

## FUNDS STATEMENTS: THE ACCOUNTING PRINCIPLES BOARD WAS TWICE BEHIND THE CURVE

*Abstract:* This paper discusses the circumstances in which the Accounting Principles Board (APB) issued Opinions 3 and 19, in 1963 and 1971, respectively, when the Board encouraged and then required companies to publish a statement of source and application of funds, known as the funds statement. In doing so, the Board both times lagged behind company practice and the views of influential organizations, including the New York Stock Exchange and the Securities and Exchange Commission.

### INTRODUCTION

Users, preparers and auditors, as well as the Securities and Exchange Commission (SEC), have traditionally looked to the private-sector body charged with developing accounting principles to take the initiative to improve financial reporting in the United States. But when the issue was whether companies should be encouraged or required to publish a statement of source and application of funds, widely known as the funds statement, the Accounting Principles Board (APB) was “behind the curve.”<sup>1</sup>

This research seeks to throw light on the APB’s criteria for issuing two of its Opinions on a financial statement that had not previously been recommended, let alone required, anywhere else in the world. The APB’s predecessor, the Committee on

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<sup>1</sup> The issue was mentioned *en passant* in Zeff (1972, pp. 183-184, 217-218).

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Accounting Procedure (1939-1959), had never given serious thought to issuing an Accounting Research Bulletin to call for the publication of such a statement. This article demonstrates how the APB, perhaps believing that the funds statement was more an instrument of financial analysis than of accounting, was content with allowing user and regulator demand to grow and coalesce, and “voluntary” preparer adoption to follow, before it finally took a position that companies should be required to publish it.

Today’s cash flow statement officially replaced the funds statement in 1987, when the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 95.

### APB OPINION 3 (1963)

In 1963 and 1971, the APB issued Opinions 3 and 19, respectively, on funds statements. In Opinion 3, the Board said that “a statement of source and application of funds should be presented as supplementary information in financial reports. The inclusion of such information is not mandatory, and it is optional as to whether it should be covered in the report of the independent accountant” (paragraph 8). The Board could not even agree on a title for the statement other than that it “should be as descriptive as possible and need not be the same in all cases” (paragraph 11). Board member Leonard Spacek, of Arthur Andersen & Co., assented to paragraph 8 but qualified his assent by contending that the funds statement should be mandatory. On the other hand, Board members Marshall S. Armstrong, a partner in an Indianapolis-based accounting firm, and Carman G. Blough, a former SEC chief accountant, the Institute’s former director of research for many years, and a widely respected authority on the application of GAAP, also qualified their assent, arguing that flow of funds analyses “do not deal with significant accounting matters and that relatively few investors who receive annual corporate reports are capable of using such statistical data in a useful manner.” Instead, they said, they believe the inclusion of funds statements in annual reports tends “to confuse most investors”. In view of these comments, their qualified assents could well have been called dissents instead. Armstrong and Blough held these views notwithstanding the previously expressed support of funds statements by the New York Stock Exchange (NYSE) and a committee of the Financial Analysts Federation (FAF), discussed below. Members of Institute committees – composed almost wholly of partners in public

accounting firms – did not ordinarily confer with or consult investor representatives, even though auditors were supposed to be acting in the interests of investors. No financial analyst served on the APB until David Norr in 1971, and he was a CPA – because the Institute required that all members of the Board be CPAs and members of the Institute. Prior to then, no financial analyst had served on an Institute committee.

The Board's timidity in Opinion 3 was noticed by Sprouse and Vagts [1965, pp. 716-717], who, with a whiff of understatement, wrote, "In view of the fact that the inclusion of [funds] statements in published annual reports was already fairly widespread, the position taken by the Board could hardly be characterized as revolutionary." What is even more surprising is that, well prior to the issuance of the Board's Opinion, word had been received from both the NYSE and the FAF that such a statement should become a staple in corporate annual reports. Moreover, the SEC's chief accountant, Andrew Barr, had also spoken in favor of such a statement. What more support from influential sources would the APB need in order to mandate the inclusion of funds statements in the financial reporting package?

