The Foundation of Financial Accounting.

James Wilson Pattillo

Louisiana State University and Agricultural & Mechanical College

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in partial fulfillment of the
requirements for the degree of
Doctor of Philosophy

in

The Department of Accounting

by

James Wilson Pattillo
B.S. in Commerce, St. Edward's University, 1958
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January, 1963
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ABSTRACT

Over the years a framework of theory and a body of practice have evolved for recording and communicating the financial and economic relationships of people and firms. In spite of advances made in these areas, the profession cannot claim an authoritative structure of accounting theory and an uncontradictory body of practice built upon that theory. That integrating force between coordinated theories and sound practices seems to be lacking in the current structure of accounting.

This dissertation proposes an enterprise financial accounting structure built upon the integrating force of the social concept of "fairness to all parties." Such a structure is characterized by successive levels of abstractions, the broadest being the objective. Successively narrow propositions implementing the objective include principles, rules, and procedures. These must continually meet the test of "fairness" to be included within the structure. The investigation is limited to studying the "foundation" of that structure: the objective, basic standard of "fairness," and broad principles. As a basis for the analyses, the literature of the field was researched.

A broad objective of all accounting is formulated,
based upon the conviction that accounting responsibilities transcend service to the owners of firms to the service of society. From this social concept and an analysis of related disciplines, a definition and objective of enterprise accounting, and objectives for its managerial and financial areas are derived. The objective of the latter area serves as the basic proposition of the structure. The determination of net income as the current objective of financial accounting is discussed as an alternative to the formulated objective.

The basic guideline to attaining the objective is the postulate; together, these serve as a framework for formulating principles, rules, and procedures. The guideline of "fairness to all parties" is judged the most pertinent to our social concept of accounting as well as to the environment of accounting. Several possible alternative postulates are considered, including "usefulness in the situation," "justice," and "truth."

"Fairness" is a social concept rooted in ethics, finding its expression in laws, customs, business conduct, administrative decisions, religious beliefs, and in other forms depending upon the time and place. Under the proposal, the profession would adopt the collective opinion of society about its concept of fairness, as officially interpreted by an authoritative body established within the profession. That concept then would be applied in the accounting for and reporting upon the various entities in
society to the holders of the economic rights and interests in those entities. An ethically fair portrayal of the society segments' interests through the media of financial statements would serve as the basis for judgments and actions relative to their interests. The society segments include stockholders, management, labor, creditors, customers, government, and general public.

The final section of the study applies the concepts above to a number of currently generally accepted accounting principles. After separate analyses, it is concluded that the "coordinating principles" of the business entity, periodicity, materiality, consistency, full disclosure, and objectivity produce results which cannot be considered unfair to all parties. However, the principles of conservatism and stable dollar are judged to produce unfair results. Some "application principles" are also tested: principles underlying the income statement which are concluded to be fair to all parties are those of matching revenues and expenses, realization of income, and separation of ordinary from unusual items in calculating net income. Two principles underlying the balance sheet are also discussed, concluding that the principle concerning liabilities is fair, whereas the effect of the unstable dollar renders the cost principle unfair to all society segments.
CHAPTER I

INTRODUCING THE STUDY

Introduction

We, and accounting, live in a world of interdependence, of mutual responsibility, and of mutual accountability. The profession of accountancy was originally established to deal with this concept of accountability in the area of financial and economic relationships. Collectively, accountants are responsible to all segments of our society for fairly establishing and communicating the existence of and change in economic resources.¹ For every resource, there is a claim to that resource; there is a moral and legal claim which is given effect either in common law, statute law, or moral law.

Accountants discharge their responsibility to measure and communicate financial and economic relationships through a framework of interrelated theory and practice. For the most part, emphasis has heretofore been

¹See John L. Carey, "Responsibilities of Certified Public Accountants," The Ohio Certified Public Accountant, VII (Autumn, 1948), 11-18; and Lloyd F. Morrison, "Some Accounting Limitations of Statement Interpretation," The Accounting Review, XXVII (October, 1952), 490-495.
on the practical aspects of the framework. Through trial and error, through some reasoned conclusions, and also being influenced by expediency and tradition, a body of practice has evolved. In some cases the evolution of the body of practice has lagged behind (and in other cases has kept pace with) the business and economic conditions, legal regulations, and modes and thought at the time. Once initiated into the body, however, practices may be hard to "weed out"; consequently practices exist which are no longer appropriate to the changed conditions. This body of practices, having its origin in meeting specific problems as they arose, has very little to give it cohesion, very little to relate the various appendages to each other. Every body of knowledge, to be called a discipline, must be formed around a conceptual structure—a body of theory. Theory, then, provides that cohesion.

Purpose of the Study

The Need for the Investigation

Theory provides the cohesion to relate the practices into a coordinated body. But, as Professor Gaa has said: "It probably is fair to say that there is no generally recognized, authoritative, and co-ordinated structure

of accounting theory."^ For practices^ to be sound and uncontradictory, they must be based on a firm foundation of theory. But how may a firm foundation of theory be established? This is a question with which this study is, in part, concerned, and to which the answer will be subsequently developed.

A complicating factor is terminology. Scanning the literature one finds many names given to the various levels of the accounting structure. The word "principle" is the worst offender; its use ranges most widely, encompassing the broadest concept to the most specific rule, depending upon the writer. Moreover, the nature of accounting "principles" is endlessly debated. Because of the unsettled terminology, some view accounting principles to be synonymous with procedures; some view them as distinctly separate.

Likewise, the scope of accounting principles causes confusion. Some believe a single set of principles should apply to all enterprises; others believe there should be a set of principles for regulated enterprises and another set for unregulated enterprises. Should a single set apply to all forms of enterprises; or should there be various sets of accounting principles for the different forms, such as incorporated and unincorporated firms or profit and

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4"Practices" here encompass rules and procedures; both of these terms will be specifically defined in a later chapter.
There is a pressing need for clarification and agreement about the definition, nature, and scope of accounting principles. There is likewise a need for the development of a sound and coherent body of accounting theory.

**Obligation of the Accounting Profession**

While terminology is a challenge, the real challenge is to develop a framework to provide a proper basis for determining appropriate accounting practices.\(^5\)

But why must we develop this framework now? The answer is implied in a statement by Arthur Cannon:

Accounting needs a logical unifying basis of postulates and a superstructure of internally consistent principles. These will make it easier to solve the knotty day-to-day problems, and to reduce the areas of inconsistency that permit similar events in similar situations to be accounted for in a variety of ways. We really must stop this business of pretending that 2 plus 2 may be "fairly presented"\(^6\) by anything from 3 to 5.\(^7\)

A framework must be developed to provide a

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\(^6\)Cannon is referring to the standard wording of the auditor's short-form report. For the complete report, see the American Institute of Certified Public Accountants, *Codification of Statements on Auditing Procedure* (New York: American Institute of Certified Public Accountants, 1951), p. 16.

"unifying and internally consistent logical basis for financial statements." Alternative procedures have caused similar events to be reported differently. The profession is obligated to produce statements that reflect actual changes, rather than apparent changes caused by the differences in accounting technique. The accountant's responsibility to the segments of society (stockholders, management, labor, creditors, customers, government, and general public) make it imperative that financial statements reflect financial and economic relationships on a fair and comparable basis. The accountant (and all accountants collectively) must preserve the truthfulness of statements of accountability. But in some cases this has not been done; the reporting of profits, for example, has been especially susceptible to distortion.  

The problem is not new. The adequacy of accounting concepts and practices was actively discussed in the literature from 1930 to 1945, and again from 1950 to the present. MacNeal, writing in 1939, noted that criticisms of the day had rendered the traditional concepts increasingly untenable. He suggested two choices: improve existing methods.

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so that they justify traditional concepts, or renounce these concepts and adopt a more restricted definition of the purpose of accounting. These charges, and choices, largely still apply today. Admittedly, progress has been made; specifics will be discussed in a later chapter.

Organizations and independent researchers have attempted to formulate a framework of accounting with varying degrees of success.

**Recent Attempt to Formulate a Framework**

Not desiring to adopt a restricted definition of purpose and scope of accounting (indeed, seeking an expanded definition), the American Institute of Certified Public Accountants "tackled" MacNeal's other alternative, that of improving existing methods so that they justify the traditional concepts. This improvement in current methods existed as an objective of the AICPA Committee on Accounting Procedure from 1938 to 1959, when the Committee was superseded by an Accounting Principles Board. The approach of the Committee was to improve existing methods as problems arose which challenged those methods. At best, this was a "brush-fire" approach.

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11 The American Institute of Accountants changed its name in 1957 to the American Institute of Certified Public Accountants. All references to the Institute will be to the new name.
In September, 1959, the AICPA set out on an expanded program of research. The program is the basis of an attempt to formulate a framework of accounting which will act as a guide in solving problems as they arise. Thus the after-the-fact approach of the Committee has been replaced by an approach which has as its goal first the formulation of a theory framework and second the solution of everyday problems according to that framework. In setting up this type of program, the AICPA seeks to avoid placing itself in the position of being the sole authority in matters of accounting principle and method, and also to avoid becoming dependent upon those firms for whom its members express auditors' opinions.12

In its Charter Rules, the AICPA Accounting Principles Board set out the essence of its new approach to the solution of problems in the area of financial accounting. The overall objective is to advance a written expression of what should constitute generally accepted accounting principles. This would involve determining appropriate practice and narrowing areas of difference and inconsistency. The broad problem of financial accounting was visualized as existing at four levels: deriving postulates to form the basis for principles which, together, would

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serve as a frame of reference for the solution of detailed problems. Third, formulating rules which apply the principles in specific situations, and fourth, continuing research in the three previous levels.\textsuperscript{13}

Thus, the Accounting Principles Board is to establish a framework through which day-to-day problems may be met on an integrated and coordinated basis. But the program is not expected to solve all problems or achieve complete uniformity in financial reporting.\textsuperscript{14}

The program outlined by the AICPA is indeed broad, but does it go to the essence of the problem? Everything which is done, is done with a purpose (goal, objective), whether done by an individual or an organization, consciously or unconsciously. And what is the objective of accounting? The Accounting Principles Board, not expressing any one explicitly, either assumes accounting objectives to be well enough known not to need verbal expression, or assumes them not capable of expression and outside the realm of its present research program. It is suggested


\textsuperscript{14}See "Research in Accounting" (Editorial), The Journal of Accountancy, CVIII (July, 1959), 21. The same editorial expresses a tinge of apprehension: "It is in fact extremely doubtful that a single completely integrated theory of accounting can ever serve the needs of all the various users of financial data. . . ."
that the former is the case. But is it possible to establish a coordinated and integrated framework without expressly setting out that motive (objective, purpose) which underlies all accounting? It is the contention of this thesis that such is not possible.\(^\text{15}\) This statement of objective must be the first problem studied; when stated, it must supply the basis for the framework, the essence of which is the best way to achieve the objective.

**Our Approach to the Problem**

We may envision in the form of a triangle a hierarchy of levels of abstractions. At its apex is one or a few generalizations which comprehend all things appearing below it. At its base are many observable relationships and phenomena. Between these two are successive levels of generalizations, each level less inclusive than the one above it. The generalizations at any level provide the basis for more specific propositions at the next lower level; they are likewise specific statements about which broader propositions at the next higher level may be formulated.\(^\text{16}\)

Accounting may be thought of in such a structure or

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\(^{15}\) At least when more than one person is involved; the Board has eighteen members, and almost as many more are involved in the research phase. Each is guided by his own notion of the basic objective.

framework. We may outline that structure in a form such as it appears on the following page.

Referring to the outline, the discipline of accounting, as viewed by this writer, is basically an information system. As such its nature is determined by economics, statistics, law and government, and social and moral attitudes. The discipline of economics provides the data and relationships with which accounting is concerned. The methods to manipulate these economic data are provided by the discipline of statistics. Law and government provide the guidelines in manipulating the data. And a perspective on the modes and customs is provided by the social and moral attitudes of the segments of society.

Accounting as an information system may be based on any one of a number of viewpoints. There may be the viewpoint of a personality—either real or fictitious—or there may be a viewpoint void of personality, such as a fund. Other viewpoints, such as an "activity concept" or an "operations concept" or an "organization theory" have been advanced. A brief elaboration on the first three

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LAW & GOVERNMENT  (Guidelines)  SOCIAL & MORAL ATTITUDES  (Perspective)

RPRISE ACCOUNTING  (An Information System)

PERSONAL ENTITY THEORY  FUND ENTITY THEORY

MANAGERIAL ACCOUNTING

TO PRESENT DATA TO FACILITATE PLANNING, CONTROL, AND DECISION-MAKING BY ALL MANAGERIAL LEVELS

USEFULNESS OF DATA

MAINTENANCE OF CAPITAL

STRUCTURE OF ACCOUNTING

 Fig. 1

SOURCE: Original
viewpoints is in order, as a basis for later discussion.

The viewpoint of a real personality is expressed in the proprietary theory. It maintains that accounting records are kept and statements are prepared from the standpoint of the proprietor or owner of a business, and are aimed primarily at the measurement of changes in the owner's "net worth." Assets are viewed as the owner's property; liabilities are the owner's obligations; profit is emphasized as an increase in proprietorship.20

With the advent of the corporation arose the entity theory, which maintains that the business entity should not be identified with the actual personality of the owner, but rather should be separate from its owner, existing as a fictitious personality in itself. Assets and debts become those of the entity; profit is an increase to the resources and claims to those resources.21 Both theories have the business firm as the center of attention, but certain implications arise concerning relevant data and value measurements, depending upon the viewpoint of the personality assumed.


The fund theory sheds any implications of personality, and a fund is viewed as a "collection of service potentials that have been brought together for some functional purpose."\textsuperscript{22} Equities are considered to be restrictions on the future use of the fund assets, rather than a legal claim against a personality. Revenues are increases to the fund assets; expenses involve the service potentials' being accomplished. There is no concept of income because income is associated with situations or personalities. The fund, therefore, implies a "pool of accountability."\textsuperscript{23}

Referring again to the outline of the accounting structure, we see that either of the three theories (fictional entity, personal entity, or fund entity) could be used as a basis for a structure of postulates, principles, and rules. As the outline shows, the fictional entity theory is the one assumed in this study. Either of the two other theories could have been chosen, and the divisions would probably be similar to those shown below the fictional entity theory; perhaps the objectives would change and thereby affect the subordinate levels of the structure.

Financial accounting and managerial accounting are the two major subdivisions (areas) of the discipline. In an oversimplification, we may say that the former is

\textsuperscript{22}Vatter, Fund Theory, p. 18.

\textsuperscript{23}See Anton, Accounting for the Flow of Funds, pp. 24-25; and Vatter, "Corporate Stock Equities," pp. 367-370.
oriented to interests external to the firm; the latter, oriented to the interests internal to the firm. These areas differ in content, objectives, postulates, principles, rules and procedures.

The major objective of financial accounting is to give a financial representation of the relative economic rights and interests of the segments of the economy. The basic standard (postulate) in achieving this objective is fairness to all parties (economy segments).

The major objective of managerial accounting is to present financial and nonfinancial operating data to facilitate managerial planning, control, and decision making. The basic standard (postulate) in achieving this objective is that the data be useful for the purpose intended.

It will be noted that in both areas (financial and managerial), the accounting discipline has the basic service function of providing information.

Next in the outline are the broad propositions which comprise the "coordinating and application principles." These are conceived as relating to the motives of the enterprises or activities involved. In the financial accounting area, therefore, the principles relating to

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those enterprises with profit as the major organization motive will be different from those principles relating to those enterprises (broadly) having the maintenance of capital as the major organization objective. In the managerial accounting area, the activities are grouped into cost accounting and specific studies; separate groups of principles are thought to relate to these two activities.

Then, depending upon the legal form and objective the enterprises assume, accounting rules, procedures and techniques are formulated, always consistent with (having been derived from) the broader principles, postulate, and objective.

Some further comments are in order about the inclusiveness of the outline, as a representation of the structure of accounting.

The structure may be looked upon from either an internal or external viewpoint. From the internal viewpoint, the enterprise accountant performs financial and managerial accounting duties. From the external viewpoint, the independent accountant reviews the financial and managerial accounting structure and product, for the purposes of attesting to its fairness of presentation or of improving the system. In both cases the same structure of objectives, postulates, principles, rules, and procedures is used in a different way to produce a different result.

Likewise the outline lends itself to embracing regulated and unregulated enterprises. An unregulated
situation is assumed in the outline. A regulated enterprise (or industry, e.g., railroads) would warrant a separate classification within the financial area, because (presumably) the accounting objective would change to that as stated in the law, and the basic standard (postulate) would become compliance with the law. Principles, rules, and procedures would vary accordingly.

The structure of accounting, then, can be viewed as a hierarchy of levels of abstraction. At the bottom are the observable relationships, the procedures and techniques developed to meet specific needs. At the top is the major objective. Between the top and bottom are successive levels of generalizations and propositions, each more inclusive than the level below it: objective, postulate, principles, rules, procedures, techniques.

**Scope and Limitations**

The possible scope has been outlined above: an integrated structure for accounting.

Let it be stated that the structure presented above was conceived as a basis for this dissertation. It is felt by this writer that the structure as it actually exists today is vague, at most, with the financial accounting area having as its objective income determination,\(^{25}\)

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usefulness as the basic standard (postulate). Principles (concepts, assumptions, conventions, doctrines), rules, procedures, and techniques are based largely on "general acceptance."

This study shall be limited in several respects. Referring again to the structural outline above, we shall assume our viewpoint is that of the fictional entity theory; further, we shall be concerned only with the financial area of enterprise accounting. And within this area, we shall study those principles which refer to enterprises having profit as their major objective. Except for an example of their derivation and application, we will omit from the discussion an analysis of specific rules and procedures. To adequately develop these parts of the structure would

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This dissertation proposes a major objective for financial accounting, and a basic standard for achieving it. The next level of propositions is drawn from existing "generally accepted principles" (concepts, assumptions, conventions, doctrines) and are tested against the basic standard to see if they are in accord with it. This study excludes the next step which would be to formulate and test other propositions not followed today; it also excludes the following step which would be to formulate and test rules and procedures based upon those propositions.

Our concern, then, is with the foundation of financial accounting: its objective, basic standard, coordinating principles, and application principles.

**Method of Presenting the Study**

To give perspective to the propositions and conclusions which follow, Chapter II relates accounting to other disciplines, to its environment, and to the evolution of the business enterprise as affecting accounting theory. Also in Chapter III a perspective on theory is gained by investigating what is meant by postulates and principles and what are their criteria, followed briefly by a survey of the attempts that have been made to formulate a comprehensive theory of accounting, and what approaches may be taken to "a theory."

