THE IMPACT OF GREAT DEPRESSION ON THE AMERICAN ACCOUNTING PRACTICE

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This article aims to prove that the events surrounding the Great Depression of the late 1920s and early 1930s, marks a maturity point in American Accounting thought and practice. In order to achieve such objective we have undergone a qualitative research, using as method of research the content analysis of the books and articles regarding the American Accounting history and the Great Crash. We can conclude that there is evidence that the crisis had a profound effect on the subsequent evolution of the American Accounting practice.
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1. INTRODUCTION

Before World War I, the Federal Reserve Board had been influential in the original efforts to develop accounting and auditing standards. From the appearance of “Approved Methods for the Preparation of Balance Sheet Statements” in 1918 until the aftermath of the stock market crash more than a decade later, the board did little about financial reporting standards. And other regulatory agencies also cease to ask for independent audits as a form of corporate control.

The social demand generated in the progressive era for corporate accountability vis-à-vis greater publicity had sustained Certified Public Accountants (CPA) in their original claim to professional status. During the 1920s that claim was significantly weakened by public indifference and a reaffirmation of the traditional American Creed. Economic theories, which focused on competition as the most effective means of promoting social welfare, suited officials in Washington well, for then they had no responsibility.

Since the public sector generated few demands for audited financial reports, accountants promoted other services that they could provide the businessman. Budgeting, implementation of standard cost systems, and other management accounting techniques were extremely important in gaining acceptance for public accountants during the 1920s. (George N., 1975)

2. LITERATURE REVIEW

Stephen Gilman evaluated accounting theory in the post World War I period and found it inexplicable that income determination had not become the focal point of financial reporting. He concluded that the maturity of large corporations, the income tax laws, and rapid advances in cost accounting ought to have led to the primacy of the income statement. That this was not the case, Gilman believed to be one of the paradoxes of accounting. But, if one examines other environmental factors in the 1920s, the continued emphasis on the balance sheet is understandable.

There are references that to the post World War I period providing the “hard historical evidence” that deviations from historical cost-based, conservative accounting led to the crash of 1929. Many accountants empathized with George O. May’s statement that: “in the 1920’s accountants fell from grace and took to adjusting capital values on the books…to an extent never before attempted…In extenuation they might plead unsound laws, unpractical economies and a widespread if unfounded belief in the new order of things combined to recommend such a course, but…the wiser course is to admit the error and not to be misled again.” (May, 1936)

Littleton analyzed the evolution of accounting theory, writing that "accounting is relative and progressive" and concluding that, "as older methods become less effective under altered conditions, earlier ideas become irrelevant in the face of new problems"(Littleton, 1933). He suggested change mandated acceptance of the "historical cost allocation model'" which became the dominant theory of accounting in the late 1930s.

But it is unfortunate that in justifying the new model, Littleton implied that previous accounting valuation theorists had not been aware of the ramifications of separation of ownership and management. Therefore, previous literature was no longer relevant. This implication seemed not only to justify disregarding questions raised in the 1920s but also to assert that once the corporate entity was accepted, theorists had no choice but to accept the historical cost allocation model.

Until the 1933 and 1934 federal securities acts, public demands for audit decreased, and the profession's obligation to third parties was obscured. The direction and growth of accounting practice was in the area of credit reports to bankers, as advisors to businessmen, and as tax experts. The New York Stock Exchange consistently refused to acknowledge the need for independent audits of listed companies before 1929. Only after the crash did accountants receive the full support of the exchange.

Perhaps a strong, united profession could have generated demands for protection of investors and developed standards to insure that all practitioners were aware of their responsibilities as professionals. But amid a wave of speculative fever unparalleled in American history which created a need for strong control and leadership in accountancy, the profession was bitterly divided. The lack of a unified, authoritative institution through which accountant could exercise strong leadership in the financial community persisted until 1936.

The academic organization was restructured in 1935, and the name was changed to the American Accounting Association (AAA). Academics issued a direct challenge to practitioners with the new stated objectives of the group. In March 1936, publication of a "Statement of Objective" served notice that academicians sought to take the lead in the development of accounting theory.