Prior to beginning its project on funds statements, the Board had commissioned an Accounting Research Study (ARS), which was published in 1961. Its author was Perry Mason, the associate director of the APB's accounting research staff, from 1938 to 1954 an accounting professor at the University of California, Berkeley, and a former president of the American Accounting Association, and it was entitled "*Cash Flow Analysis and the Funds Statement*."<sup>2</sup> In the section of his study on the funds statement, Mason discussed and illustrated the practices used by the 190 companies in the AICPA's annual survey of 600 companies, *Accounting Trends and Techniques*, for 1959. Already, almost one-third of this large sample of publicly traded companies were issuing funds statements, and financial accounting textbooks had been instructing students on how to prepare the funds statement since the 1930s (Anton, 1962, p. 50; see Mason's list of four leading textbooks that he noted were doing so, on page 95). Mason said at a conference in December 1962 that "At least twice in recent years the CPA examination has called for the preparation of a cash flow statement, much to the consternation of many of the candidates who had never heard of such a thing. Now we are in better shape since some of the textbooks

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<sup>2</sup> At the APB's invitation, Merle S. Wick, of the NYSE, served on the advisory committee for Mason's study.

have picked it up – Finney and Miller, and Milroy and Walden, for example” [1963, p. 32; misspelling corrected]. The bibliography at the end of Mason’s study showed that there had been many articles written about the funds statement.

At the end of his thorough study, Mason recommended that “The funds statement should be treated as a major financial statement. It should be presented in all annual reports of corporations and be covered by the auditor’s short-form report” (page 90). Two frequent writers on cash flow reporting, Mulford and Comiskey [2005, p. 47], wrote, “The position taken by the APB in Opinion No. 3 was somewhat surprising given the strong recommendation in ARS No. 2 [i.e., the Mason study] to make the funds statement mandatory.”

As mentioned above, the APB, in issuing Opinion 3, lagged behind the very positive views on funds statements emanating from the NYSE and the FAF. In October 1958, Phillip L. West, a NYSE vice president who frequently conveyed the Exchange’s views on accounting issues, said at the AICPA’s annual meeting in Detroit that “a third statement would be most helpful in annual reports to stockholders in addition to the balance sheet and the profit and loss statement,” which he called “The Source and Disposition of Funds” [West, 1959, p. 29]. He added, “Today, because of the rapid changes that are taking place in our economy, such a statement assumes the importance of the income account and balance sheet as we have known them in the past” (page 30).<sup>3</sup> In the event that West’s message had not been fully appreciated by the Board, he responded to the recommendation in Mason’s study with an even more forceful message. In the AICPA research division’s summary of comments received on Mason’s study, published in September 1962 issue of *The Journal of Accountancy*, West was quoted as writing: “I...hope that the recommendation that the funds statement be treated as a major financial statement will be adopted by the Institute. If this is done, we will urge listed companies to include such statements in their reports to stockholders, as we believe this will be a big step forward in financial reporting” [“Comments on ‘Cash Flow’ Analysis and the Funds Statement’,” 1962, p. 64; ellipsis in original]. West’s message was received even before the Board had issued an exposure draft of its proposed Opinion.

Then, in 1962, Corliss D. Anderson, in a monograph sponsored

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<sup>3</sup> The author has seen the typescript of West’s presentation in Detroit, and his remarks on the funds statement were precisely the same as in his published article.

by the FAF's corporate information committee, recommended that a funds statement form part of the corporate annual report [Anderson, 1962, p. 34]. Rosen and DeCoster [1963, p. 133] observed that some of the credit for the great increase in the frequency of appearance of the funds statement in corporate annual reports between 1958 and 1963 must go to the NYSE and the FAF, "who strongly advocated its use."