The foundation of financial accounting is the
subject matter of the remainder of the dissertation. Chapter IV studies the broad objective of the accounting discipline and the major objectives of its two areas. A definition of accounting is formulated and the evolution of accounting objectives is considered, to give perspective. Alternative objectives of financial accounting are discussed.

Chapter V investigates in depth the basic standard of fairness to all segments of society: how it is derived, defined, justified, and applied. The role of financial reporting, in connection with the postulate, is discussed. The alternative standards of usefulness and fairness are weighed.

In Chapters VI and VII, two groups of principles are explored. The first group (composing Chapter VI) includes those traditional accounting concepts which have ultimately coordinated the activities of accounting into a body of practice. Individually these principles have been stated by various writers to be (among other names) postulates, principles, conventions, concepts, assumptions, desirable attributes, virtues, conveniences. In this study these were assigned the status of "coordinating principles" for the purpose of organization, critical analysis, and testing against the standard of fairness to all parties. Conclusions are drawn as to their propriety in meeting the test.

In Chapter VII the same type of analysis is made on
the second group of principles; they include those upon which procedures are based, which in turn apply in specific situations. These are grouped under the title of "application principles."

The final chapter is an overview of the previous analysis and summary of the conclusions derived. Pertinent general observations which present themselves concerning the foundation of financial accounting are also included.
CHAPTER II

THE PERSPECTIVE OF ENVIRONMENT AND

THE STUDY OF ACCOUNTING THEORY

In proposing a structure of accounting theory and practice based upon fairness to all parties as the basic standard, one runs contrary to the majority of current thinking in two ways.

First, "accountants do not appear to have any complete system of thought about accounting";¹ that is, accountants have no complete structure of theory. Most attempts to devise such a structure only categorize and summarize current practices. However, it is useful to sort out and classify rules which are currently followed. From this, inconsistencies and contradictions can be discovered. But the criteria for eliminating such contradictions must come from more fundamental propositions—-from the theory of the discipline.²


As a second contrast, instead of "fairness to all parties," the basic standard for current practice appears to be the "usefulness" of the particular concept or procedure in question. Generally speaking, what is useful to the practitioner becomes accepted. Thus we have the common reference to "generally accepted accounting principles."

Before investigating these two items further, let us put that investigation into its proper perspective by first surveying the environment of accounting. What is the relation of accounting to other disciplines, and to the economy in which it operates? Also, what is the relation of the evolution of business enterprise to accounting theory and practice?

In the following chapter we obtain a perspective on accounting theory by examining what is meant by postulates and principles, and how they become generally accepted. A brief survey is also made of past attempts to formulate a comprehensive theory of accounting, followed by a discussion of possible approaches to accounting research.

**Terminology and Accounting**

It is desirable to mention at this point the problem posed by using words. They are at the same time an arrangement of letters and a suggestor of meaning (mental interpretation) about phenomena within our experience. Normally a special body of knowledge is characterized by a special body of words, unique and largely unfamiliar
outside the field. Some words may be shared with other fields, and/or with the vernacular. Accounting uses very few words that it can claim exclusively. Many words in general use have been given special meanings for their use within accounting. More confusion arises when other bodies of knowledge adopt some of the same words and attach to them their own special meaning. It is, of course, outside the scope of this investigation to solve that problem. However, we may be able to treat the subject of accounting theory without becoming hopelessly involved in problems of semantics. In this study we will attempt to use the common terminology of accounting in its generally understood manner. Where this is not possible, specific definitions and meanings will be supplied. (To minimize confusion regarding technical definitions, we adopt those definitions given in Appendix C.)

The Function of Language

A major ingredient of the environment of accounting is our language. Society wants to know about the resources it has committed to satisfy its desires. It gives to accountants the duty to study, observe, record, and report on the financial and economic aspects of these resources

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and society's claim upon them. That knowledge is then conveyed through the medium of language, a system of symbols that the mind can use to associate ideas. Knowledge grows through the use of a language; therefore, all fields of knowledge must be concerned with preservation of knowledge. Viewing its importance, it is not surprising that language itself has been actively studied.  

Although study and use have advanced language as a medium, imperfections still exist.

**Ambiguities and Imperfections in Language**

Since language is a collection of symbols, it is almost inevitable that there be imperfections. A perfect language would be one in which unequivocal symbols were used. But because humans comprise the users of language, different meanings and concepts invariably will be assigned to the same symbol by different persons. To be unambiguous, a word (symbol) must alone or in its context uniquely identify some object or concept.

Not only do symbols take on different meanings according to the user, those meanings are constantly being shaded into other meanings through their use. Thus the language evolves as time passes and users change.

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The language of accounting also is not without ambiguity. As noted above, words in common use have been given meanings and shades of meanings unique to accounting. When these uses are not conveyed to the reader of the accounting product, misunderstanding results. Misunderstanding compounds when new and unfamiliar terms are introduced to the uneducated reader.

Consider the following: Some years ago the Securities and Exchange Commission disagreed with the American Electric Power Company about the accounting for a situation involving federal income taxes. The dispute was settled by creating a new account in the company's records called "Accumulated Amount Invested in Business Equivalent to the Reduction in Federal Income Taxes Resulting from Accelerated Amortization and Liberalized Depreciation, Which Is Recorded as Earned Surplus Restricted for Future Federal Income Taxes in Accounts Maintained Pursuant to State Regulatory Requirements." Needless to say, it would take an expert accountant to decipher that.

The Need for and Process of Definition

The existence of an imperfect relationship between symbols and ideas causes language to be imperfect. Only by striving to form a clear association between symbols and ideas (i.e., striving to define) can language become less ambiguous. But definitions alone cannot be perfect, for they are also composed of symbol-idea associations. We can only hope that definitions will provide some advance toward
mutual understanding, toward a mutual symbol-idea matching.

In defining symbols we attempt to circumscribe meaning; ideas are correlated to proper words. In this process, ideas must be isolated and investigated; symbols also must be isolated and the most appropriate one chosen.\(^5\)

The accountancy profession has not been oblivious to the need for definitions, and has made some progress in formulating certain definitions. In 1920 the Committee on Terminology of the AICPA was formed to compile a vocabulary of words and expressions used peculiarly in accounting and to define them. To date, four terminology bulletins have been prepared defining a few of the fundamental terms used in the field.\(^6\)

Accounting is commonly referred to as "the language of business."\(^7\) It is a medium of expression by which the many events and relationships of a financial and economic nature of an enterprise are communicated. As a language, accounting involves business activities and events (the

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\(^5\)Ibid., pp. 12-38.

\(^6\)See American Institute of Certified Public Accountants, "Accounting Terminology Bulletins," Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961). The original Bulletins were issued separately over a period of years. All references hereafter to the Bulletins are to their reprint in the "Final Edition."

communication object); it involves outside parties (the communicatee), who receive and interpret the financial statements; it involves the management (the communicator), whose accountability representations are embodied in the financial statements.⁸

**Relation of Accounting to Other Disciplines**

Accounting is a means of expression. The things expressed are economic data and relationships; the mode of expression is through statistical summaries. Economic relationships are governed by law and moral attitudes. As disciplines, economics, statistics, and law are the determinants of the accounting language. Let us examine these three disciplines more closely (moral attitudes are discussed in Chapter V), as a basis for later formulations.

**Accounting and Economics**

Mattessich pointed out that accounting and economics have the same objectives of knowledge, and that both examine the individual unit as well as the entire economic body of a country. Moreover, both investigate the administration of scarce resources and the determination of income.⁹ In short, wealth—its existence and changes—is


the focus of both disciplines.

The viewpoint, however, is slightly different. Economics is largely concerned with the society as a whole, of wealth in general, of the wants of people, and of the satisfaction of those wants. Accounting is largely concerned with the individual units of society, the wealth of each unit, the requirements of each unit, and the efforts and accomplishments of each unit.\(^\text{10}\) Thus economics is said to have a social viewpoint, whereas accounting is said to be limited to the viewpoint of the individual enterprise. While this is true to an extent, the gap between the two disciplines is steadily narrowing. Accountants (with vision) have come to look upon their product as having a social significance. On the other hand, economists have turned more of their attention to the individual firm.

We may compare the scope of accounting and economics by stratifying the subjects investigated according to the degree of inclusiveness in the strata (see Figure 2 on the following page). Each stratum would contain a section of the whole of accounting and the corresponding section in economics. Thus, the level encompassing the smallest unit would be the individual. The next level would include enterprise accounting and its corresponding microeconomics. Broader still would be the next stratum

\(^{10}\text{Kenneth W. Perry, "Accounting and Economics Reciprocally Indebted," The Accounting Review, XXXIII (July, 1958), 450.}\)
including social (national) accounting and macroeconomics. The last level would contain international balance of payments on the accounting side corresponding to the field of foreign trade in economics. Wealth permeates all levels of both disciplines.

Such a classification is based on the content and methods involved. National accounting and international balance of payments accounting use many of the same techniques as enterprise accounting uses. We readily admit, however, that these two classifications are normally thought of as exclusively within the realm of economics,
and outside the pale of accounting.\(^{11}\) (The majority of accountants would have it no other way.) As a generalization, we might say that the discipline of economics is concerned with behavior within the strata, whereas accounting is concerned with the measurement of that behavior.\(^{12}\)

Accounting and economics are clearly intertwined, though in comparing them we must realize that they represent two different dimensions which have a common basis but spread out in different directions.\(^{13}\)

These different dimensions flow mainly from the diverse origins of the disciplines. Mattessich pointed out\(^{14}\) that philosophy is the origin of economics, whereas accounting grew out of bookkeeping techniques; both economics and accounting changed to attune themselves to the problems of the times. Economics has constructed conceptual


\(^{14}\)Ibid., pp. 552-553.
frameworks and taken a predominantly deductive approach to solutions. On the other hand, accounting is looked upon by many as capable of being no more than a collection of procedures, without any conceptual framework (unless the related but uncoordinated conventions, assumptions, standards, and doctrines are considered as such a framework), with the inductive approach to solutions being predominant. But lately economics has increasingly relied on induction, and accounting upon deduction, as methods of analysis. Both methods are essential; only when the deductively derived propositions are proved by their being inferred from observable phenomena through inductive analysis, are the propositions valid. In spite of their diverse origins, accounting and economics have grown to be disciplines mutually related and interdependent.

Probably the greatest relationship between accounting and economics, from the accountant's viewpoint, is in the measurement of income. There is still disagreement about the extent to which economists' concepts of income should be recognized in accounting for income. A recent

15 Fortunately, this view is diminishing; for example, see the analysis in Flanders, "Accountancy, Systematized Learning, and Economics," which compares accounting and economics within the framework of philosophy, history, arts, sciences, and analytical tools.

publication by the research staff of the Accounting Principles Board recommends (among others) recognizing capital gains and losses separate from operating profit. To be sure, this concept is not new to accountants (one needs only to scan recent issues of The Accounting Review to see that it has been actively discussed). The novelty of the recommendation arises from its semi-official status, although the publication expressly states that the recommendations at the time of publication do not represent the official position of the American Institute of Certified Public Accountants.

In contrast to the recommendation, the present accounting technique is to calculate net income on the basis of historical costs (with some exceptions); using historical costs is justified on the grounds of objectivity

17See Robert T. Sprouse and Maurice Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises," Accounting Research Study No. 3 (New York: American Institute of Certified Public Accountants, 1962), Chapter 6. (Hereafter referred to as "Broad Accounting Principles.") The research study was published for purposes of exposure, and has not been approved by the AICPA Accounting Principles Board. In "Accounting Principles Board Comments on 'Broad Principles,'" The Journal of Accountancy, CXIII (May, 1962), 9-10, the comment was, in part: "... The Board is ... treating these two studies (the one on 'Postulates' and the other on 'Principles') as conscientious attempts ... to resolve major accounting issues which, however, contain inferences and recommendations in part of a speculative and tentative nature. ... that while these studies are a valuable contribution to accounting thinking, they are too radically different from generally accepted accounting principles for acceptance at this time. After a period of exposure and consideration, some of the specific recommendations ... may prove acceptable to the Board. ..."
and relative ease of determination. Such a procedure does not, however, recognize any distortions in reported net income which may have been caused by changes in the price level.

Managerial accounting has benefited greatly from economic concepts, especially microeconomics. Theories involving cost and revenue, marginal analyses, forecasting, efficiency concepts, and diagrammatic representations are but a few of the concepts developed from economics. The potential for further development is very great.18

Littleton says that economics may be considered as a body of doctrine synthesized from many different theories about man's wealth-creating and wealth-consuming activities.19 Basically, the methodology of accounting produces a record of those activities. Accounts reflect wealth at one stage or another. One group of accounts reflects the existence of wealth (assets, liabilities, capital invested), whereas another group reflects changes in wealth (revenues, expenses, gains, losses, additional investments, distributions); in both cases the sources are emphasized. From such a viewpoint we may conclude that accounting is concerned with data that are essentially economic in nature.


19 Littleton, Structure of Accounting Theory, p. 9.
Accounting and Statistics

Both accounting and statistics involve methods of quantifying data. A difference between the two—their scope—is commonly cited. Statistics, on the one side, is concerned with the collection, tabulation, analysis, presentation, and interpretation of any type of quantitative data. Accounting, on the other side, is concerned only with data which ultimately may be quantified in money terms.20

In an accounting system, many records which are nonfinancial are maintained as a part of the process. Production, sales, or inventory data, for example, may be recorded in terms of sizes, quantity, styles, or other classifications. These data ultimately may be translated into monetary terms, or left in their original state as nonmonetary extensions of the basic monetary data.21

It was noted above that the basic methodology of accounting is statistical in character. That both involve collection, tabulation, analysis, presentation, and interpretation attest to this fact. The means that accounting uses to accomplish this is the account, a device into which enterprise events are categorized, arrayed, and


summarized. However, the double-entry technique (as distinguished from an account, per se, a device with statistical capabilities) is unique to accounting. Double entry has proved its usefulness as a technique to facilitate the recording of events and as a check upon the accuracy and completeness of the record. But by no means is it essential to the accounting process. Other techniques might be developed which are superior to the double-entry system (perhaps tri-entry?). Single-entry accounting is used in many cases where double-entry would be possible, but is not feasible for other reasons (personal capabilities, operational characteristics, maintenance cost, need).

From just the recording viewpoint, we may say that the financial statements produced by the accountant are statistical summaries, being a culmination of the categorizing and summarizing process through the device of accounts.

These few observations bear out the point that statistics and accounting are mutually related disciplines.

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23 D R Scott, in his chapter on "Accounts and Statistics" concluded: "To meet the demands made upon it under the complex conditions of modern business enterprise, the accounting system has been made progressively more flexible and more comprehensive through the introduction of statistical procedure. Now it stands virtually as an application of statistical methods within a limited field. At least, that is the point towards which it appears to be rapidly moving." D R Scott, *The Cultural Significance of Accounts* (New York: Henry Holt and Company, 1931), p. 224.
Accounting and Law

Accounting is "affected with the public interest," and must therefore operate within the law. Thus, accounting exists within the environment of law.

Both law and accounting are essentially "human-service institutions." Both are interested in public policy to the extent that the rights and interests of all parties must be considered; both serve a "social purpose." Social, economic and political forces are at work expanding the size of their common ground, and also the points of possible conflict.

Law had its foundation in the general truths and principles of human conduct. The discipline of law has classified the interrelated facts about this human conduct and embodied them in a system which can be broadly termed "principles of law." These principles are concerned with such problems as the administration of community interests, the assessment of various responsibilities, and the adjudication of overt conflicts of interests. The principles of

24 Rufus Wixon, "Legal Requirements and Accounting Standards," The Accounting Review, XX (April, 1945), 146.


law act as standards for the judgment of human conduct. In its judgment, law and its principles are dominated by the concept of justice.\textsuperscript{27}

Accounting must follow the will of the law in a number of areas. For example, a statute law may prescribe a course of procedure to be followed in specific instances. Thus the corporation laws of the various states define capital stock and perhaps forbid its sale at less than par value. Or the law may specify that only retained earnings may be used for the declaration of nonliquidating dividends.\textsuperscript{28}

Another area of legal influence on accounting is through regulatory agencies, charged with the administration of specific laws. The laws and subsequent agency regulations may provide a uniform system of accounts for a specific type of business or industry, with detailed procedures described for entries into the accounts.\textsuperscript{29} Also the forms to be used for reports are usually set out in detail.

\textsuperscript{27}R Scott, "Basis for Accounting Principles," The Accounting Review, XVI (December, 1941), 341.


\textsuperscript{29}Statutory authority to promulgate accounting rules and regulations are contained in The Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940. Not all of the administering agencies have used that authority to the extent authorized in the statutes.
In effect, a manual of accounting procedures is prescribed, written from the point of view of providing information which can be used in the agency's regulating activities.

Also there are tax regulations which influence accounting. The tax laws define and calculate particular amounts in a certain way; the accountants may or may not have similarly recorded them in the accounting records. At least there is a strong incentive to keep the records in a manner which makes compliance with the law easier. In some cases alternative methods are available (to compute inventory valuation in income taxation, for example). There may be restrictions on the method selected, such as using the same method for internal records and tax calculation when one choice is selected; however, there may be no such restriction if an alternative method is chosen. Another example of the influence of the tax laws upon accounting procedure is the accounting for sales taxes. These taxes are imposed upon the consumer and collected by the retailer (in most cases); the retailer must keep sufficient records to report sales correctly which are subject to such taxes. His records are tailored to facilitate meeting this requirement.

Lastly, the courts influence accounting by their rulings. Controversies involving accounting may be decided by the court, but the merits of the case and intent of the parties are the governing factors.
Judicial pronouncements on accounting matters cannot be accepted out of context. Rarely have the courts had an opportunity to consider accounting principles free of legislative or contractual involvement, for absent such involvement there is little chance of litigation. If the source of the difficulty is a commercial contract, the court will endeavor to find the accounting intent of the contracting parties and will not gratuitously write into the contract generally accepted principles of accounting. If the source be the law of estates, the court will apply estate accounting precedents regardless of their nonconformity to general accounting principles. If the question relates to the payment of dividends, the court will construe the applicable state statute to determine whether its minimum requirements have been met. And if this source be statutory regulation, the court will disregard accounting principles which do not conform to regulatory prescription.

Therefore, when the law deals with accounting matters, law takes precedence over procedures of accounting, and sets the conditions under which the accountants must work. Since the law is a distillation of man-made and man-accepted rules of justice and social responsibility, it has a significant effect upon accounting theory and practice.

