

If management's control over corporate accounting policies were restricted, the independent accountant's ability to narrow the range of accepted alternatives would be strengthened. More important, where alternative accounting measurement procedures are available, the independent accountant would be encouraged to make his choice on grounds more consistent with the basic objectives of performance measurement. Finally, freeing external accounting measurement from strong managerial influence may be an important first step in gaining acceptance for new accounting principles in which the inevitable compromise between objectivity and economic relevance is weighted more heavily toward the latter. The challenge to improve accounting measurements would be thrust directly at the independent accountant, and hopefully his greater independence of management would give him the authority to harvest the fruits of his accounting research studies and put them into practice.