Practitioners did not empathize with the AAA's attempt "to develop accounting principles and standards, public and private accountants and governmental bodies." Practitioners had long assumed this to be their function and were reluctant to cede this privilege to group, whether within (academics) or outside of (the SEC) accounting.

With the publication "A Tentative Statement of Accounting Principles," also in 1936, the AAA left little doubt that they had adopted a new strategy. But the institute was not prepared to abandon the matter of developing of accounting principles to academicians, for clearly there was much at stake in the matter. Prior to 1936 there were no standardized accounting curricula and very little uniformity of course coverage among schools. Research, despite the excellent efforts of certain individual academicians, continued to lag behind other disciplines in terms of normative theory.

3. THE DEPRESSION YEARS

It is a formidable task to assess the impact of the stock market crash in 1929 – historical evidence suggests that contemporary observers did not foresee the lasting impact that the event would have. Yet it seems clear that the crash had a profound effect on the subsequent evolution of accounting practice. Politicians could no longer argue that Americans would prosper under a business system managed – or unmanaged – as it had been in the 1920s. But reaction was slow, and political leaders neither blamed accountants for the debacle of the 1920s nor looked to the profession for protection in the 1930s.

In the 1929 the American Institute of Accountants, with the support of the Federal Reserve Board, issued the Verification of Financial Statements. This pamphlet is fondly remembered as the "auditor's bible" by some older accountants. Although it was an attempt by the institute to provide guidelines to the profession, practitioners made clear that they were not attempting to receive the concept of uniform accounting.

Many accountants seemed to believe that the issuance of the document "Uniform Accounting" had created an illusion that there were accepted accounting and auditing procedures in widespread use which led to complacency on the part of both the public and the profession. An editorial in the Journal of Accountancy condemned any suggestion "for uniform systems of accounting and auditing for all sorts of business conditions" as extremely dangerous because that implied to many investors a degree of assurance that could not be given by auditors faced with the uncertainty that existed in the business sector.

At the 1930 annual meeting of the American Institute of Accountants, J. M. B. Hoxsey opened the door for cooperation between the New York Stock Exchange and Certified Public Accountants. May, who had served as advisor to the exchange, became chairman of the Special Committee on Cooperation with the New York Stock Exchange. The committee presented its first draft of accepted accounting principles in 1933 and submitted six recommendations to the institute and exchange for approval the following year.

The exchange agreed to five of six recommendations. They rejected the requirement that "all listed companies…disclose the accounting methods employed" (AIA Minutes 1932: 62f). Cooperation resulted in the publication of Audits of Corporate Accounts, which listed five basic principles that dealt with the most overt abuses of the 1920s:

1. no unrealized profit;
2. no charges of expenses to surplus to relieve the income account;
3. earned surplus prior to an acquisition is not earned surplus of the parent;
4. dividends on treasury stock are not income;
5. notes and accounts receivable due from officers or employees must be shown separately. (AIA, 1934: 14).

A sixth principle – (6) donated capital does not result in earned surplus – was added at the annual meeting of the Institute in 1934 (AIA, 1934). These basic views indicate that accountants had recognized the validity of the argument that the inability, or perhaps unwillingness, of the profession to properly aggregate capital and income had been one of the major reasons for unsatisfactory reporting in the previous decade.

Despite the many theories about the nature of capital and income, there was general agreement among accounting practitioners that dividends should be paid from earned surplus. But there was no generally accepted procedural approach to this problem. Eric Kohler became a leading spokesman for the "revenue-expense," income orientation, which came to dominate accounting theory in the 1930s. One of the more interesting assertions made by historical cost-oriented accountants was that bankers had influenced accounting standards and had oriented accountants toward liquidation values.

Faced with a direct challenge from academics with the American Accounting Association's publication of "A Tentative Statement of Accounting Principles" (1936) and the specter of federal intervention with the establishment of the SEC, practitioners united.