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We have been reviewing the related disciplines of economics, statistics, and law in order to obtain a perspective on the environment in which accounting theory and practice exist. In addition to these disciplines, there exist certain aspects of the economy and the entities within it and their interrelations which we should also view to round out the setting of the accounting environment. The survey of these aspects of the economy and its entities completes this chapter.

The Environment of Accounting

Characteristics of Organizations

An organization is usually thought of as a coordinated association of individuals. This concept basically involves three elements: cooperation, management, and an entity.

Cooperation can be considered as "the willingness to participate in joint effort with others." Cooperation involves effort; effort involves activity; and activity involves people. Depending upon the type of organization, different types of people participate in the activity. In a business organization, for example, stockholders and creditors contribute funds, managers contribute guidance and control, employees contribute time and effort and

skills. Participants outside the firm include customers who buy the products (the really essential firm activity). Suppliers also contribute by delivering necessary raw materials and supplies; governmental agencies provide protection, security, and general welfare. Therefore, the participants in the activities of a business organization supply the factors of production or the means of getting factors of production. For their contribution and cooperation, the participants are offered some type of reward which in part satisfies the participants' objectives in cooperating. Inherent in cooperation is the existence of some overall organization objective, which should unify the activities of all the participants.34

Another characteristic of an organization is management. Management facilitates the coordination of the activity of other participants through a system of communication. The overall objective of the organization and the means to achieve it are communicated to the other participants.

Coordination of activities implies rational coordination. Thus rational management entails considering alternative courses of action, deciding on the best courses of action in the various situations, and facilitating their execution and reviewing their consequences. A communication- or information-providing system supplies the raw

34 Ibid., pp. 11-44.
material used to form alternative courses of action, and also supplies the raw material used as a basis for judging the adequacy or effectiveness of the alternative chosen. A part of this overall communications system is the accounting system.\(^\text{35}\) (The accounting system as an information-providing system will be elaborated upon in the following chapter.) Thus, accounting operates within the environment of individuals cooperating toward some goal, their activities being coordinated by managers acting rationally.

A further aspect of the environment of accounting is that it exists within some entity. The entity may be a single business organization, a department or an activity within that organization, a group of associated businesses, an individual, a nation. In short, accounting is concerned with an activity, however broadly conceived. In each case wealth (resources) is committed to carry on the activity. The entity as a concentration of activity then converts or combines the resources to produce other resources for purpose of sale or transfer to others. We noted in Chapter I that the accounting for an entity may take one of several viewpoints. For example, it may take the viewpoint of the actual owner of the resources, or of the organization to which these resources were entrusted, or that of an activity for which a collection of service potentials have been

assembled (respectively: proprietary theory, entity theory, fund theory).

Accounting, then, furnishes data about the wealth of an entity. The data are in terms of the medium of exchange of the whole economy.

A Money Economy and Exchange Values

The unit of currency used in the economic system is the most relevant unit with regard to entities within the system. Accounting for an entity therefore is in terms of the common denominator of the dollar (in the U.S.).

Money is used throughout the economy as a medium of exchange and as a measure of value. As a medium of exchange, money facilitates the flow of goods and services between entities by making it possible to abstract from the real item for purposes of exchange. As a measure of value, money has two facets. First is the facet of its use as a standard of value, or common denominator, in which exchange ratios may be expressed. Money enables individuals and organizations to represent, in a manner which can be easily understood, events and transactions which may be substantially different in form and substance. The second facet of money as a measure of value is that it represents a store of value; cash or other resources (measurable in money terms) may be accumulated or exchanged. If they are exchanged there arises value in exchange; that is, the parties to the exchange determine the value of the item in
the transaction situation. A measurement may be made in the absence of exchange transactions, but these are thought to be less accurate because they were derived from a subjective evaluation of worth to the holder, rather than a bargained exchange between parties.36

Exchanges take place within a market economy. Production is primarily for exchange rather than for consumption by the producer, the reason being that specialized and cooperative efforts result in greater efficiency, and also because the range of choice is widened through using money as a medium of exchange. Prices (values in bargained exchanges) are therefore generated in the market for goods and services exchanged.

Thus a price system existing within a market economy is a part of the accounting environment, since accounting records and reports on transactions and events (wealth accumulation, bargained exchanges) of specific entities within the money economy.37


Wealth as the Focus

The economy is composed of entities producing, distributing, and consuming wealth; all its activity is carried on for the purpose of wealth accumulation and exchange. In this environment accounting "must assign the 'wealth' and its changes to some specific entity for a specified time period."38

As the economy has grown, the major entities within the economy—business enterprises—have evolved from one form to another. Accounting theory and practice have followed this evolution. Let us survey the evolution of business enterprises in order to obtain a perspective on the development of accounting.

Evolution of the Business Enterprise and Its Relation to Accounting Development

Entrepreneur Sole Owner and Manager

The evolution of accounting has been closely related to the evolution of mankind's economic affairs. But only in comparatively recent times has accounting developed beyond the recording phase.

As civilizations advanced, nations were formed out of conquered lands; accounting grew as a method of control over the people and their activities. As trade between persons and nations became more important, and the

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relations between them more complex, bookkeeping became more refined. Late in the fifteenth century Fra Luca Pacioli wrote down the bookkeeping developments to that time. By then double-entry bookkeeping had reached a stage of maturity which is very similar to that used today.39

During this first stage of accounting development, the entrepreneur was the sole owner and manager of his enterprise. The record he kept was for his own use; ledgers were opened and closed at irregular intervals. Few formal reports were prepared from the accounts since opening and closing entries provided the same information, which could be readily viewed.40

Introduction of the Creditor

The impetus to produce formal reports from the ledger information was supplied by the entrepreneur's use of borrowed funds, thus bringing an outside interest into the business picture. Creditors insisted upon receiving information about the condition and prospects for the firm before making the loan. The information they desired was oriented to the view of liquidation of the pledged properties in case of nonpayment by the borrower. The balance sheet was thus


40Littleton, Structure of Accounting Theory, pp. 82-83.
emphasized as a representation of the status of the firm.\textsuperscript{41}

**Growth of the Corporation**

As the need increased for large pools of capital to finance large-scale ventures, statutes were enacted which provided for limited liability of investors. These statutes first took the form of limited partnership, and ultimately the corporate form.

The introduction of limited liability made the protection of creditors more important. Since the firm's legal capital was considered to be the main protection of creditors, stringent rules were built up to prevent reducing legal capital other than by the ways specified in the law.\textsuperscript{42} Creditors continued to influence accounting even while share ownership grew more numerous and geographically dispersed.

The separation of owners from management and the delegation of the managerial function resulted in a new external interest in the activities of the firm. This owner-manager separation further enhanced the position of the balance sheet as representing a report showing the discharge of the managers' stewardship over the funds entrusted to them. Despite the recognition of the stockholders' need for accounting information, the viewpoint of the creditor dominated. This situation continued until the mid-1930's.


\textsuperscript{42}May, *Financial Accounting*, p. 52.
Gradually the creditors came to view the earning power to be of greater importance than immediate liquidity, and the suppliers of accounting information gradually recognized that stockholders were more concerned with profit than with stewardship. These and other forces caused a shift in emphasis from the balance sheet to the income statement and the performance of the firm.43

Not only has the growth of the corporate form of business shifted the emphasis from the balance sheet to the income statement, it has also greatly increased the significance of the accounting function.

The Expanded Viewpoint of Accounting

All during the corporate growth the accountant grew in stature as an independent auditor. It was recognized that stockholders should have the protection of an independent objective review of the management's report on what was done with the resources entrusted to it. Thus the accountant, acting as an independent auditor, was established to have a special responsibility to outsiders, separate from his responsibility to the management of the

As economic affairs become more complex and business firms become larger and involve more people, accounting data are relied upon more and more. The result: accounting is now exposed to responsibilities far beyond the immediate task of the profession. Accountants perform internal work for the firm, but to a large extent accounting data represent public information material and also are an important public relations media for management. These data form essential sources of information to stockholders, labor unions, creditors, customers, governmental bodies, and the general public.\footnote{Carey, "The Expanding Role of the C.P.A.," p. 70.}

Another development of accounting, as the result of bigness and complexity of economic institutions, is that accountants are giving more high-level administrative assistance to management. Internally this is taking the form of an expanded scope of the controller,\footnote{Konrad Engelmann, "In Search of an Accounting Philosophy," \textit{The Accounting Review}, XXIX (July, 1954), 389.} and externally, the form of increased emphasis upon management\footnote{See Mary Murphy, \textit{Accounting--A Social Force in the Community} (New York: Cambridge University Press, 1956), pp. 153-203; Oswald Nielsen, "New Challenges in Accounting," \textit{The Accounting Review}, XXXV (October, 1960), 583-587; Robert M. Trueblood, "The Management Service Function in Public Accounting," \textit{The Journal of Accountancy}, CXII (July, 1961), 40; and many of the recent articles in \textit{The Controller}.}
services by certified public accountants. \(^47\)

As the accounting profession grows in stature and approaches maturity, accountants have come to engage in a soul searching to discover or create the philosophy (theory) which underlies current practices. Let us now turn our attention from the development of accounting and its environment to a brief survey of the past and present of accounting principles, in order to obtain a perspective on accounting theory.

CHAPTER III

THE PERSPECTIVE AND FORMULATION
OF ACCOUNTING THEORY

What Are Accounting Postulates
and Principles?

In 1953 the Committee on Terminology\(^1\) defined an
accounting principle as "A general law or rule adopted or
professed as a guide to action; a settled ground or basis of
conduct or practice. . . ." The Committee chose this defi-
nition over two others connoting a "source, origin, or
cause" and a "fundamental truth . . ." because it came
nearest to describing what most accountants meant by the
word "principle." This was followed by an explanation of
the word "postulate." Accounting postulates were thus
described as unproved principles, having been derived from
experience and reason. Once they were proved useful they
became accepted as accounting principles; when acceptance
became widespread, they became a part of the body of "gener-
ally accepted accounting principles."\(^2\)

\(^1\)American Institute of Certified Public Accountants,
"Review and Resume," Accounting Terminology Bulletin No. 1,
in Accounting Research and Terminology Bulletins, pp. 10-11.

\(^2\)Ibid., p. 11.
A different viewpoint was taken in 1958 by the Special Committee on Research Program. In its "Report to Council" three basic terms were used: postulates, principles, and rules. Postulates were defined as the basic assumptions upon which principles rest, being derived from the economic and political environment, customs, and modes of thought of all segments of the business community. Accounting principles should be formulated using the postulates as their basis. The principles and postulates would serve as a framework of reference in solving detailed problems. Rules would apply this framework to specific situations.

In the first research study published under the auspices of the AICPA Accounting Principles Board, Maurice Moonitz accepts the definition of postulates as "the basic assumptions on which principles rest." Accordingly he sets out propositions which are generalizations to be accepted as self-evident facts. These generalizations describe the economic environment, the enterprise operations which accounting reports upon and interprets, and the basic ideas which

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3 American Institute of Certified Public Accountants, "Report to Council," p. 63. See Appendix A for a part of that report.

point to the formation of principles.\(^5\)

More specifically, he proposes three groups of postulates.\(^6\) The first group he derives from an analysis of the environment of accounting and includes statements concerning quantification, exchange, entities, time periods, and unit of measure. The second group of postulates applies these ideas about the environment specifically to accounting; Moonitz characterizes these postulates as being the aspects of accounting which appear to be valid in every circumstance. This second group includes the postulates of financial statements, market prices, entities, and tentativeness. The third group of postulates concerns the "imperatives" of accounting; that is, postulates pointing the way accounting "ought to be done." These include continuity, objectivity, consistency, stable money unit, and disclosure.

Extending the analysis contained in the "Basic Postulates," Robert Sprouse and Maurice Moonitz formulate a tentative set of broad accounting principles for business enterprises in the Accounting Research Study No. 3.\(^7\) These


\(^6\)These are summarized in Appendix B.

\(^7\)Robert T. Sprouse and Maurice Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises," Accounting Research Study No. 3 (New York: American Institute of Certified Public Accountants, 1962), 87 pp. The summary of the principles is contained in Appendix C. See also footnote 17 of Chapter II.
principles do not seek to describe existing practices, but rather to provide a general framework of financial accounting theory. The immediate reactions are contained within that study in the form of comments by individuals on advisory committees. These comments range from the extremes of pro and con.

Our approach to a general framework of financial accounting theory (as stated in Chapter I) is slightly different. We begin with a stated objective, then formulate a basic postulate which is conceived as being the basic standard by which all subordinate propositions are judged. Accounting principles are "broad guides to action" consistent with the basic postulate and objective, whereas rules are instructions detailing the manner in which the appropriate principle should be applied to the specific situation. Accounting principles are thought to be of two classes, coordinating and application principles. The differences between these are set out at the end of Chapter I and are the subject matter of Chapters VI and VII.

In the past the terminology of accounting theory has been plagued by confusion. With little or no distinction between them, we find such terms as doctrine, convention, canon, axiom, assumption, standard, concept, principle, law, maxim, practice. It would be futile to enumerate how these have been used, and further, would serve no purpose here.\(^8\)

\(^8\)But there is no dearth of individuals who do express opinions about their meaning. See, for example:
We should, however, investigate what is meant by the phrase "generally accepted accounting principles" since it signifies what now guides accountants in their work.

Modern Dilemmas of Accounting

Certain problems arise from the profession's adhering to general acceptance as a criterion to following certain accounting principles. Further, there is confusion over what "accounting principles" means in the phrase "generally accepted accounting principles," despite the pronouncement by the Committee on Terminology referred to above.9

What Is Commonly Understood as "Generally Accepted Accounting Principles"

The phrase usually refers to the broad limits used to determine the acceptability of accounting methods and


9See footnote 1 of this chapter. For comments on the history of the phrase, see May, Financial Accounting, pp. 37-44, 72-85; George O. May, "Comments on Mr. Greer's 'Benchmarks and Beacons,'" The Accounting Review, XXXI (October, 1956), 581-583; and George O. May, "Retrospect and Prospect," The Journal of Accountancy, CXII (July, 1961), 33-34.
measurements. Accountants are not unanimous as to what the individual principles are, nor has there been an authoritative statement listing those principles. These principles are supposedly found in the current literature of accounting; for example, in the published Accounting Research Bulletins of the American Institute of Certified Public Accountants, in the pronouncements of the American Accounting Association, and in the writings of individuals.

As it is used in the phrase, "accounting principles" has come to mean the whole body of methods and procedures, and the generalizations from them. Reflecting this meaning, F. P. Byerly stated that:

... what has frequently been spoken of as accounting principles includes a conglomeration of accounting practices, procedures, policies, methods and conventions relating both to the construction of accounts and their presentation; ... there seems to be a general agreement ... that the difficulty of any attempt to formulate so-called principles ... is that the field is so large and the conditions encountered so diverse that few, if any, sweeping generalizations can safely be adopted.

10 Black and Champion, Accounting in Business Decisions, p. 768.


12 F. P. Byerly, "Formulation of Accounting Principles or Conventions," The Journal of Accountancy, LXIV (August, 1937), 94.
Or more recently, Carman Blough expressed the opinion that "accounting principles" means nothing different than the term "accounting procedures."

The "general acceptance" in the phrase is considered to be the authority and basis upon which accounting principles rest. But, acceptance by whom? In determining what constitutes general acceptance, George Catlett pointed out the wide range of viewpoints:

1. Actual usage in business and industry is required because accounting principles must be accepted by business managements and not imposed upon them.

2. Accountants in public practice have a responsibility in this area, and acceptance by them is a necessary prerequisite.

3. Pronouncements of the American Institute of CPAs are said to be the most authoritative statements and, therefore, are the best evidence of acceptance. A similar view is held by some with respect to the pronouncements of the American Accounting Association.

4. The entire accounting profession must be involved in any general acceptance.

5. General acceptance results only from authoritative support by those best qualified to render accounting judgments.

6. General acceptance may, in some instances, result from laws and governmental regulations applying to business organizations.

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14 George R. Catlett, "Relation of Acceptance to Accounting Principles," The Journal of Accountancy, CIX (March, 1960), 34. See also A. C. Littleton, "Coordinated Research" (Accounting Exchange), The Accounting Review, XX (April, 1945), 231-232; and Delmer P. Hylton, "Accounting
After inspecting each of these viewpoints Catlett concluded that there is no clear understanding about the identity of those by whom accounting principles must be generally accepted. If it could be determined by whom principles are accepted, a further problem would arise about the extent of acceptance necessary to warrant "general acceptance."

Accounting principles (broadly) are thought to be adaptable to the times so that outmoded principles are replaced by new ones. But the stress on general acceptance places a premium on tradition, in spite of changed conditions which make certain principles obsolete. In this sense, the criterion of general acceptance impedes improvements in principles and practices.

The evolutionary process of accounting principles which the profession relies on in the development and acceptance of principles and practices can be traced through five steps. First, no general acceptance exists for either the principle or its related practice. Second, general acceptance of the basic principle exists, but the related

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15 See Arthur R. Wyatt, "Tradition and Accounting," The Accounting Review, XXXI (July, 1956), 395-400. Wyatt points out (p. 397): "... the force of general acceptability tends to promote continuation of traditions by pointing out their very fact of acceptability and past usefulness. The force of general acceptability also acts as an effective deterrent to acceptance of new ideas by pointing out their lack of general acceptability or their conflict with the 'tried and true' ideas found in past practice."
practice does not follow the principle. Third, general acceptance exists for the basic principle, but there are several alternative practices, of which some are not entirely in accord with the principle. Fourth, general acceptance exists for the basic principle, but there are alternative accepted practices, with one practice in majority use. Fifth, general acceptance exists for both the basic principle and its related practice. These transitions usually occur over a period of years. The result in some cases is that the use of more desirable practices are taken exception to in the auditor's report because they are not recognized as generally accepted.

Should "Soundness" Displace "General Acceptance"?

General acceptance rather than "soundness" has been the principal test for accounting principles and practices. In some cases alternative and sometimes undesirable practices have resulted. To remedy the situation, disclosure of the method followed and consistency in following it are prescribed.

The main arguments advanced in favor of the

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17 The dictionary definitions of "founded in truth or right; not fallacious or faulty" apply here.
criterion of general acceptance are: (1) it results in more
uniformity; (2) when a practice becomes generally accepted,
it must be sound; and (3) it is an objective criterion.18
Likewise, arguments heard against soundness as the criterion
include: (1) there should be flexibility among accounting
principles; (2) soundness is subjective; and (3) there has
been progress made without adopting soundness as the crite-
ron.19

It is not necessary at this point to answer all
these arguments. It is desirable, however, to comment here
on the arguments of objectivity-subjectivity of the two cri-
teria, as the basis for a later discussion.