Finally, in a speech to the American Accounting Association (AAA), the body led by accounting academics, delivered in October 1960, SEC Chief Accountant Andrew Barr had expressed an interest in seeing the funds statement in filings with the Commission: "Emphasis in some circles on cash flow reporting suggests that the time may be ripe for prescribing some form of statement of source and application of funds in addition to balance sheets, income and surplus statements" [1961, p. 19]. Barr's speech caught the attention of partners at Arthur Andersen & Co. Russell Morrison, a senior technical partner, wrote in an internal memorandum on October 21, 1961 that he expected that Perry Mason's study "would receive the approval of the Accounting Principles Board, and would give immediate impetus to the inclusion of funds statements in stockholders' reports possibly even for 1961. I would expect, too, that since Andy Barr has indicated interest in such statements for SEC filings, the SEC might well begin to require such statements fairly soon."<sup>4</sup> In fact, the APB recoiled from accepting Mason's recommendation, even though the SEC chief accountant had said that "the time may be ripe for prescribing some form" of funds statement. To be sure, SEC registrants and their auditors would have duly noted the chief accountant's remarks as a sign of what might be coming.

Even earlier, in 1954 and again in 1957, two blue-ribbon AAA committees unanimously concluded that funds statements "may be essential to attainment of reasonable disclosure standards" and "are recommended as a means of disclosure," respectively [*Accounting and Reporting Standards...*, 1957, pp. 49, 8].

Why, then, in the face of all of this evidence in support of a funds statement, was the APB unwilling to go no further in 1963 than to recommend, but not require, that a funds statement be issued, and only as supplementary information and not be covered by the auditor's report? One reason may have been that

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<sup>4</sup> On the same date, Marvin Deupree, one of Morrison's partners, wrote along similar lines in another internal memorandum. These memoranda are in the author's files.

a funds statement did not raise the core accounting issues of asset valuation and income determination (today called recognition and measurement), but was instead viewed as just an additional disclosure. Some Board members may have thought that a funds statement was more a part of financial analysis than accounting. Also, the Institute's leadership, including the APB, was critical of the use, which they saw all too often, of such terms as "cash earnings" and "cash flow" in a manner that would diminish the importance of net income, and both the Mason study and Opinion 3 inveighed against the use of such terminology.<sup>5</sup> There may well have been a belief among some APB members that an endorsement of the funds statement might lead to a proliferation of such usage.

Just after Opinion 3 was issued in October 1963, Richard C. Lytle, the director of the Institute's technical services division, confirmed that, following his informal sounding of leading CPAs, there was general agreement that the funds statement "should ordinarily be considered as an additional statement presented to provide useful information not otherwise readily available, rather than as a basic financial statement necessary for the fair presentation of financial position and results of operations" [1963, p. 71]. These leading figures in the accounting profession were evidently no more forward-thinking than the APB.

Once the APB had issued Opinion 3, the NYSE "served notice that its requirements for new listings were being amended to include a funds statement and urged companies already listed to conform to the new requirement" [Moonitz, 1970, p. 62]. The NYSE's letter to the presidents of more than 1,200 listed companies was signed by its president, G. Keith Funston, and was dated February 10, 1964. Going well beyond the APB's recommendation, he wrote, "we strongly urge you to consider including [a funds statement] in future annual reports to your shareholders. Preferably this should be part of the regular financial statements covered by the opinion of your independent accountants and in keeping with generally accepted disclosure practice should be in comparative form for the past 2 years."<sup>6</sup> Moreover, in the May-June 1964 issue of the *Financial Analysts Journal*, the directors of the FAF, after taking note of Opinion 3 and Keith Funston's

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<sup>5</sup> See also the editorial in the November 1963 issue of *The Journal of Accountancy* which was critical of this terminology ["APB Opinion on 'Cash Flow,'" 1963]. Professor William A. Paton [1963], a leading accounting academic, wrote that he was critical of "cash flow" as a substitute for net income.

<sup>6</sup> The NYSE's letter is in the author's files. The author is grateful to Steven Wheeler, of the NYSE, for furnishing the letter.

letter and reciting the benefits of funds flow analysis, went on record as “favoring the inclusion of the statement of the source and application of funds in corporate reports to shareholders” [“Funds Analysis in Corporate Annual Reports...,” 1964, p. 14].