In 1936 the American Institute of Accountants embarked on a new research program. Accountants were successful in their efforts to keep the standard-setting process in the private sector and in retaining their right to set those standards despite demands from some that the federal government assume absolute control over the financial reporting process. For example, William Schulter's proposal, contained in his Economic Cycles and Crises (1993), called the entire federal control of accounting.

Schluter advocated an institute of accountancy and pricing on valuation that would require al business enterprises to keep accounts according to standards set by the federal government. Although Schluter would permit some latitude, standardized systems would be adapted to the needs of different industries. He believed that such rules would permit the "elimination of the present day system of certifying individual public accountants" and allow the government to do this important work. His proposed national institute of accountancy would be analogous with respect to accountancy to the Supreme Court of the United States.

He posited three divisions within the government to handle accounting data: first, there would be a division of accounting theory, methods, and procedure, empowered to develop accounting theory and principles: second, a division of reports for uniform classification and compilation of data; and, third, a division of examination and audit, whose duties would be similar to those now performed by public accounting firms. Given such proposals, the SEC, with its emphasis on disclosure, was not as onerous to the profession as has sometimes been suggested.

4. THE FEDERAL SECURITIES ACTS

The 1933 and 1934 federal securities acts marked the beginning of the development of a "social consciousness" with respect to business and financial reporting in the US (Greer 1964). Although that statement may eventually be proved to be historically true, since this legislation did acknowledge the importance of financial information for economic and social control, its immediate impact upon the accounting profession seemed to narrow somewhat the traditional concepts of the independent public accountant's responsibilities.

Despite the fact that the image of the profession was enhanced by the call for independent audits, these acts were not regarded as salutary for the profession. Many CPAs were frightened, not as some have suggested purely by the increased legal liability, but also by the extravagant claims being made by some reformers about the efficacy and reliability of accounting information.

Perhaps Clem Collins, AIA president, best summed up the prevailing sentiment within the profession when he wrote: "It is altogether possible that accountancy has been oversold. That is, a general belief has apparently developed that accounting procedures are infallible.

Medical science may have its defects, the principles of engineering may fail because of unforeseeable conditions, justice may miscarry because of malevolent human ingenuity, and even our spiritual destination might be uncertain as a result of the diversity of human understanding and belief, BUT, in the minds of many, accountancy seems to stand as the one science against which the machinations of the human mind shall not prevail." (Collins 1939)

By 1933, in fact, many felt that the terms "accountant" and "auditor" were synonymous. Walter Staub attempted to clarify the picture, explaining that auditing "has been sometimes described as the analytical phase of the accountant's work and accounting per se as a synthetic phase."

5. CONCLUSION

The purpose of this study was achieved so we can conclude that that the events surrounding the great depression of the late 1920s and early 1930s, marks a maturity point in American accounting thought and practice.

Most accountants believed that any theory must be pragmatic (useful, Practical, leading to desirable social consequences) and adaptive (to meet the changing demands made upon the profession). During the 1920s there is little evidence that any user group would have supported efforts to report only income from operations. To do so would have limited, or at least dampened, the wave of optimism which swept the country.

The desire for certainty seems to have been one of the characteristics of the "depression mentality." Accountants could not give legislators all the assurance they demanded. Over the years, it had become apparent to most practitioners that there were no simple rules in accounting.

What might conceivably be viewed by others as a simple question (Does an asset exist?) was not elementary for the CPA who believed that managerial intent was an important consideration in asset recognition. Assessment of managerial intent was not an objective matter, according practitioners. And professional judgment continued to be a most important attribute of the CPA.

Social role of accountants came to be seen as minimization of taxes. Although some reformers questioned Mellon's synergistic approach, which assumed that the wealth of the rich would eventually filter down to the poor, social thought appeared to support Mellon. (Andrew M., 1924)

During the early 1930s there was an effort to divorce accounting from economic theory on "practical" grounds. Topics such as the accountant's function in a regulated society, the need for multiple valuations, and the problems of articulation introduced in the 1920s were subsequently ignored as the work of "valuation theorists."

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