General acceptance is considered by some to be
objective because the accountant has satisfied himself that
a particular principle had "substantial authoritative sup-
port." Such a judgment would be derived from examining
reports by other CPA's, usage in business, views of authors,

18Catlett, "Relation of Acceptance to Accounting
Principles," p. 37. See also Carman G. Blough, "Accounting
Principles and Their Application," in American Institute of
Certified Public Accountants, Robert L. Kane, editor, CPA
Handbook (volume II; New York: American Institute of
Certified Public Accountants, 1953), Chapter XVII, pp. 2-3.

Carman Blough, the principal opponent of "soundness," con-
cedes: "Reluctant though I am to express such an idea, I
have been forced to the conclusion that procedures so gener-
ally followed among accountants as to constitute substantial
precedent are not always fundamentally sound. In such
cases, I think the fault is in their historical develop-
ment. . . ." Pp. 31-32 of "Need for Accounting Principles,"
The Accounting Review, XII (March, 1937), 30-37.
expressions of technical committees, and the opinions of governmental officials. In essence, the accountant in applying the criterion of general acceptance makes a value judgment based upon observable attitudes.

But soundness as a criterion is objectionable to some because it is considered subjective, a personal viewpoint. This cannot be denied. However, if we were considering whether a particular principle were sound, could we not survey the collective opinion of usage in business, views of authors, expressions of technical committees, and the opinions of governmental officials, as a basis for our own judgment? As is the case of general acceptance as a criterion, would not the accountant make a value judgment based on observable attitudes, in applying the criterion of soundness? It is submitted that he would, and that soundness is no more subjective than is general acceptance.

To be sound, accounting principles must be capable of being objectively tested as meeting the standards of moral attitudes and economic realities as accepted by the public and dictated by law. If they do not meet such tests, they should be rejected from the framework of accounting theory.

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20 Blough, "Principles and Procedures," p. 53. See also Samuel J. Broad, "Recent Developments in Accounting and Auditing," The Journal of Accountancy, LXXVIII (September, 1944), 186.

21 Ralph E. Lee, Jr., "Are We Accounting for Facts or Fables?" (address before the Accounting Association of
Reflecting upon these criteria brings us to the realization that there is something even more fundamental than general acceptance and soundness. Or expressing it another way, what is behind general acceptance and soundness? It is submitted that the bases are usefulness in the situation (for general acceptance) and fairness to all parties (for soundness). A discussion of these is the subject matter of Chapter V.

An Authoritative Body to Set Criteria for Principles

In current practice the accountant must judge for himself whether a particular principle is generally accepted. General guidelines exist in the forms of official pronouncements of AICPA committees and expressions of opinion from other sources, but the final judgment about the general acceptance of the principle is the individual accountant's. Likewise, if soundness were the criterion for accounting principles, the judgment about what is sound would be based upon a value judgment in the light of collective opinion.

But we may validly ask: Should the individual accountant have to bear the burden of such judgments about what constitutes collective opinion? Currently there is no

place nor any means of bringing to issue or challenging the basic criteria of accounting principles and rules. The accountant may judge a certain principle to be generally accepted, but feel that an alternative principle, not generally accepted, gives a fairer presentation. Yet he is stymied in implementing the alternative for fear of a qualified audit report.

It seems feasible that an official body could be established which would have the authority to specify the objectives of accounting, to set criteria for principles and rules, and to indicate what constitutes "generally accepted" or "sound" accounting principles. The profession now has trial boards and an ethics commission to enforce rules of professional conduct; could not similar machinery be set up for accounting principles? Such a "court system" will be discussed more in detail in Chapter V.

Attempts to Formulate a Comprehensive Theory of Accounting

We have been surveying the existing structure of accounting practice for the purpose of obtaining an insight into the foundation and framework of accounting theory. In doing so we gain a perspective on the approach taken in this dissertation to the foundation of financial accounting theory. Let us deepen our insight by briefly investigating other attempts to formulate a comprehensive theory of accounting.
Gilman, "Accounting Concepts of Profit"\(^2\)

A substantial contribution to the body of accounting literature when it was published in 1939, this book was concerned mainly with describing the practice of accounting. From this practice Gilman abstracted some fundamental ideas which he carefully categorized as conventions, doctrines, rules, and principles. The primary purpose of accounting, as Gilman saw it, was to determine "accounting profit"; the balance sheet was relegated to the status of a by-product of profit determination. The whole accounting mechanism was explained by the concept of the business being an entity in itself. He studied other concepts also, but much of his book treated of alternative methods existing in practice at the time.\(^3\)

Sanders, Hatfield, Moore, "A Statement of Accounting Principles"\(^4\)

This work preceded Gilman's by one year, and was, in the words of Scott, "a clear and straightforward exposition

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of principles underlying the best current accounting practice." The study aroused much discussion because its authors were widely known and its publication was hailed as a formulation of a "code of accounting principles that would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public." Although the "Statement" did not receive very wide acceptance as such a code, its publication did represent a milestone in the continuing attempts to formulate a theory framework.

Paton and Littleton, "An Introduction to Corporate Accounting Standards"

In describing the basis of their study the authors wrote: "The intention has been to build a framework within which a subsequent statement of corporate accounting standards could be erected." This volume was the most


26 Sanders, Hatfield, Moore, A Statement of Accounting Principles, p. xiii.


28 Ibid., p. ix.
theoretical discussion of accounting theory to that time. In a brief publication in 1936 by the American Accounting Association (see below), the basic concepts believed to be essential to a sound and fundamental structure of corporate accounting were outlined; the Paton-Littleton monograph represented an elaboration upon these concepts. Although the study was limited to accounting standards (gauges by which to measure departures), the authors conceived accounting theory to be a "coherent, coordinated, consistent body of doctrine." Even though it was published over twenty years ago, in the opinion of this writer, the "Introduction" still represents today the greatest contribution to clear thinking about and formulation of a body of accounting theory.  

Littleton, "Structure of Accounting Theory"  

This monograph was divided into two parts, the first

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29 Ibid.  


on the nature of accounting and the second on the nature of theory. The first part had the purpose of showing that accounting is a closely-knit discipline in which all parts support each other, rather than being merely a collection of traditional methods. The second part discussed at length the nature of theory and also related theory and practice in accounting. From this relation of theory and practice, Littleton stated twenty-three "inductively derived" principles. Littleton limited his discussion as applying to double-entry accounting, on an accrual basis, for business enterprises; thus it cannot be represented as a comprehensive theory underlying all accounting, as the title would suggest. In spite of its scholarly investigation, it has not had the impact of his co-authored Introduction to Corporate Accounting Standards.

American Accounting Association Pronouncements

In 1936 the American Accounting Association first undertook the formulation of "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements." This was described as an experimental formulation of basic principles and was intended to (and did) arouse discussion which would foster the development of a more comprehensive formulation. Revisions of this initial effort appeared in 1941, 1948, and 1957. Between 1950 and 1954 a series of eight supplements to the 1948 statement were issued, some portions of which were included in the 1957 revision.
These pronouncements were intended to be an integrated statement of the basic principles of accounting which business corporations should follow in preparing general-purpose financial statements. The pronouncements did not intend to cover all accounting practices in depth, but rather were to be used as a guide in testing the propriety of a particular accounting practice.32

A general idea of the development of these several statements can be obtained by a comparison of the titles


used:

1936—A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements

1941—Accounting Principles Underlying Corporate Financial Statements

1948—Accounting Concepts and Standards Underlying Corporate Financial Statements

1957—Accounting and Reporting Standards for Corporate Financial Statements

American Institute of Certified Public Accountants Pronouncements

The approach taken by the American Accounting Association was in direct contrast to the Accounting Research Bulletins issued by the Committee on Accounting Procedure of the AICPA. These bulletins were limited to recommendations on specific aspects of accounting practice, and were issued only as the occasion presented itself. The problems were approached from a practical (i.e., rules to guide everyday work) point of view. The pronouncements cannot be said to be basic in nature--nor were they so intended.

As noted above, the newly-formed AICPA Accounting Principles Board (replacing the Committee on Accounting Procedure) has set out on a program to determine and define basic accounting postulates and principles. This framework of postulates and principles would serve as a basis for subsequent pronouncements involving rules and procedures.
Approaches to Accounting Research

The survey of the publications by the individuals and associations as set out above represents the prime contributions to accounting research, theory, and practice during the past twenty-five years. Comprehensive as they are, however, one is inclined to agree with Louis Pilié: "Unfortunately, with all this effort, a really integrated and basic accounting philosophy acceptable on a broad front has not resulted."\(^33\)

To round out our perspective on accounting theory, we should briefly comment on the approaches that may be used in undertaking accounting research. These approaches may be characterized as (1) axiomatic, (2) ethical, and (3) pragmatic.

The axiomatic\(^34\) approach is the most abstract of the three. This approach tends to separate the form from the substance by proposing self-evident truths (axioms) and definitions and then proving the axioms by applying the rules of deductive logic. Commenting on this approach, Moonitz implies that because the method is through reason alone and not through experience it probably will prove


\(^34\)A dictionary definition for "axiom" suitable for our purposes: "a statement of a self-evident truth."
incapable of dealing with the real world of accounting practice.35

Richard Mattessich is presently the main advocate of the axiomatic approach. In one study36 he sets forth three axioms,37 seventeen definitions,38 and seven "requirements."39 With the aid of deductive logic and a mathematical apparatus of matrix algebra, he proceeds to prove some "theorems" that represent important aspects of the accounting structure.40

Although not relying as heavily on mathematics as does Mattessich, another important contributor to this approach is R. J. Chambers. In his "Blueprint for a Theory

35Moonitz, "The Basic Postulates of Accounting," p. 3.


37(1) Plurality, (2) doubled effect, (3) period.

38Including: account, entity, closed system, to balance.

39Including: evaluation, duration, unit.

of Accounting" he proposes four "fundamental premises" which lie outside the field of accounting. He assumes these propositions to underlie all accounting.

The ethical approach to accounting research and theory formulation takes as its starting point concepts which are found in the accepted social attitudes of the time and place. These attributes are expressed primarily in the form of laws, customs, administrative edicts, religious edicts; they form the objective basis for subjective decisions. Thus Stead proposes "integrity" as the "one all-pervading principle of accounting." Such concepts would


42 Condensed (perhaps unjustly), these are: (1) entities organize activities and exist through cooperation; (2) rational management; (3) entity transactions and relationships may be summarized into statements in money terms; (4) deriving such statements is a service function.


be extended and applied as the basis for accounting.

The third and currently popular approach to accounting stresses the pragmatic character of accounting. One cannot deny that accounting must be useful to justify its existence. But to apply that criterion to the entire structure of accounting ultimately causes formulations which are viewed in terms of special interests. At least as far as financial accounting is concerned, we cannot view it as "the monopoly of any one group."\(^{46}\) (We may, however, consider managerial accounting as the private domain of managers.)

What are the implications of these three approaches to this dissertation? We do not take one approach to the exclusion of the other two. Rather, our approach is a cross-section of the three. As the structure of enterprise financial accounting is conceived by this writer, its basic foundation is an ethical one, its method is logical and coherent, and the ultimate test of the formulations lies in its application to the real world.

To summarize, this and the previous chapter have attempted to survey the environment in which accounting

exists—the disciplines which shape its nature, the economy within which it operates, and the activities it seeks to report on. The evolution of business enterprises has affected accounting theory; we sought to bring out this relationship and the results. Then, by examining what is meant by postulates and principles and how they become generally accepted, we obtained a broader perspective upon the formulation of accounting theory. We rounded out that perspective by briefly surveying past attempts to formulate a comprehensive accounting theory.

With an understanding of the environment of accounting, and using that environment as our basis, we now turn our attention to formulating what we conceive to be the foundation of financial accounting; the cornerstone of that foundation, the objective of accounting, is discussed in the following chapter.
CHAPTER IV

BROAD OBJECTIVES OF ENTERPRISE ACCOUNTING

The Need for a Stated Objective

In Chapter I we pointed out that the structure of accounting theory herein conceived is a logical structure, built upon a hierarchy of levels of abstractions. At the apex of this hierarchy is one or a few generalizations comprehending all abstractions (propositions) below it. This all-inclusive abstraction is the objective (or function) of all enterprise accounting. Enterprise accounting's two areas, financial and managerial accounting, likewise each have their major objective.

Accounting practice, in much the same fashion as any activity by individuals or associations of individuals, is guided and motivated by some basic objective. This objective is the one thing which stands out as the force giving meaning and purpose to the activity's performance.\(^1\)

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\(^1\) A dictionary definition expressing the meaning of "objective" intended here: "An aim or end of action; point to be hit, reached. . . ." Also, in this and following chapters, "accounting" should be mentally qualified by the term "enterprise" (enterprise accounting) to connote the scope intended, unless another scope is expressly identified.

\(^2\) William L. Campfield, "Basic Philosophy Underlying
Therefore, some goal consciously or unconsciously motivates all activity.

Developing a structure of accounting is not just a matter of deciding disputed issues as they arise. There is a need for a foundation of broad insight into the environment of accounting, as well as a need for the use of reason and logic in drawing from that environment the objectives of accounting and the means to obtain them. The overall objective of accounting is the starting point and supplies the basis for the accounting framework.

After surveying the evolution of accounting objectives, this chapter investigates a definition of accounting. Also a broad objective of all accounting is formulated, which provides the basis for formulating the objectives of the financial and managerial accounting areas. Alternative objectives of financial accounting also are discussed.

The Evolution of Accounting Objectives

Paralleling Business Enterprise Objectives

Generally speaking, accounting objectives have paralleled the objective of the activity for which the accounting is being done. Thus, if the activity were the liquidation of the estate of a deceased person, the

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accounting process would assume an objective of recording and providing information about the liquidation of the estate. The accounting therefore would be concerned with recording and providing information about sales of assets, transfers of legacies, payment of debts, and so forth, for that particular liquidation activity.

We may view the objectives of business enterprises and accounting as being oriented in two directions—internally directed and externally directed.

In the previous chapter we characterized the origin of accounting as an outgrowth of a recording function. The sole owner-manager presumably was motivated by the desire to earn a living from his business. Accounting took the form of recording the events of the business activity and of showing the wealth or status of the proprietor.

As the need increased for larger amounts of capital, creditors and shareholders were brought into the business picture. As long as ownership was closed, accounting remained predominantly a recording function, with reports being increasingly influenced by the wishes and needs of the creditors. When ownership became separated from management, stewardship reporting became predominant over recording. Gradually the emphasis in managerial and accounting objectives shifted from stewardship to income determination. (Income determination as a major objective of financial accounting is discussed in a later section of this chapter.)

In recent years managements of many large
corporations have adopted multiple and diverse goals as business objectives. These goals extend beyond the primarily economic objective of profit making, which in the past has had a great influence upon managerial motives. The new goals go beyond the internal economic activities and relate to the requirements of the external society in which the corporation operates. Profit maximization is subordinated to other goals, such as contributions to economy growth, advances in technology and productivity, innovation, meeting community requirements, stability of employment, enlarged public services, and so on with a variety of socially oriented objectives. These nonincome-oriented objectives are thought to be a reflection of the values of the institutions and groups in which managers live and work. The highest level of achievement by managements may then be defined in terms of developing and fulfilling the human values of society. In adopting such goals, managements recognize that their responsibility is a public and social one, and is not limited only to the shareholder-owners of the enterprise.

If accounting objectives are to parallel management

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and enterprise objectives, what should be the implications to the enterprise accounting structure from adopting multiple socially oriented goals? Since these goals are presently considered as purely qualitative, should they be excluded from the accountant's attention? Should accountants continue to derive an income figure and establish it as a general index of effectiveness in attaining all the goals collectively? Or should an attempt be made to quantitatively account for these multiple goals?

The selection of enterprise goals is the function of the enterprise participants—the society segments; the goals necessarily will reflect the social and moral attitudes of society. In this writer's opinion, the structure of accounting ultimately must be broadened to include in its scope the measuring and reporting on the effectiveness of attaining socially oriented enterprise goals, but exclude the selection of those goals.

The development of a detailed structure of accounting which would embrace specific multi-goals is beyond the scope of this dissertation. Suffice it to say that the adoption of socially oriented multi-goals is a manifestation of the growing awareness of managements' responsibility to the general public and economy. As the basis for

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5For an elaboration on the problems and implications of measuring and reporting on multiple goals, see Bedford and Dopuch: "The Emerging Theoretical Structure of Accounting"; and "Research Methodology and Accounting Theory--Another Perspective," pp. 358-361.
formulating an accounting objective suitable for the current stage of social awareness, let us investigate more closely the social concepts of management and accounting.

Social Concept of Management

The developing social concept of management can be portrayed best in the light of the classical capitalistic view of the corporation and management.

The classical capitalistic viewpoint holds the owners of the business enterprise in the central position. The owners have absolute control over the use of their private property, within the bounds of legal and contractual obligations. Maximum profit in the long run is the prime objective in committing capital to the enterprise. Management is under the control of the owners, and acts in accord with the owners' wishes, in a fiduciary capacity. The other segments of society (labor, consumers, creditors, government) are groups to whom management has a contractual or legal obligation, and are looked upon as constraining the maximum profit goal.\(^6\)

The emphasis in the classical view therefore is on the enterprise as an economic institution. The "invisible hand" is the watchword, as the mechanism of free competition guides the self-interest pursuits to culminate in the

maximum good for all. The maximum social good is the auto­
matic result of a properly operating unobstructed system.7

The new social concept of enterprise, in contrast
with the classical view, places management (not the owners)
in the central position. The goal of long-run profit maxi­
mization is compromised to optimization and coordinated with
considerations of public service and satisfaction. Manage­
ment is viewed as having an equal responsibility for the
welfare of shareholders, labor, consumers, creditors, gov­
ernment, and general public. The interests of these groups
no longer conflict with the pursuit of a fair profit, and
management's essential role becomes one of evaluating the
rights and interests of the respective segments of society
and mediating among them.8

This concept of enterprise views business as a
social institution and views management as having a social
responsibility. The public interest is placed ahead of
individual interests. The maximum social good is not an
automatic product of the competitive system, rather is
achieved through conscious effort.9


8Ibid., pp. 35, 37-40; and Howard Bowen, Social
Responsibilities of Businessmen (New York: Harper and
Brothers, Publishers, 1953), pp. 48-68.