From 1964 onward, as shown Exhibit 1, more than half of the 600 companies surveyed in *Accounting Trends and Techniques* included a funds statement with their other financial statements, and in 1964 there was a significant jump in the number of funds statements covered by the auditor’s report. One suspects that the action taken by the NYSE was more responsible for this prompt and full corporate response than was the tepid recommendation in the APB’s Opinion 3.

#### APB OPINION 19 (1971)

It took the APB some years before revisiting its recommendation on funds statements. Exhibit 1 shows that, during the 1960s, the number of companies displaying a funds statement, among the 600 companies surveyed in *Accounting Trends and Techniques*, showed a strong upward trend, and a significant downward trend in its not being covered by the auditor’s report.

#### EXHIBIT 1

Company Adoption and Auditor Coverage of the Funds Statement, 1962-1970

|  | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 |
|--|------|------|------|------|------|------|------|------|------|
| Funds statements covered by the auditor’s report     | 50   | 65   | 191  | 273  | 354  | 413  | 443  | 476  | 573  |
| Funds statements not covered by the auditor’s report | 178  | 213  | 196  | 185  | 149  | 111  | 92   | 72   | 14   |
| Totals   | 228  | 278  | 387  | 458  | 503  | 524  | 535  | 548  | 587  |

Source: Author’s analysis of the data reported in *Accounting Trends and Techniques*.

In 1969, the APB set up a subcommittee to deal with the funds statement, but its progress was slow in part, one supposes, because of the Board’s lengthy and difficult deliberations leading up to Opinions 16 and 17 [Accounting Principles Board, 1970a, 1970b] on business combinations and intangible assets,

which were finally issued in August 1970. Yet the Board could have seen several years earlier that the number of companies issuing funds statements was bounding upward every year, including especially those whose funds statement was covered by the auditor's report. October 1970 was when the Board finally began to move. At the Board's meeting on October 21-23, its planning committee recommended that the Board issue an Opinion requiring a funds statement, and the subcommittee got right to work.<sup>7</sup> The die was cast – but not by the APB. On October 14, the SEC had issued Accounting Series Release (ASR) No. 117, which announced the Commission's adoption of an amended article in Regulation S-X to govern the form and content for a newly imposed funds statement [SEC, 1970a]. On October 21, the SEC issued Release No. 34-9000 to adopt a revision of Form 10-K, which, inter alia, included a requirement for a funds statement in periodic filings as well as in registration statements.<sup>8</sup> The SEC announced these new rules in its *News Digest* on October 26 [SEC, 1970b, p. 1; "SEC Makes Sweeping Changes in Disclosure Regulations," 1970]. The SEC thus carried forward the recommendation contained in its major disclosure policy study, entitled *Disclosure to Investors*, which was submitted to the Commission in March 1969, that a funds statement should henceforth be included in prospectuses [1969, pp. 12, 65, 90-91]. On September 15, 1969, the SEC had published proposals to amend its registration and reporting forms to require a funds statement.<sup>9</sup> Hence, the Board knew – or should have known – of the SEC's intention with respect to a funds statement for a year prior to its October 1970 meeting.

Further, on October 20, the day before the Board's meeting, the NYSE sent a letter to the presidents of listed companies, signed by Phillip West, pointing out that, since 1964, "the Exchange has actively promoted the use of funds statements to the point that over 90% of all listed companies now include such statements in their reports." The Exchange referred in the letter to the SEC's ASR issued on October 14, and it stated in the letter that the Exchange is "adopting a requirement that all listed companies include a comparative, audited Source and Application of Funds Statement in their annual reports to shareholders

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<sup>7</sup> Minutes of meeting of the Accounting Principles Board, October 21-23, 1970, in New York City, section VI (in the author's files).

<sup>8</sup> See SEC Release No. 34-9000 (October 21, 1970) [1970 SEC LEXIS 312].