9Andlinger, "The Crucible of Our Business Creeds," p. 35. See also: Mason, "The Apologetics of Managerial­
ism," pp. 1-11; D. Mead Johnson, C. H. Nolen, H. F. Smiddy,
C. Hewitt, "Are Profits and Social Responsibilities
What are the implications to accounting of the broadened social responsibilities of management and enterprise? Paralleling the growth of the social responsibilities of management has been an increasing awareness of the social responsibilities of accounting.

Social Concept of Accounting

As pointed out above, the growth and development of accounting closely parallel that of business enterprise. The recognition of management's public responsibilities brought with it a realization that accounting responsibilities transcend service to the owners and management of enterprises. While serving business, accounting today serves society.10

As the language of business, accounting expresses economic facts and relationships. Through the media of financial statements, accounting communicates the

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contributions and the relative economic rights and interests of the economy segments—stockholders, management, labor, creditors, customers, government, and general public. These segments of society must be able to rely on accounting information which is "judged from the standpoint of society as a whole—not merely from that of any one group of interested persons." 

This dissertation is based upon such a social concept of accounting. From this social concept and from accounting's relation to other disciplines (as outlined in Chapter II), we now formulate our definition and objectives of enterprise accounting.

Definition of Enterprise Accounting

Chambers has pointed out that "accounting" is an abstraction, and when used without qualification the term can be presumed to refer to the whole of a general class of processes, of which all are called accounting. Thus we have

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12 American Institute of Certified Public Accountants, Accounting Research Bulletins, p. 7.

a vertical stratification such as was referred to in Chapter II, as well as a variety of forms (horizontally) within each stratum. In the vertical stratum of enterprise accounting, for example, there are (horizontally) various forms of enterprise including among others the corporation, partnership, government, estate, receivership.  

Is it possible to formulate a definition for accounting in its broadest sense? William Paton answers the question by providing the following definition: "... accounting is a synthesis of concepts, rules, and techniques designed to facilitate understanding and control of economic activity."  

We may be attributing a broader scope to this definition than Paton intended. Though not explicitly referring only to enterprise accounting, the context in which the passage appears would imply such a scope. However, in our opinion, the quoted definition is an adequate formulation of accounting in its broadest sense. We shall therefore adopt the definition as all-inclusive.

If it be possible to formulate an overall definition of accounting, then it should also be possible to formulate a definition for each stratum of accounting. The

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14 See the structural outline in Chapter I, p. 11, for the various forms, and Chapter II, p. 29, for the stratification.

definitions so formulated necessarily would involve defining the particular stratum within the outlines of the overall definition. Since the other strata of accounting are outside the scope of this study, we will concentrate on formulating a definition for the area of enterprise accounting.

The Committee on Terminology of the American Institute of Certified Public Accountants in 1941 formulated the following definition "after extensive consultation and careful consideration":

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.17

In a similar vein Moonitz, in "The Basic Postulates" study, defines accounting in terms of its function.18

The function of accounting is (1) to measure the resources held by specific entities; (2) to reflect the claims against and the interests in those entities; (3) to measure the changes in those resources, claims, and interests; (4) to assign the changes to specifiable periods of time; and (5) to express the foregoing in terms of money as a common denominator.19

16That is, international balance of payments accounting, national income accounting, and individual accounting (see Chapter II, p. 29, for the stratification).

17American Institute of Certified Public Accountants, Accounting Terminology Bulletins, p. 9.

18Presumably there is a distinction (however fine) between a definition (describing what it is), a function (describing what it does), and an objective (describing what it intends to do); we may equate the latter two for all practical purposes, however.

More compactly, Bevis states that when it is necessary to consider the fundamental nature and purpose of accounting, he "... start[s] with the broad definition of accounting as the measurement and communication of financial and other economic data." Others could be mentioned, but the above definitions are representative.

The definitions above fall short in several ways, however, relative to enterprise accounting as conceived in this study.

First, the AICPA definition (if it is being interpreted correctly) restricts enterprise accounting to stewardship responsibilities and only implies the accountant's responsibilities in the decision-making process.

Second, the AICPA and Moonitz definitions ignore (or vaguely imply) the communication (reporting) element in enterprise accounting. Accounting is not an end in itself; it exists to communicate economic data to the society segments. This information (economic data) then becomes the basis for or assists in judgment formulation or action taking by the society segments. Therefore, economic data

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useful for decision making must be communicated. As Bevis said: "... failure to include communication ... robs [accounting] of its life blood." Third, Moonitz and Bevis include "measure" in their definitions. But does accounting (or, do accountants) measure wealth and economic data? Or do accountants merely record the measurements which arise from sources outside the accounting system? To say the system measures wealth or data, per se, implies that the system itself has the inherent capacity to estimate values. It seems to this writer that enterprise accounting is capable of only making an inventory of value measures which have their origins outside the system.

Fourth, the AICPA and Moonitz definitions are restricted to dollar data. Since enterprise accounting includes both financial and managerial facets, an appropriate definition would include not only dollar data but all quantitative data (granted, ultimately expressed in dollars) which may be a part of the control and operational mechanism of management. We might use "economic data" as the all-inclusive term. Economic data pervades every functional activity within an enterprise, so accounting must be

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concerned with the generation, transfer, and manipulation of these data in all operational activities of the enterprise.25

Fifth, only the AICPA definition suggests enterprise accounting to be a system involving certain steps in the process. To be effective as an information processor and communicator, the enterprise accounting system must be orderly and efficient, producing information that is needed when it is needed.

These observations on the above definitions lead us to formulate the definition of enterprise accounting as it is conceived in this study:

Enterprise accounting is a control and communication system which involves gathering, compacting, interpreting, and disseminating economic data for purposes of judgment formulation or action taking.

From our definition of enterprise accounting we shift our viewpoint slightly to investigate the objective26 of enterprise accounting.

The Objective of Enterprise Accounting

Scott observed that accounting had three major jobs to do. In the order of their development (as pointed out in Chapter II), these jobs are the record function, the control


26 See footnote 18 of this chapter.
function, and the protection-of-equities function.  

The recording function involves techniques of information gathering and processing. Gathering and processing are necessary to make readily available data which can be used in certain ways by certain people. This recording phase of accounting is discussed more in detail later in this chapter.

The control function carries with it connotations of the power to make decisions and the authority to make changes. The function is concerned with revenue and expense control as well as technical problems of use of materials, labor, and capital in attaining organization objectives. Thus, we may think of two broad areas of control in an enterprise, operational control and financial control.

The protection-of-equities function focuses upon accounting as a system designed to differentiate between and protect the various interests which are jointly involved in the business' activities.

These three jobs can be separated for purposes of analysis, but in reality are merely different phases of the same process. Protection of equities comes about through managerial and financial control, as well as the recording

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process. Effective control rests upon dependable and relevant information about the enterprise supplied through the recording system. In turn, the recording system is not detached from the other two phases; the data requirements for control, decision making, and protection of equities largely determine the form of the recording system.\textsuperscript{29}

Similar observations on the interdependency of the recording, control, and protection-of-equities phases caused Littleton to conclude that "... accounting has one function--to furnish dependable, relevant information about a business enterprise."\textsuperscript{30}

In another article\textsuperscript{31} Littleton identifies six "areas of accounting action." These areas are (1) homogenizing diverse events; (2) converting events into entries; (3) classifying entries into accounts; (4) reclassifying account data into fiscal periods; (5) reporting or summarizing periodic data; and (6) reviewing accounting data and processes. For each of these areas he inductively derives "intermediate objectives" and broader "antecedent objectives." For example, the first action area, homogenizing diverse events (or, pricing business transactions), would have the intermediate objective "to reduce objects and

\textsuperscript{29}Littleton, "Relation of Function to Principles," pp. 235-236.

\textsuperscript{30}\textit{Ibid}.

events to price data." Its broader antecedent objective would be "to represent greatly diversified economic events and transactions in a manner that will permit them to be marshalled into a variety of useful calculations." More general than the antecedent objectives, and encompassing all of the accounting action areas, would be the "top objective." 32 Littleton formulates a top objective, not unlike his conclusion quoted above:

... In order to achieve the chief objective of helping people concerned to understand a business enterprise, accountancy must classify its data without misrepresentation, compress them without distortion, report them without concealment. 33

Harry Kerrigan said that all other accounting purposes may be fairly subsumed (according to circumstances) under one or the other of the two following purposes of accounting:

(1) To exhibit the financial position of a particular unit of activity...

(2) To exhibit the financial results of the particular unit over a length of time. 34

In reaching these objectives, Kerrigan said, accountants made use of a medium of expression (financial statements),

32 Ibid., pp. 281-283.
33 Ibid., pp. 283-284. See also Littleton, Structure of Accounting Theory, pp. 124-127. Incorporating similar wording is Parker's formulation of the accounting objective as "the provision to interested parties of useful and relevant information concerning economic quantities." R. H. Parker, "The Nature and Purpose of Accounting," The Accountant (Eng.), CXLIV (June 10, 1961), 716.
34 Kerrigan, "Whither Accounting?" p. 61.
a body of principles, and a technique (double-entry bookkeeping). 35

In its 1957 Revision, the American Accounting Association takes a broader view of enterprise accounting and its objective:

The primary function of accounting is to accumulate and communicate information essential to an understanding of the activities of an enterprise, whether large or small, corporate or non-corporate, profit or non-profit, public or private. 36

Another statement of the objective of enterprise accounting which is pertinent to our survey is found in the Accountants’ Handbook:

In a broad sense accounting has one primary function: facilitating the administration of economic activity. This function has two closely related phases: (1) measuring and arraying economic data; (2) communicating the results of this process to interested parties. 37

Each of the above statements is in some way inadequate for our purposes here, although each contains some element of merit. We may formulate the following objective of enterprise accounting to serve as the basis for later

35 Ibid., pp. 61-64.

36 American Accounting Association, Committee on Concepts and Standards Underlying Corporate Financial Statements, Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision (Columbus, Ohio: American Accounting Association, 1957), p. 11. The 1957 Revision was originally published in The Accounting Review; all page references are to the reprint by the A.A.A. which included the 1957 Revision and previous statements and supplements.

statements of the objectives of its two areas of financial and managerial accounting:

The objective of enterprise accounting is to provide an information-communication system by gathering, compacting, interpreting, and disseminating economic data, in order to facilitate judgment formulation or action taking by the economy segments.

Enterprise accounting is not an end in itself; rather it is a tool through which information (economic data) is gathered and summarized into reports and analyses. These reports are then interpreted and communicated to the society segments (shareholders, management, labor, creditors, customers, government, and general public) as the basis for judgment formulation and action taking by them. (To formulate a judgment does not necessarily include taking action; those judgments which are followed by action taking we call decisions.)

The recording phase (or function) mentioned above encompasses the gathering and compacting elements of our objective. By gathering is meant that part of the information system in which business forms and records are collected either at the source of the data or indirectly by means of preliminary forms. These data are made up of enterprise operating and financial transactions, events, and facts. The gathering phase also includes recording the data into the accounting system books and records. A number of steps are involved, such as analyzing and classifying the data, and formulating the entry to be made into the
records.\textsuperscript{38}

The \textit{compacting} element of our objective involves summarizing like data in specific groupings (accounts and ledgers) and further summarizing the groupings into reports and statements. The procedures normally followed include periodic posting to accounts, summarizing into a single listing (the trial balance) the total or balance of each account, and preparing the financial statements and supplementary statistical reports from the trial balance and other operating data. Accounting procedures and financial statements and reports are based on the belief that monetary and nonmonetary quantitative data provide an effective means of describing enterprise events. Such quantitative data are essential to communicate qualitative information about the enterprise.\textsuperscript{39}

Interpreting the information produced in the form of statements and reports is perhaps the most difficult phase of the accounting process. Interpretation involves making certain analyses and computations of ratios and percentages. More importantly interpretation also involves judgment on the accountant's part to relate items to each other in

\begin{itemize}
  \item \textsuperscript{39}American Accounting Association, \textit{Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision}, p. 1.
\end{itemize}
discerning the causes for the changes or deviations.  

The next phase or element in the objective is disseminating or communicating the economic data and interpretations to the economy segments. It was noted above that accounting's sole reason for existing is in the communication or transmission of economic data to all segments of the economy. Accounting is a form of language used to communicate economic data between individuals and groups of individuals.

The objective states that accounting provides a communication system. The idea is that accounting records experiences and events which serve as a pattern or reference to guide and facilitate decisions or judgments. The system "audits" all operating activities to bring significant quantitative information to the attention of interested parties. These parties, through their varied needs, largely determine the content and quality of the reports. As new conditions and needs arise, the communication system adapts to the changes. An important job of the accountant is to be

\[\text{40 This statement seems to be contrary to Littleton's: "There can be no question that accounting data are able to serve the interpretative needs of business. There may be reason to doubt, however, that the accountant is an interpreter searching for meaning and significance beneath account data. It would be closer to the fact if he were considered to be an analyst who undertakes to resolve a complex into more understandable form." A. C. Littleton, "The Interpretative Function," Illinois Certified Public Accountant, XXII (Winter, 1959-1960), 3.}\]

\[\text{41 See Bevis, "Comments on 'The Basic Postulates,'" pp. 2, 7.}\]
receptive to and cognizant of changing needs and situations.\textsuperscript{42}

From our definition and objective of enterprise accounting we are able to formulate objectives for the two areas of enterprise accounting—managerial and financial accounting. Since the primary interest of this study is financial accounting, we shall be content to state (for purpose of contrast) and discuss briefly the objective of managerial accounting. Following the managerial accounting discussion is a more detailed investigation of the objective of financial accounting herein formulated.

**Objectives of Enterprise Accounting Areas**

At this point we may digress briefly to question the validity of separating enterprise accounting into the two areas of financial and managerial accounting. The separation is not valid if we take the viewpoint of the overall process. In this light accounting is for the enterprise and of the experience and events which shape its existence. There is only one accounting, and its processes produce a single set of reports about the status and operations of the enterprise. On the other hand, the separation between managerial and financial accounting is valid if the primary

concern is the parties which are interested in the results of the accounting system. The parties interested in the firm's operations are shareholders, managers, labor, creditors, customers, government, and general public. These society segments may be divided, from the vantage point of the enterprise, into two groups, internal and external interests. The information produced by the accounting system is thus directed to these two groups of interests; managerial accounting is directed to the internal operational needs of managers, and financial accounting is externally directed to the other segments. This latter concept is held to be the more valid viewpoint and thus acts as one of the bases in our analysis.43

**Objective of Managerial Accounting**

This writer views managerial accounting as including all aspects of the development, presentation, interpretation, and communication of economic data for the information and guidance of managers at all levels of the enterprise.44

Drawing from this concept and from the objective of enterprise accounting previously stated, we formulate the following objective of managerial accounting:

The objective of managerial accounting is to provide an internal information-communication system by gathering, compacting, interpreting,

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44Cf. ibid., p. 21.
and disseminating economic data in order to facilitate planning, control, and decision making at all managerial levels within the enterprise.

Essentially, accounting reports the results of decisions made and actions taken by people. The importance of accounting does not lie only in that fact, however. Accounting's importance arises from its being also a tool with which to evaluate those decisions and actions. If the person were not interested in the results of his decisions and actions, there would be no need for an accounting thereof. If he were interested, there would be a need for a means of evaluation. Decisions are made in the present and have their effects in the future. As a basis for decisions, the person must rely upon facts marshaled about current conditions, upon forecasts of future conditions, and upon evaluations of the results of past decisions. Each decision is made under a different set of circumstances, but an evaluation of the results of past decisions relative to current conditions may give an insight into the possible results of current alternatives, and therefore indicate the best alternative. There is a need, then, for a means by which to evaluate the effects of past decisions to serve as part of the basis for making current decisions.\textsuperscript{45}

Being a basis for evaluation, enterprise accounting

assists management in evaluating business decisions. Thus accounting contributes to sounder current decisions and also contributes to controlling current events and to the planning for future events concerning the business. The body of processes and concepts which compose this information system is called managerial accounting. Managerial accounting has two main areas, cost accounting and special studies, although it draws from all the data produced by the enterprise accounting system.46 Other departments of the business would use the data coming from these two main areas. For example, the marketing department could use cost data and special studies to determine an optimum product mix or to evaluate salesmen efficiency; the production department could use the data for production scheduling; all departments could use the data in budgeting operations.

Management planning involves establishing day-to-day and longer range operational goals and the means of achieving them. This planning is based on forecasts about internal operations and external (or market) conditions, as well as on current events and evaluations about past decisions. The data produced by the entire enterprise accounting system make up a large part of the data needed in planning, forecasting, and budgeting.47

46 See the outline of the structure of enterprise accounting, Chapter I, p. 11.

Management control refers to the actions necessary to assure conformity with objectives, plans, and policies. Control involves observing, recording, and reporting actual results as compared with planned results, and taking action to correct observed deviations or to alter future plans. Needless to say, accounting data are widely used in the managerial control over operations.

Management accounting is only indirectly related to reporting to interests outside the firm, in that it makes use of most of the same information going to outside interests. Let us now turn our attention to that area concerned with reporting to outside interests, financial accounting.

Objective of Financial Accounting

As the reader will remember from Chapter I, the major contention of this dissertation is that a coordinated body of enterprise accounting theory must be built upon a statement and understanding of its basic objective. We


49 To be sure, this writer is not the first to advocate such an approach. Devine stated "... the first order of business in constructing a theoretical system for a service function is to establish the purpose and objectives of the function. The objectives and purposes may shift
have formulated an objective of enterprise accounting. This objective acts as the guideline to formulate the remainder of the theory structure—postulates, principles, rules, and procedures.

Drawing upon this overall objective, a basic objective for enterprise managerial accounting was formulated for the purpose of contrasting it with the basic objective of enterprise financial accounting (which is yet to be stated). Carrying the analysis of managerial accounting to lower levels of its structure is beyond the scope of this dissertation. Our goal is to formulate and investigate a coordinated and logical foundation of enterprise financial accounting. Such a foundation includes its objective, postulate (or basic standard), and principles.

Drawing upon the discussion in Chapter II of accounting's relation to economics, statistics, and law, and also upon the statement and discussion of the objective of enterprise accounting, we formulate the following objective of enterprise financial accounting:

The objective of financial accounting is to provide an external information-communication system by gathering, compacting, interpreting, and disseminating economic data which gives a financial representation of the through time, but for any period they must be specified or specifiable. Once this first step is taken we have a framework that lets us investigate and conduct research in terms of carefully constructed objectives." Devine, "Research Methodology and Accounting Theory Formation," p. 399.

50 See p. 93 of this chapter.
relative economic rights and interests of the economy segments, in order to facilitate judgment formulation or action taking by those economy segments.

Financial accounting is understood by this writer as having an essentially historical character and serving as a service tool to the present and the future. On this basis, the emphasis in the objective is on the determination and communication of the accumulated enterprise experience in the ultimate form of the economic rights and interests of society segments. Society segments, rather than equity interests (creditors and shareholders), also are emphasized to point out the social nature of accountants' reports. All the society segments have economic rights and interests in enterprises, but not all the society segments have equity claims (rights) in enterprises. Moreover, this view does not subordinate one or more society segments to another; all are considered to have an equal right to information about their relative economic rights and interests in the enterprise individually and all enterprises collectively. With this information about their relative economic rights and interests in the enterprise, society segments formulate judgments or take action with respect to their rights and interests.

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51 Cf. Leonard Spacek, "Accounting Has Failed to Prevent Major Misrepresentations" (address before Chicago Control, Controllers Institute of America, April 19, 1956), p. 6.

52 Cf. Catlett, "Factors that Influence Accounting Principles," p. 44.
The primary media for making financial representations of the society segments' relative economic rights and interests are the enterprises' financial statements. The financial statements are representations of the existence of enterprise wealth and the changes in that wealth during a particular time period. The existence of enterprise wealth is shown principally in the balance sheet. The change in enterprise wealth is portrayed principally in the income statement.

The viewpoint of financial statements' being financial representations of economic rights and interests of society segments does not subordinate one statement to the other, but instead views the statements as complementing each other. But let us briefly defer completing this investigation of the objective of financially representing the society segments' economic rights and interests, in order to study the predominant view of income determination as financial accounting's main objective.

Alternative Objectives of Financial Accounting

The Objective of Income Determination

The majority of accountants probably would agree with the following statements:

The measurement of efforts and accomplishments of business by rendering services
is the ultimate goal of accounting, the actual subject of income accounting in particular.  

Net income determination under the historical cost method lies at the heart of the whole of accounting methodology.

In his *Structure of Accounting Theory*, Littleton set out to find the "unique concept" which pervades all accounting. He felt such a concept makes accounting different from all other methods of quantitative analysis. This concept would be a central idea which expresses the characteristic objectives, effects, results, ends, and aims of accounting.

Littleton systematically inspected popular beliefs about such a "center of gravity." Some hold a set of financial statements to be the focus of accounting. This he rejected on the basis of the nature of financial statements: mere tabulations which summarize a particular type of accumulated statistical data. Littleton felt others might consider "assets" as the unique accounting concept, since assets are the principal means of sustaining enterprise activity. This notion he rejected as being only one of the concerns of a business (others include borrowings and

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53 Engelmann, "In Search of an Accounting Philosophy," p. 385. In fact, the author characterized the "predominant importance of income accounting" as "one of the few points upon which most accountants agree."


55 In Littleton, *Structure of Accounting Theory*, Chapter II, pp. 18-35, from which these observations are taken.
More basic than assets is the concept of "capital," to which Littleton was more receptive as the center of accounting. Capital directs thought to property in productive use, he observed. But also this concept he rejected, saying "income" is even a more fundamental concept. One must understand production and income as a necessary antecedent to understanding capital (property used to produce income). Moreover, accumulated income constitutes capital, he argued.

From these observations Littleton concluded that the idea of income is more fundamental in accounting than the ideas of capital, assets, or financial statements. After examining the various uses of a calculated net income, he deduced that (p. 22): "... to accountancy, which is at base a special type of calculative service, this means that correct income determination is its central problem." From this conclusion Littleton abstracted that the income statement is the most important product of enterprise accounting. His thesis about periodic net income determination is summarized in the following statement:

The central purpose of accounting is to make possible the periodic matching of costs (efforts) and revenues (accomplishments). This concept is the nucleus of accounting theory, and a benchmark that affords a fixed point of reference for accounting discussions. [Emphasis added.]56

56 Ibid., p. 30.
Attempts to discover the unique concept pervading all accounting are indeed commendable and worthy of the effort. If it were stated, the concept could be expected to provide an explanation of or justification for all the things done in accounting. This concept would become the end to be achieved, whereas the accounting processes would be the means to achieve that end.  

But the question is: Should this unique concept come from within the field of accounting, or should the concept lie outside accounting? The answer seems to evolve from reflections on the very nature of accounting itself. Accounting is essentially historical in character and serves as a service tool for the present and future. Accounting is not an end in itself, but exists to serve definite purposes. Those purposes therefore lie outside of accounting and point to a unique concept existing outside of accounting. If the field were not a service tool, it would be an end in itself, and thus find its purposes within the field.

Moreover, to choose one concept (income determination) over other concepts within the field runs the risk of being an arbitrary selection. The result is to emphasize one feature of accounting which may or may not be all-pervasive. For example, to emphasize income determination

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57 For most of the following ideas on income determination as the objective, this writer is indebted to Chambers, "Some Observations on 'Structure of Accounting Theory,'" pp. 585-587.
as the unique concept of all accounting certainly is questionable when one considers that not all enterprises have profit (income) as their organization objective. Even if the concept of income determination were limited to being the unique concept of all business enterprises (presumably operated for profit), the concept may not apply to the firms which have subordinated the profit motive to the other motives which are socially oriented.

Even if we limit ourselves to select only profit-oriented business objectives, there still remains the question of the propriety of income determination as the all-pervading concept. Following this idea of the dominant nature of income determination to its logical conclusion (as Littleton did), the balance sheet becomes a by-product of the accounting process. The balance sheet becomes merely a receptacle for carrying forward amounts to be shown on future income statements. Surely the balance sheet is useful or it would not be prepared at all, not even as a by-product. Why waste the time in preparing it since the accounts themselves act as the receptacle to carry forward residual amounts?

Based upon our statements above concerning the objective of financial accounting, and on the belief that financial statements are representations of the society

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An amount represented as "net income" in and of itself is meaningless. It takes on meaning only when compared with other amounts—income statement and balance sheet amounts. Upon what sales was the income earned? Upon what equity investment was the income earned? Both sources of the income are equally pertinent. Solvency is another case in point. Income by itself is not a representation of solvency, nor are the amounts in the balance sheet alone such a representation. Only by considering the amounts in both financial statements may the solvency status be indicated.

Not only is the ability to earn income important, but equally important is the structure of resources and equities which produces that income to keep the firm solvent.

The earning power of a firm is another example of interpretations involving the financial statements as complementary sources of information. But we need not belabor the point. Suffice it to say that the approach to understanding financial condition requires consideration of both the income statement and balance sheet (at least, such is
From these observations, we conclude that income determination cannot be the unique concept (i.e., the objective) pervading all accounting. We cannot find such a concept within a field which is not self-sustaining and self-justifying.

The Objective of Portraying Economic Rights and Interests

The discipline of accounting is not an end in itself. Thus it seems imperative to study related disciplines and attitudes in seeking the "unique concept" which pervades all accounting. In other words, the purposes of accounting are to be found outside of accounting. The purposes are to be found in the related disciplines of economics, statistics, and law (as discussed in Chapter II). Social and moral attitudes are also important and directly bear upon formulating and implementing the unique concept of accounting (in part, this is the subject matter of the following chapter).

For such a basic concept that pervades all accounting we must ask and seek an answer to why accounting is carried on. The answer can only be to provide information to people outside the accounting system. Further, why do people need information? They need information in order to formulate judgments and take action. Upon what information do they do this? The information needed to formulate judgments and take action is a financial representation of their
relative economic rights and interests. These answers provide the link between accounting and the related disciplines of law, economics, and statistics, as well as with the moral and social attitudes of the society segments.\textsuperscript{60}

If the basic concept is the provision and presentation\textsuperscript{61} of certain information for certain purposes, this idea should be incorporated into the definitions and the objectives of accounting. This has been done in our formulations above,\textsuperscript{62} which serve as the major contentions of this dissertation.

Financial statements and supplementary reports are therefore the primary media by which the relative economic rights and interests of the economy segments are presented. Accounting reports specifically, and accounting practices in general, should be based upon an objective which embraces the concept of accountability to all segments of society. Thus the objective should be to present enterprise information which is a financial representation of the relative economic rights and interests of shareholders, management, labor, creditors, customers, government, and general public. The basic standard by which to achieve the objective, fairness to all parties (society segments), is discussed in the

\textsuperscript{60}See Chambers, "Some Observations on 'Structure of Accounting Theory,'" pp. 585-586.

\textsuperscript{61}We may consider "provision" and "presentation" to be synonymous, and use the latter term hereafter.

\textsuperscript{62}See pp. 88, 93, 97-98, and 101-102.
following chapter. Accounting does not seek to determine these rights and interests, but rather to ascertain them as they already exist. The interdependent rights and interests in enterprises are determined by laws and social and moral attitudes of the time.63

In reporting on the financial affairs of enterprises, accountants do not pass judgment on the acquisitions of rights by enterprises, nor of the corresponding rights and interests of society segments in enterprises (assuming the legality of the acquisitions). Rather, the accountants' responsibility is to report on the financial aspects of such rights and interests. (As an oversimplification, we might characterize the balance sheet as a representation of rights and interests; assets represent the enterprise rights, while the equities represent the corresponding rights of certain outside parties.) The financial aspects of rights and interests include their physical and legal existence, of which both must be ascertainable and not merely assumed.64

The purpose of the financial statements, the auditor's standard short-form report tells us, is to give a fair presentation (or, to "present fairly") the financial position and results of operations of the enterprise. Financial


64 Cf. ibid., pp. 11-12.
reports must present fairly enterprise information to all segments of society. To be acceptable to those segments, the enterprise reports must be a fair presentation of the segments' relative economic rights and interests in the enterprise. With such a presentation, those segments are able to formulate judgments or take actions with respect to their special interests. The various uses of financial reports by different society segments will reflect self-interests, since each segment will act according to its own welfare. Therefore, accounting reports must not be prepared to reflect or favor one society segment over another; to do so would be unfair to other segments. 65

Let us now examine more closely the basic standard for achieving a presentation of the relative economic rights and interests of the segments of society: fairness to all parties.

65 Ibid., pp. 25-29.
CHAPTER V

THE ACCOUNTING POSTULATE: FAIRNESS
TO ALL PARTIES

The Nature of the Postulate

The Relation Between the Financial Accounting Objective and Postulate

In the previous chapter we characterized the objective of financial accounting as the starting point from which to formulate a theory framework. The framework is conceived as a logical structure, built upon a hierarchy of levels of abstractions. At the top of this hierarchy is the objective, the one generalization that comprehends all abstractions (propositions) below it. The propositions

1For the basis of the majority of the ideas presented in this chapter (especially the concept of "fairness"), this writer is primarily indebted to the publication by Arthur Andersen & Co., The Postulate of Accounting, and also to the writings and speeches by Leonard Spacek, George R. Catlett, and Russell Morrison, all partners of Arthur Andersen & Co.

2"The objective of enterprise financial accounting is to provide an external information-communication system by gathering, compacting, interpreting, and disseminating economic data which gives a financial representation of the relative economic rights and interests of the economy segments, in order to facilitate judgment formulation and action taking by those economy segments."
subordinate to the objective include the postulate, principles, rules, and procedures.

The postulate is the basic standard by which all propositions subordinate to it are judged. If some of these propositions are adjudged not to meet the test of the basic standard, then they will not be accorded a place in the financial accounting structure. Every level of the structure must in some way help attain the objective, and the basic guideline to attaining the objective is the postulate. The postulate is that concept used to give cohesion to the whole structure—it establishes the "why" for each concept and action in the structure.

Together the objective and postulate serve as a frame of reference in the formulation of principles and rules. Accounting principles are those generalizations and concepts which act as "broad guides to action." A rule is a directive detailing the manner in which the principle should be applied to a specific situation. A procedure is a group of step-by-step instructions by which the directive (rule) is accomplished.

In Chapters VI and VII we use the objective and postulate as a frame of reference by which to test certain accounting principles for the propriety of their being included in our foundation of financial accounting.
More on the Nature of the Postulate

Webster's New International Dictionary (Second Edition, Unabridged) defines the term "postulate" in a number of ways. Paraphrased, these definitions are:

(1) A proposition which is taken for granted or put forth as self-evident; an assumption providing the first premise; an underlying hypothesis;

(2) A condition; an essential prerequisite;

(3) A proposition which is indemonstrable;

(4) A demand that something be granted without proof.

In its "Report to Council," the AICPA Special Committee on Research Program said concerning postulates:

Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear its understanding and interpretation of what they [the postulates] 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. [Emphasis added.]³

The Committee does not state specifically which of the definitions above it is using in its report. It does imply the first definition, however, by saying that "postulates ... are the basic assumptions. ..." On the other hand, by saying that they are derived from the environment

and modes of thought and customs seems to point away from any definition implying that the postulates are self-evident, or taken for granted, or are indemonstrable. But yet, "... to provide a meaningful foundation ..." indicates "an underlying hypothesis," thus pointing back to the first definition.

The more feasible interpretation to this writer seems to hinge on the emphasized portion of the quotation. As the basis for principles and rules, postulates which were derived from the economic and political environment and from the modes of thought and customs of all segments of the business community of necessity would seem to rely on a demonstration or observation of those modes and that environment. Thus, the postulates derived from a study of the environment and modes would not be self-evident postulates, but rather demonstrable and provable.

If postulates were conceived as assertions, per se (declarations indifferent to evidence), we might speculate that such a basis would not be fitting as a part of a practical art. That is, such a basis is perhaps lacking contact with the realities of everyday accounting practice. If that were the case, then those postulates so conceived would not be a valid basis upon which to build a theory framework and solve practical problems. If such assertions (propositions, hypotheses, assumptions) were in fact adopted as the basis, the result may well be that the public relying upon the
accounting data would become skeptical of the validity of the data and turn to other means of appraisal. To be acceptable to the public and valid as a basis for accounting theory and practice, the postulate(s) must be drawn from the reality of the environment and modes of thought and custom of all the society segments. These modes and environment cannot be taken for granted as a basis for accounting principles.

In Chapter II we studied the environment of accounting: its relation to the disciplines of economics, statistics, and law; the characteristics of organizations and our economy; and the evolution of the environment of business enterprises. These environmental aspects were demonstrated as a basis for the formulation of accounting principles and rules, and also as a basis for the existence of the accounting profession. Important also are the customs and modes of thought of the society segments. These customs and modes are implied in the same study of the environment (especially in the section on accounting and law), and will be expanded upon in this chapter as a part of the basis for our financial accounting framework.

In essence, the environment and modes of thought and custom form "a condition or necessary prerequisite" for the existence of the profession and as a basis for the accounting objective, principles, and rules. The expression of these conditions and necessary prerequisites are found in our postulate, the basic standard by which to judge
accounting principles, rules, and procedures. Thus, the only definition (of the four above) which seems applicable to our interpretation of the Committee's statement about postulates is the second one: "a condition; an essential prerequisite." Likewise, this definition applies to the term "postulate" as it is conceived and used in this dissertation. In this study, therefore, the postulates we seek are those which are conditions or prerequisites which will serve as the basis for formulating a framework of financial accounting. Necessarily these prerequisites must be derived from the political and economic environment and the customs and modes of thought of all segments of our society.4

If our postulates are essential conditions to formulating a financial accounting framework, what are these conditions? Our investigation of this question follows, and is in the form of two alternatives from which we select that postulate which we feel is most pertinent.

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Possible Alternative Postulates

Again, our starting point is the objective of financial accounting as formulated in the previous chapter (or in footnote number two of this chapter). The relevant question is: What should be the basic standard for achieving the objective?

The Postulate of Usefulness

In Chapter III we introduced this study of postulates by discussing the profession's adherence to "general acceptance" as the criterion for following certain accounting principles and rules. As an alternative to "general acceptance," we proposed "soundness" of the principle or rule to be the criterion. That discussion of these two alternatives was deferred to this chapter by observing that there are more fundamental ideas underlying the two criteria. We submit that the basis for "general acceptance" is "usefulness in the situation," and that the basis for "soundness" is "fairness to all parties." This section discusses the concept of "usefulness in the situation" as the basic standard for accepting a principle or rule as part of the accounting structure. The next section and the remainder of this chapter deal with "fairness to all parties" as the basic standard.

No one can truthfully deny that accounting is a service tool, that it is useful in some way to somebody. If it is not, it has no reason for existence. Although its
neatly ruled columns and the inevitably balancing figures give a semblance of accuracy and absolute truth in figures, its aesthetic qualities alone are not sufficient to warrant the existence of accounting.

As we noted above in Chapter III, the currently popular approach to accounting theory and practice is a pragmatic one. This approach asserts that the test of an accounting principle or rule rests in its practical results. From the viewpoint of management and of the accountant preparing the reports, a description of the pragmatic approach may be summed up in these words: good accounting is the accounting found useful by business. If enough businesses and accountants find the particular principle or rule acceptable and useful, it becomes a "generally accepted accounting principle."

The shortcoming of this pragmatic approach is that no control exists over what may be considered useful. The concept of usefulness will follow the desires and purposes of the one controlling the preparation of the report. There are no objective criteria by which to measure the principle or rule; there is only the subjective desire to produce a particular result. As such, accounting becomes a tool by which data may be manipulated to produce results as the manipulators see fit. The concept of utility (or usefulness)

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must be defined in terms of the usefulness desired, in order to be meaningful. As shown above even erroneous results are useful to the manipulator.  

Another interpretation of the concept of usefulness is from the viewpoint of the reader of the data. This approach may be worded in this manner, similar to the description above: good accounting is the accounting found useful by the persons and groups receiving the reports. Two broad classes of reports are envisioned here: special-purpose statements and general-purpose statements. Those groups receiving special-purpose statements would have the statements patterned to meet the users' specific needs. For example, financial statements and reports submitted by regulated utilities to certain agencies are limited-purpose reports for the purpose (among others) of rate-determination. Or, another more common example is the detailed financial statements and operating reports which only management receives; these are also special-purpose reports.

General-purpose statements, on the other hand,

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normally refer to the enterprise's financial statements prepared for "general consumption"; that is, these statements are designed to give condensed data about the firm which interested persons may use to fit their own needs as best they can. Accountants realize the impossibility of preparing general-purpose statements which would meet all the needs of all the statement readers. Thus, the tendency is to attempt to rank the users and their needs in the order of importance, and direct the general-purpose statements primarily to those most important user-groups and only secondarily to other groups. The ranking is necessarily a value judgment, based upon the circumstances and such interdependent criteria as the collective influence of the group, the group largest in numbers, or the group wielding the most control, to name only a few. For example, today's published corporate financial statements are highly condensed and are primarily directed to the stockholder group. These reports present data thought to be most useful to them, including, in addition to the statements, data such as the number of stockholders, earnings per share, return on investment percentages and other investment-oriented ratios, and dividends per share.