<sup>9</sup> These proposals were discussed in a speech by Andrew Barr in April 1970 [1970, p. 8]. See SEC Release No. 34-9000 (October 21, 1970) [1970 SEC LEXIS 312] and the SEC's *36th Annual Report* (1970c, p. 59).

beginning not later than their reports covering the results of operations for the year 1973.”<sup>10</sup>

Additionally, the AAA's 1966-68 Committee on External Reporting had recommended the inclusion in the financial reporting package of a “statement of current monetary flows,” which was a variation on the funds statement that focused more on cash flows [“An Evaluation of External Reporting Practices,” 1969, pp. 121-122].

APB Opinion 19, issued in March 1971, was entitled “Reporting Changes in Financial Position.” In the first paragraph, the Board acknowledged the significant increase in the number of companies presenting funds statements as well the support of its Opinion 3 by “the principal stock exchanges.” The Board also recognized that several regulatory agencies “had acted recently to require funds statements in certain reports filed with them.” The Board chose to give the statement a new name: Statement of Changes in Financial Position. The broadened name evidently could be traced to the Board's expectation that “The Statement of each reporting entity should disclose all important aspects of its financing and investing activities regardless of whether cash or other elements of working capital are directly affected” (paragraph 8).<sup>11</sup> The Board, as can be seen, allowed the statement to be drawn up on the basis of cash or working capital. It recommended that “When financial statements purporting to present both financial position (balance sheet), and results of operations (statement of income and retained earnings) are issued, a statement summarizing changes in financial position should also be presented as a basic financial statement for each period for which an income statement is presented” (paragraph 7; footnote omitted), thus implying that the funds statement should be covered by the auditor's report. By finally taking this step, the Board was doing little more than confirming a *fait accompli* as far as publicly traded companies were concerned. The Board's Opinion did have the effect of expanding the requirement to present a funds statement to include private companies.

One of the 20 Board members actually dissented to the Opinion. Newman T. Halvorson, of Ernst & Ernst, claimed that, by issuing the Opinion, “the Board is going outside its province, if not its authority, by requiring that a summary of changes in

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<sup>10</sup> The NYSE's letter is in the author's files.

<sup>11</sup> This broadened view was called the “all financial resources” approach in Mason's study [1961, pp. 54-56], which the Board recommended in Opinion 3 (paragraph 9).

financial position become one of the basic financial statements” (paragraph 16). Charles T. Horngren, an academic member of the APB from 1968 to 1973, said of Halvorson: “in general [he] had many strong opinions based on his own conceptual framework, and in general he was regarded by the Board, and certainly by me, as the epitome of ‘no change’ on nearly any issue that might be brought up. The status quo was his god.”<sup>12</sup>

## CONCLUSION

When it was founded in 1959, the Accounting Principles Board was viewed as the body that would take a leadership role in improving the practice of financial reporting. On the subject of encouraging and eventually requiring the use of a funds statement in company annual reports to shareholders, the Board was a follower, not a leader.

In fairness to the APB, the Board was preoccupied with the intense controversy over the investment credit in 1962-1964 and with the prolonged controversy over business combinations and intangible assets in the late 1960s. But these impediments did not justify the Board’s slowness in coming to appreciate the importance of the funds statement, especially with the full-throated support for such a statement by major user bodies and the SEC.

## METHODOLOGICAL NOTE

The author sought published works from an examination of the *Accountants’ Index* and the extensive bibliography at the end of Perry Mason’s *Accounting Research Study* (1961). He also examined the contents of *The Journal of Accountancy* and *The Accounting Review* from the middle of the 1950s to 1970 as well as the successive annual issues of the AICPA’s *Accounting Trends and Techniques* for the same period. He approached the AICPA Library at the University of Mississippi, the New York Stock Exchange, and the SEC’s Office of the Chief Accountant for relevant published and unpublished documentation. Many years ago, Arthur Andersen & Co. invited the author to photocopy documents from the firm’s extensive files on the APB, and that is where he found the minutes of APB meetings. All of the unpublished documentation cited in this article is in the author’s files and is available to interested researchers.

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<sup>12</sup> Author’s interview with Charles T. Horngren, February 15, 2002, dealing with his service on the APB.

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