Therefore, following the concept of general usefulness as a guide, and concentrating upon what was felt to be the most important user-group, much of the existing accounting structure has been defined in terms of the vested interests of the stockholders, to the exclusion of other equally
important groups. Besides the stockholder segment, a second group having great influence upon the formulation of accounting theory and practice (especially the latter) is the Internal Revenue Service. Income tax regulations have given great impetus to incorporating certain tax-sanctioned methods into the accounting structure as "generally accepted accounting principles" (LIFO inventory valuation and declining balance depreciation, to name the most common).

The point is, when the concept of usefulness is carried through all phases of theory and practice of financial accounting, an arbitrary ranking of vested interests results. When this happens, other interests and their needs are either ignored or overlooked or compromised in reporting on the enterprise activities. The enterprise financial statements thus become directed to the most important group (supposedly), those statements having been derived through the application of principles and rules also defined in terms of the primary group's interests.

Our conclusion should be evident at this point. Considering the results (as pointed out above) from using an all-pervading concept of usefulness in the situation, and also considering this study's contention of the social importance of accounting statements and reports (as pointed out in Chapter II), we must reject the concept of usefulness as the basic standard by which accounting concepts and practices are judged.
The Postulate of Justice, Truth, and Fairness

Scott, writing in 1941, proposed as the basis for accounting principles the concepts of justice, truth, and fairness. Scott observed that our system of government by law includes general principles which evolved throughout the history of human society. Such conceptions serve as standards in judging human conduct. The concepts, he said, include justice, fairness, truth, kindness, friendliness, beauty, and are so general in character that they defy exact definition. These general conceptions persist through the ages, but men's beliefs about them change.

Various areas of action are concerned with one or more of these concepts. Thus the fine arts are concerned with beauty, but what is considered beautiful is the product of the time, place, and people. Likewise theology is concerned with God, virtue, and vice (among others), but mankind's ideas of these concepts also change over time.

Law and government are concerned with administering the community interests and welfare, assessing various responsibilities, and settling conflicting interests. The concept of justice dominates in law and government. Another

7 D R Scott, "Basis for Accounting Principles," The Accounting Review, XVI (December, 1941), 341-349.

8 A much longer list (over 100) may be found in Brother LaSalle Woelfel, C.S.C., Business and the Christian Virtues (Austin, Texas: St. Edward's University Press, 1961), p. 5, who quotes The Great Ideas: A Synopticon of the Western World.
related concept which pervades men's thinking and actions is the concept of truth. But it, too, is a product of the people and the time: witness the meanings currently given to it by the East and West. The extent to which justice and truth prevail in human affairs is determined by the decisions and understandings and actions of men in the process of living. These concepts, then, express and interpret the actual experiences from which they are drawn, and are in fact a part of those experiences.

Scott stated that accounting is most directly concerned with the principle of justice because of the relations with which it deals. Accounting principles and rules reach back to the principles (or concepts) underlying social organization as a basis for determination. Thus, applying the concept of justice to the accounting field, he concluded that accounting theory and practice must afford equitable treatment of all interests actually and potentially involved in the enterprise's activities.

The social concept of truth Scott also applied to accounting. Thus he stated that the accounting records and statements should present a true and accurate statement of the information which they purport to present, and not be made a means of misrepresentation. In spite of the broader application of the concept of truth in culture, Scott subordinated it to justice. The reason was that any misrepresentations and untruths would violate the concept of justice. Scott recognized that in applying the concept of
truth to accounting, truth was in fact relative, and absolute truth could not be obtained.

Separately, but actually as a corollary to justice, Scott applied to accounting the third concept, fairness. Here he observed that accounting theory and practice should be fair, unbiased, and impartial, and serve no special interests. 9

Our purpose in studying Scott's proposals in some detail is that we also believe that accounting is founded upon and relies upon such social concepts. Let us further examine these concepts which Scott mentioned.

Taking first the concept of truth, we cannot hope to give a definition (for this the philosophers have been attempting for centuries) other than to say that which is true conforms to fact or reality. The connotation is that of an ideal quality existing in a statement or act. Applying this to accounting, the implication is that recording and arithmetic accuracy must be rigorously observed. From this accuracy would result flawless accounting statements. The primary fact which invalidates such accuracy is that many of the amounts recorded are estimates. Absolute truth (or accuracy) could never be obtained in accounting reports and statements. Only relative truth may be approached by using presentations which are unbiased and not misleading. We must agree with Scott, therefore, and subordinate the

9 Scott, "Basis for Accounting Principles," pp. 342-343.
concept of truth to other considerations.\textsuperscript{10}

The social concepts of justice and fairness we may treat together. Scott considered fairness as a corollary to justice. In his comment on applying justice to accounting, Scott used the term "equitable treatment" obviously as a synonym to "just treatment." In applying to accounting the concept of fairness, Scott used the terms "fair," "unbiased," and "impartial."

Our dictionary gives as synonymous the following words: fair, just, equitable, impartial, unbiased, objective. All mean free from favor to any side, but each has a slightly different connotation. \textit{Fair} implies an elimination of one's own feelings and prejudices, and is the most general of the synonyms; \textit{just} implies an exact following of a standard of what is right and proper, without regard to other considerations. \textit{Equitable} is less rigid than just and implies fair and equal treatment of all concerned, whereas \textit{impartial} implies absence of favor for or bias against either person or side. \textit{Unbiased} is stronger than impartial and implies the absence of all prejudice and a disposition to be fair to all. Similarly, \textit{objective} implies a tendency to view events and persons impartially and as apart from oneself.

As applied to accounting, we are inclined to choose "fair" over "just." There are three main reasons for this choice. First, "just" implies a too-rigid adherence to "what is right and proper." More often than not "what is right and proper" is not so clearly defined; there can be no "exact following" of any standard which is not exactly defined. Second, "just" rules out all considerations other than "what is right and proper." In accounting at least, judgments involve a standard as well as other considerations which must be weighed. Third, the implication of "equitable" (as a close synonym of "just") is an equal treatment. It seems that in a specific situation one could be fair to all parties without giving each equal treatment (per se).

Likewise, we tend to choose "fair" over the other synonyms mentioned. "Fairness" includes the connotations of impartiality and objectivity, but more than that it implies ethical considerations. That is, "fairness" implies consideration of the social attitudes of people, which we believe should be the controlling force.

Accounting must look to the accepted social standards and attitudes and concepts of the time and place. These are expressed in the forms of laws, customs, business conduct, administrative decisions, religious beliefs, and the like. These are used as a basis for personal decisions, and must also be the basis for accounting decisions. Such attitudes and customs that currently guide society should be the basis upon which to gauge the merits of demands for
information. The social attitudes and customs are thus translated into the standard by which accounting propositions are measured. Moreover, as the social concepts change over time, the accepted body of accounting theory and practice should also change. Leaders of the profession must be able to understand social institutions and be able to recognize and interpret social trends and changes. More importantly, the profession itself must recognize the necessity of change, be receptive to the change, and have an effective means of implementing the change. Therefore, with such social concepts and attitudes as the basis, accounting reports would reflect its social responsibilities and express the society's needs in the accounting area. Accounting is directly related to a dynamic society; it is imperative that accounting take its rightful place in that society.11

From these observations on the relation between accounting and the current social concepts and attitudes we conclude that accounting is essentially social in nature and has significant responsibilities to society. Furthermore, relating these ideas to the objective of financial accounting causes us to stress the communication of economic interests of the economy segments. Finally, from contrasting

the connotations of justice, truth, and fairness, we choose the current social concept of fairness to be the basic standard by which to measure the propriety of accounting principles and rules which purport to be the means of attaining the objective. Fairness to all parties, therefore, is formulated to be the postulate of accounting, that "condition, or necessary prerequisite" which accounting propositions must reflect before being included into the accounting structure.

**Fairness to All Parties as the Basic Standard**

As we point out above, the concept of fairness is a social concept, and finds its expression in the forms of laws, customs, business conduct, administrative decisions, religious beliefs, and the like, of the time and place. Our world is one of mutual interdependence and accountability. Economic rights and interests of the society groups are mutually interdependent, and arise out of the social and legal environment and the customs, conduct, decisions, and beliefs of society. What is the place of accounting in the scheme of things? Accounting is concerned with the accountability of the various entities in society to the holders of the economic rights and interests in those entities, as well as the economic rights and interests of the entities themselves. This accountability, therefore, rests upon the customs and attitudes within the social and legal
environment.

The next question is, then, if the profession adopts fairness to all parties as its basic standard, are the individual accountants to determine the ethical content, or should they adopt its content as understood by contemporary society? The answer should be apparent from the discussion above. The accountant should adopt the current social concept of fairness, rather than forming (independent of other factors) his own subjective opinion about the ethical content. Thus, the concept of fairness to all parties becomes an objective standard, being based upon the collective opinion of society. Accounting thus merely adopts this collective opinion as its basic guide toward achieving its objective.

To say that the fairness standard should be based upon the collective opinion of society, and that this basis constitutes an objective standard, appears to be a contradiction of concepts. But the contradiction is more apparent than real. It cannot be denied that an opinion is a subjective value judgment; moreover, in the final analysis all concepts and understandings are subjective. But if we are able to view those ideas or opinions apart from ourself—that is, to see opinions of other people as coinciding with ours but in fact separate from our own—then others'

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\textsuperscript{12} Cf. Flanders, "Accountancy, Systematized Learning, and Economics," p. 566, footnote No. 5.
opinions become impersonal and detached from us, and become objective, therefore. The problem resolves itself into determining what constitutes the "collective opinion" of society about a particular concept--fairness, in this case.

We feel that the collective opinion of what constitutes the social concept of fairness is not expressed in any one place, to be sure. Rather, the concept is expressed in a number of places: laws, customs, business conduct, administrative decisions, attitudes, and religious beliefs, to name the more obvious. If fairness to all parties were established as the criterion for acceptance of accounting propositions, then the problem is to find some means of interpreting and setting out what constitutes the collective opinion about the concept of fairness. Obviously, this is no small task; however, we feel it is not impossible. Has not the discipline of law and government done the same thing for its underlying concept of justice? The problem seems similar, and it is submitted that a court system similar to that found in law and government (i.e., similar in concept and mechanics, though not necessarily as extensive), but existing under the auspices of the profession of accountancy, would provide the means of interpreting and establishing the content of the fairness standard.

Surely the existence of a competent and impartial court system (or, as a minimum, some authoritative body) would enhance the effectiveness of the fairness standard. To leave to the individual accountant the responsibility of
judging the collective opinion about such a broad concept as fairness, would, most likely, result in an undesirable situation similar to that existing today in which the accountant must individually judge "general acceptance." Such a situation would perhaps defeat the purpose of the fairness standard, since, individually, the accountant could intentionally construe his interpretation to serve his own purposes (but in this case there is no reliance upon the collective opinion, only subjective rationalization).

Leonard Spacek has advocated such an accounting court, based upon the case system similar to courts at law (see footnote 6 above). In this court could be argued and settled cases concerning the content of the standard of fairness to all parties, as well as the application of that standard to each accounting proposition. Conceivably, each principle and rule would have to be demonstrated to be fair to each economy segment before it would be acceptable to the profession. To do so would force a statement of the bases of each principle, which, in turn, could be defended and challenged. As the concepts held by the economy and society change, the effects upon accounting principles would be felt through the actions of the court, using additional evidence and arguments as its basis for decisions about amending the principles. Such a court system would have the further advantage of being a means of informing the public about the reasons for or against adopting certain accounting principles and rules.
Through its examination of accounting propositions, an inevitable by-product of the deliberations of an accounting court would be a clearer statement of what constitutes the economic rights and interests of the various sections of the economy.

Accounting Reports on Relative Economic Rights and Interests

The society's economic rights and interests, as established by laws and social customs, must be accounted for. Through the media of financial statements and supplementary reports and primarily in terms of the monetary unit, accounting gives a financial representation of those relative interests in the enterprise. Each group is entitled to a fair statement of its relative position concerning its economic interests; therefore, no one group is to be favored at the expense of the others.

Reflecting this view of accounting, Campfield stated:

The public [and private] accountant's role and his opportunity in the national

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13Our distinction between rights and interests is this: all rights are interests, but not all interests are rights. An interest is a moral claim to some personal good; it is a legitimate and inviolable moral power of having or demanding some thing. A right is an interest protected by, or given effect in, the law. Economic rights and interests are singled out because the rights and interests have to do with the existence and changes in the wealth of entities. See LaSalle Woelfel, Business and the Christian Virtues, pp. 56-58; and Roscoe Pound, Social Control Through Law (New Haven: Yale University Press, 1942), pp. 63-102, especially p. 86.
economy would then appear to be that of serving as a guide by the proper display, analysis, and interpretation of economic fact-figures. . . . The total picture, therefore, may be viewed as a balancing of responsibilities to and the equal protection of all groups.\textsuperscript{14}

The broadened social responsibilities of enterprises have imposed upon accounting the weighty obligation to report their economic interests in enterprises to all the society segments. Accounting has the responsibility to report fairly to those who share in enterprise profits as well as to those who actually and potentially share in enterprise revenues. Moreover, people are concerned with a fair presentation of their individual contributions as an indication of their individual rights and interests.\textsuperscript{15} Such considerations are elaborated upon in a later section of this chapter and also in Chapter VII.

\textbf{Fairness to All Parties--}

\textbf{Favor No Single Interest}

Accountants report upon and communicate the economic facts of enterprises. If we may think of one enterprise as a pool of rights and interests, at any one time there is a certain structure of rights and interests claimed by the

\footnotesize{\textsuperscript{14}William L. Campfield, "Need for a Reexamination of the Conventional Accounting Method," \textit{California Certified Public Accountant}, XIX (May, 1952), 20.}

various sectors of the economy. Over time this structure is constantly changing as the result of judgments formulated and decisions made and action taken with respect to each segment's relative position in the pool. Each individual will act in his own interest (welfare) because he is constantly trying to better his position.

For accounting reports and statements to misstate the size of the pool would be misleading and unfair to all parties. Likewise, to misstate the size of any one segment will necessarily distort the other segments' shares; i.e., an unfair reporting to one (either favorable or unfavorable) will cause an unfair reporting to the other.

One point needs clarifying here. We are speaking of fairness to all groups within the national community—stockholders, management, labor, creditors, customers, government, and general public. We are speaking of external reporting. Why then include management? We include management here from the viewpoint of its economic rights and interests in the enterprise. Management stakes its continued reign on the results of operations and enterprise status as shown in the financial statements. Stockholders appraise management's ability and performance to determine if management should have a continuing interest in the enterprise. Thus, the accounting statements and reports which management uses to evaluate its economic rights and interests are different from the internal statements and reports which it uses to formulate judgments and take
actions in the planning, operating, and controlling of the enterprise. The latter statements and reports are more detailed and contain a wider variety of information than those general-purpose statements presented to the society segments. Therefore, when we speak of the society segments, we are including management as one of those groups which have economic rights and interests in the enterprise.

Furthermore, when we speak of society segments we are talking about groups which can be clearly distinguished—for instance, management, labor, customers. The groups can be distinguished, but people are likely to belong to several at any one time. If a person, for example, belongs to the stockholder, labor, customer, and general public groups simultaneously, he will view the financial representation of his economic rights and interests in the enterprise from each of the relative positions. From this evaluation he will form judgments or take actions to alter one or more of his relative positions.

Each separate segment has conferred on it by laws and social customs definite interests and rights. These are protected by society and its institutions. The relative rights and interests must be clearly defined for each sector and the fairness of the accounting for those interests

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16 The "general public" includes all individuals, from the viewpoint of their being a part of our national economic and social structure; their interest is an aggregative one, rather than personal.
clearly demonstrated. Only in this way will the results of the accounting process be fully acceptable to society. Therefore, the enterprise financial position and results of operations cannot be misstated or slanted to favor certain interests, for to do so would be unfair to all the segments. "No single view can prevail. A balancing of forces is necessary."

The Attest Function of Public Accountants

Laws and social customs confer economic rights and interests in enterprises upon various economy segments. Enterprise managements and accountants are generally thought to have the primary responsibility of furnishing enterprise data to outside parties. Since managements are in the position to bias the data in favor of their own self-interests and to the detriment of other society segments, the outside parties had to have a method of confirming or attesting to the reliability of the reports on their interests.

Through laws and customs, the public has established the public accountant to provide this independent review and

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18 Littleton, Structure of Accounting Theory, p. 33, as quoted in Arthur Andersen & Co., The Postulate of Accounting, p. 30.
confirmation. Thus, independent auditors (accountants) express their opinions on the reliability and fairness of the enterprise data to those outside parties having economic rights and interests in the enterprise.

The public accountant is equally responsible to all segments of the economy by virtue of his independent status. As an independent reviewer, the public accountant must be able to demonstrate why management's financial statements of the enterprise positions and operations do or do not give a fair representation of the economic rights and interests held by the various groups of individuals. Expressing the position of the public accountant, Carey stated:

... He is the guardian of fairness in financial reporting. He is not to be regarded as a part of business management, or a representative of labor, or an agent of the government, or an arm of the investing public, or an employee of credit grantors, or an investigator for taxpayers. He is an independent, impartial, qualified expert, whose findings may be accepted with confidence by any and all parties at interest. He stands for fairness and full disclosure in accounting, let the chips fall where they may.19

Therefore, the independent public accountant expresses his opinion on the fairness and reliability of published financial data. Each economy segment holds its own self-interest to be predominant, so the enterprise accounting must conform to the standard of fairness to all parties; in this way, no segments are overlooked or

neglected or favored.  

**Fairness and the Standard**

**Short Form Audit Report**

The opinion paragraph of the standard short-form audit report reads that the financial statements "present fairly" the financial position and operating results of the enterprise in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Let us look more closely at the concept of fairness which is currently advocated in practice and expressed in the opinion paragraph. In commenting upon the implications of "present fairly" in the auditor's report, Blough said

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that fairness is considered only within the framework of generally accepted accounting principles. Other sets of standards could be used, he said, such as regulatory agency rules or the American Accounting Association pronouncements (or, presumably, the social concept of fairness). However, he maintained that a subjective decision as to what constituted a fair presentation would not be acceptable, because of the absence of a standard to follow. Furthermore, he said no one could challenge the auditor's fairness or integrity (only his judgment) if such a subjective criterion were the final test of a fair presentation. From such notions he concluded that only if judgments are reached within the framework of generally accepted accounting principles (which he explained as "the recognized and widely accepted conventions and procedures") can there be any test of reasonableness or honesty of a particular presentation.

That there exists no authoritative statement of generally accepted accounting principles seems not to disturb Blough. Likewise, that there may be a general consensus of the concept of fairness and that this could be stated authoritatively seems not to occur to him. The objectivity or subjectivity of "generally accepted" and

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can be in a position to state that a company's financial statements 'exactly present' financial position. . . ." This passage appears devoid of ethical implications and therefore points to the following dictionary definition of "fair" as applicable: "Free from marked merit or defect; hence, average; pretty good. . . ."
"soundness" (or "fairness") is discussed in Chapter III, and earlier in this chapter, and need not be repeated here. Our conclusion to that discussion is that soundness is no less subjective than general acceptance.

At least one national accounting firm makes "present fairly" independent of "generally accepted accounting principles." The wording in its opinion paragraph includes 
"... present fairly ... and were prepared in conformity with generally accepted accounting principles ... ."22
(Emphasis supplied.) The effect of this wording is the expressing of two opinions rather than one as under the standard wording. The implication is that in some circumstances the financial statements might conform to generally accepted accounting principles but would not, in the auditor's opinion, present fairly the financial condition and operating results.23 Also commenting upon the "maverick" wording, Werntz stated:

... I doubt whether such language solves the problem [of alternative generally accepted principles], since it substitutes for the test of generally accepted accounting principles an undefined and subjective concept of "fairness."24

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23 Blough, "Implications of 'Present Fairly' in the Auditor's Report," pp. 76-77. Blough described this as a "most unfortunate practice."

But the point is that the concept of "fairness" is definable and objective. Referring to the discussions above concerning its objectivity and interpretation, we may conclude that we feel the usefulness of the concept lies precisely in the fact that it cannot be strictly defined. Accountants and society have a general concept of it based upon observable attitudes (which could be more definitely interpreted by some authoritative body), but what "fairness" means specifically can be determined and demonstrated only in relation to a specific set of circumstances. Its meaning will therefore vary over the range of possibilities within the limits of observed and interpreted attitudes, and as applied to specific situations.

Reflecting our social concept of fairness to all parties as the basic accounting postulate, and therefore rejecting "general acceptance" as the test for accounting principles, we might reword the audit report opinion paragraph along the following lines:

"... present fairly the financial position and results of operations ..., conforming to accounting principles and procedures considered equitable to all parties, based upon the economic and political environment and the customs and modes of thought of all segments of society."25

Fairness to all segments of society, then, is our basic standard by which accounting principles, rules, and procedures are tested for the propriety of their being included in the financial accounting structure.

**Financial Statements Are Basis for Evaluation**

Through the media of financial statements and supplementary reports, accounting gives a financial representation of the economy segments' economic rights and interests in enterprises, as established by laws and customs. The application of principles, rules, and procedures, all meeting the test of fairness, will assure a presentation fair to all parties.

A fair presentation of the segments' rights and interests will enable each segment to formulate judgments or take action on his position relative to other segments. As we pointed out above, accounting information is a tool used to evaluate past decisions and to serve as a basis for current decisions affecting the future. Current decisions are based upon evaluations of past decisions and their results, current position, and expected future conditions. The individual's current rights and interests are the result of his past decisions; a fair presentation of the enterprise's status and operations will enable him to better evaluate the effects of those past decisions. The individual formulates a judgment that his position is either desirable or undesirable. If his position is evaluated as
undesirable, he will take action to change his relative position. Thus, the stockholder sells his shares or buys more shares. The creditor makes a decision to lend on certain terms or to deny the loan. Each reader will have some reaction to the financial presentation of the enterprise. To be relied upon by each individual the representation must be fair to all parties.

If the financial statements are to be a fair-to-all-segments presentation of their relative economic rights and interests in enterprises, the basic standard of fairness must pervade the accounting structure. Favoritism to certain segments causes distrust in the accounting reports by the other groups. If lack of confidence exists, the disfavored segments may turn to government intervention as an alternative. Therefore, with the conflicting interests of individuals and groups, accounting principles and rules must be established that meet the test of fairness to all parties. The general-purpose statements and supplementary reports may take various forms and include information directed at special uses and purposes. Even so, the basic standard of fairness to all parties and the broad accounting principles must be the same for all enterprises and industries similarly oriented (e.g., for profit). Specific rules applying the principle will vary according to circumstances.\(^26\)

\(^{26}\)Catlett, "Factors that Influence Accounting Principles," p. 48.
When we consider the many uses of financial statements, we impress upon ourselves the importance of accountants' responsibility to provide fair presentations of enterprise activities. The information needed by the different groups upon which to base their judgments and actions is a financial representation of their relative position regarding their economic interests in enterprises. Therefore the segments' rights and interests are reflected in the enterprise data they need and use.

Rights and Interests Reflected in Segments' Informational Needs

The uses of accounting statements and reports by individuals and groups reflect their own self-interest. The judgments formulated and actions taken will always reflect a desire to enhance personal welfare and position.

Since Chapters VI and VII contain more detailed discussions on the information needed and the uses of such information by the society segments, we will only survey here their informational needs as an indication of their economic interests in enterprises. Another purpose here is to point out the diversity of interests of each society segment.27

27The following examples of the segments' uses of accounting data are adapted from R. Morrison, "What's All This About Accounting Principles?" pp. 1-2; Bevis, "Riding Herd on Accounting Standards," pp. 10-12; Bevis, "Accounting Function in Economic Progress," p. 28; and Albert J. Bows,
The stockholder group, for instance, includes unincorporated proprietors and owner-managers (for purposes of this study); individuals with large or small share holdings, with long-term or short-term investment intentions; security underwriters; security analysts representing actual and prospective investors; fund investors, such as mutual, pension, welfare, and union funds; institutional investors; and other companies affiliated through share ownership. Most of these preferred and residual equity groups have similar or common informational needs. However, there are sufficient differences among them to caution against assuming all investors are alike. The stockholder segment is interested in all phases of enterprise data—profits, sales, financial position, dividends paid and to be expected, production and distribution data.

The management segment includes owner-managers (from the latter's viewpoint), and corporate managers of large and small corporations and of the "hired" and "professional" varieties. This segment is most interested in information which shows its discharge of accountability—profits, financial position, expansion, return on investment. Management is also interested in the same information from the viewpoint of enhancing its own welfare through increased compensation, bonuses, profit sharing, stock options, and the like. To

the extent that individual managers hold share ownership in their company or other companies, they would be included in the stockholder segment.

Perhaps the newest influence in providing accounting information is that of the labor segment. Either individually or through their union representatives, employees desire information which shows profits, employee conditions and expectations, and financial condition. Labor also wants to know if profits are excessive; if so, how much of the excess should it share with stockholders. If a union represents the employees of an enterprise, the union's interest in accounting data may vary depending upon its "opportune" or "partnership" philosophy of bargaining relations.

The creditor interest is perhaps the oldest of outside influences on accounting information. This segment includes groups with both long-term and short-term viewpoints; among them are trade creditors, banks, insurance companies, bond holders, pension funds, and credit agencies. This sector of the economy wants information which will indicate that there are sufficient assets to pay off the debts; facts about the nature and condition of assets; data about the earning ability of the enterprise; what other liabilities are owed and prospects for their repayment; and the earnings retained to improve the security behind the obligations.

The customer group is one area frequently overlooked—at least not emphasized—by accountants. This
segment buys and uses the enterprise's goods and services. The information this group desires relates to those exchanges which will show the company's capability to perform on its contracts. Also, where product or service prices are based upon sellers' costs or other economic data (as in cost-plus agreements), accounting data are very important to the customers.

The government segment is an ever-increasing consumer of accounting information. A number of groups with diversified interests in accounting data are involved. For example, regulatory bodies want information about the affairs of enterprises they regulate which shows compliance with the statutory provisions. Taxing authorities want data which help in levying and collecting taxes. Courts use the data in solving disputes and other proceedings. Lawmakers and investigating committees use accounting data as part of their base for decision making and policy making. Supervisory agencies, sometimes also acting as guarantors for enterprises (e.g., for banks, saving and loan institutions, insurance companies), require accounting data pertaining to their supervisory activities. Also, various agencies compile enterprise data for national statistics purposes.

The last economy group is the general public, which includes those individuals not included in the groups above, as well as the segments included, all from the viewpoint of their being a part of our national economy and part of our economic, political, and social structure. This sector is
interested in accounting data in the aggregate which bears upon the public welfare and safety.

The uses of accounting data by various society segments, as set out above, are intended to be illustrative of the diversity of interests, uses, and viewpoints; they are not intended to be all-inclusive. Our purpose in illustrating this diversity was twofold. First, we intended to link the need for information with the economic rights and interests of the various economy segments. Second, we wanted to point out that, in spite of the diversity of interests and viewpoints of groups within each segment, it will be necessary in this study to consider only the segment as a whole rather than the groups within it separately.

Also, we should point out that some of the uses mentioned above would require special-purpose statements and reports in place of or in addition to the general-purpose reports. Our consideration here is with the uses to which general-purpose reports are put by the various segments.

For general-purpose reports to be useful to each of these segments, they must have been based on reliable data to which was applied accounting principles and rules that have met the test of fairness to all parties.

Applying the Basic Standard in Determining Accounting Principles

The postulate of fairness to all parties is that basic standard by which all subordinate propositions
(principles and rules) are judged. Accounting principles are those broad guides to action according to which enterprise information is marshaled into meaningful statements and reports. Applying accounting principles to enterprise data does not necessarily produce results which are fair. It must be demonstrated, therefore, that the results as well as the principles meet the test of fairness to all parties. However, if principles which were demonstrated to be fair were applied to a complete set of facts, and if both principles and facts were not irrelevant to the situation, such would constitute evidence that the resulting statements were also fair to all parties.

A demonstration of reasons why fairness to all parties is achieved by applying certain accounting principles is as important as the selection of the appropriate principle. In demonstrating the fairness of the principle we must first consider the segments of society. These were set out above to be stockholders, managers, labor, creditors, customers, government, and general public. We feel that in all accounting situations each of these segments is represented. The degree to which they are represented, however, will vary with the particular situation. Because all segments are always to be considered, fairness must be demonstrated as to all segments.

Second, in demonstrating the fairness of the principles to all segments, we must consider the relative economic rights and interests of those segments. Such claims are
based upon laws and social customs and are reflected in the information desired by the segments. The accounting for the enterprise must, therefore, be a fair financial representation of the relative economic rights and interests of all segments of society.28

To summarize, this chapter includes discussion on the derivation and justification of the postulate of fairness to all parties. The following two chapters demonstrate the application of that basic standard in determining the propriety of certain accounting principles.

28See Arthur Andersen & Co., The Postulate of Accounting, pp. 33-36.
CHAPTER VI

ACCOUNTING PRINCIPLES BASED UPON THE POSTULATE:
COORDINATING PRINCIPLES

The Objective of This and the Following Chapter

The objective of enterprise financial accounting as formulated in this study consists of three main elements. First, accounting is to provide an external communication-information system. Second, that system is to communicate economic data which gives a financial representation of the relative economic rights and interests of the society segments. Third, that economic data must serve the society segments by facilitating judgment formulation and action taking.

Economic data about the enterprise are accumulated and summarized by the accounting system. In the process certain accounting principles, rules, and procedures are applied to the data. Our basic standard in this application is fairness to all parties. The products of the accounting system are statements and reports which financially represent the society segments' interests in the enterprise. These statements and reports must be fair to all segments to be acceptable to them. Such fairness can result only from
applying to the enterprise data accounting principles, rules, and procedures which have been demonstrated as fair to all segments.

The objective of this and the following chapter is to demonstrate the fairness (or unfairness) of certain accounting principles. The principles selected are those that currently form a portion of the body of "generally accepted accounting principles." The reader will recall from discussions above that these individual principles have gained their place in current accounting practice largely by meeting the test (criterion) of usefulness in the situation. Our objective now is to determine if these accepted principles meet the test of fairness to all parties. Those not meeting the basic standard of fairness to all parties will not be accorded a place in our financial accounting structure.

Accounting principles, rules, and procedures are the means to obtaining the objective. Each principle, each rule, each procedure should separately meet the basic standard of fairness to all parties. But since a rule applies a principle, and a procedure applies the rule, then a principle demonstrated to be fair to all parties is evidence that the subordinate propositions (rule and procedure) are also fair to all parties. Proposing this, of course, assumes there has been no flaw in deriving the rule and procedure from the principle. Where alternative rules are proposed, each must be subjected to the test of fairness.
If we were formulating a complete financial accounting structure based upon fairness to all parties, a number of steps would be involved. The first step would be to examine current practice to see if the currently used principles, rules, and procedures could meet the test of fairness. Second, we would test those principles, rules, and procedures which have been proposed but which are not now accepted in current practice. Third, other principles, rules, and procedures would have to be formulated and tested against the criterion of fairness to all parties. If the first two steps were completed and the fairest principles, rules, and procedures retained in the structure, the third step would be a continuous one because the accounting environment and social customs and modes of thought are constantly changing. No principles, rules, or procedures can be considered sacred; new or old, they must all continually meet the test of fairness to all parties and help to achieve the accounting objective. As conditions change, accounting practices must also change.

It is not possible to cover all three steps in such a short study as this one. Even to include the second step would take another dissertation at least of comparable length. Therefore, we are concentrating on the first step—and then on only part of that. This chapter and the

1Some of the principles summarized in Appendix C could be considered as such formulations; see paragraphs B, D-1, D-2, D-5, E, H-1, H-3.
following one investigate some accounting principles currently in use. Except for an example of deriving a rule and procedure from an acceptable principle (in the last section of the following chapter), we must also leave the testing of currently used rules and procedures to some later investigation.

What Are Coordinating and Application Principles?

The generally accepted accounting principles which we will concentrate on are drawn from the literature of the field (since there is no single authoritative list). The terms "coordinating principles" and "application principles" will not be found in the literature however.

These terms were selected to connote the two broad classes into which principles fall. The classes are intended to be on the same level and complementary to each other rather than being one subordinate to the other.

In this chapter we study the first group, coordinating principles, and test them against the fairness postulate. These principles include those traditional accounting concepts which have coordinated accounting activities into a

2The reader should realize that all of the principles to be discussed are to a great extent interrelated. In some cases certain principles appear as extensions or corollaries of other principles. While we may set the principles out as separate and discuss only one at a time (thus assuming "other things being equal"), the reader should bear in mind their interdependence.
body of practice. Individually these principles have been stated by various writers to be postulates, principles, conventions, concepts, assumptions, desirable attributes, virtues, or conveniences. Rather than confusing the issue with these various terms, in this study we assign the status of "coordinating principles" to these "broad guides to accounting action" that do the job of coordinating accounting activities.

In the following chapter we apply the same type of analysis to the second class of principles. These "broad guides to accounting action" we term "application principles" because the group includes principles upon which specific rules and procedures are based. The appropriate principle, rule, and procedure are then applied to a specific situation and its relevant facts. The following chapter investigates these application principles in light of the basic standard of fairness to all parties. Also an example is presented of using a principle, rule, and procedure in a specific situation.

**Coordinating Principles of Accounting**

The coordinating principles investigated in this chapter are concerned with three broad areas of accounting activity: The concept of the business; recording and reporting practice; and guides which facilitate business operations and reporting on business operations.
Concerning the Business Concept

Business Entity

We pointed out in Chapter I that the accounting information system may be based upon any one of a number of viewpoints. The most commonly cited are the real personality viewpoint (the proprietary theory) and the fictitious personality viewpoint (the entity theory). A third viewpoint is devoid of personality (the fund theory).

These theories must not be confused with the activity being accounted for. The first two theories normally have the entire business as the pertinent activity to account for. The difference in viewpoint, however, causes variations in the recording and reporting upon the activity of the business, depending upon the viewpoint followed.

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3 However, the activity may be more or less broadly conceived. For example, there may be a number of separately accountable activities within the business (e.g., departments). Or, the activity conceived may be broader than the single business, as when consolidated statements are prepared for a group of affiliated companies as if the group were a single legal entity. See the discussion below in this section on consolidated statements. For further information on the entity principle and affiliated companies, see Maurice Moonitz, The Entity Theory of Consolidated Statements (Brooklyn: The Foundation Press, Inc., 1951); William H. Childs, Consolidated Financial Statements: Principles and Procedures (Ithaca, N.Y.: Cornell University Press, 1949); and James W. Pattillo, "Consolidated Financial Statements: Theory and Utility" (unpublished Master's thesis, Texas Technological College, 1959). The problems met in selecting the appropriate viewpoint and the appropriate activity to account for are set out in Thomas H. Sanders, "Progress in Development of Basis Concepts," in AICPA Contemporary Accounting (New York: American Institute of Certified Public Accountants, 1945), chapter 1, pp. 3-6.
The dominant viewpoint currently followed by accountants is that of the fictitious personality. From this entity theory follows the generally accepted accounting principle of the business entity. This principle is expressed in the following statements:

A business entity is a formal or informal unit of enterprise—a collection of economic goods and services and a group of persons—organized to accomplish certain express or implied purposes. . . . Accounting procedures and financial reports are concerned with specific business entities and their activities. . . . The business entity concept provides a basis for identifying economic resources and activities with specific enterprises, and thus for defining the area of coverage appropriate to a given set of records or reports.4

The business undertaking is generally conceived of as an entity or institution in its own right, separate and distinct from the parties who furnish the funds, and . . . that the business accounts and statements are those of the entity. . . .5

Therefore, the principle means that the ownership of the business rests in a fictional entity and that the accounting records and reports pertain to the activities of the business. Laws recognize the corporation to be an artificial person separate from its real owners. On the other hand, although sole proprietorships and partnerships are legal organizational forms, they are generally not legally


5 Paton and Littleton, An Introduction to Corporate Accounting Standards, p. 8.
separate from their owners.

The accounting principle of the business entity extends the concept of the artificial being not only to corporations but to other legal forms as well. The entity, therefore, for all accounting purposes owns the resources used in the business and owes other businesses or persons for resources acquired—no matter what legal form the entity may in fact take. What are the implications and effects of this principle, and does it meet the test of fairness to all parties?

It will be remembered that the objective to be obtained (or at least furthered) by applying this and other principles is a financial representation of the relative economic rights and interests of the society segments. The result obtained by applying the business entity principle is a set of financial statements and supplementary reports which present the position and progress of the entity separate from the affairs of the actual owners or other parties.

We may picture the position statement (balance sheet) as a pool of rights and interests. The assets are owned by the business and represent rights to the use of the properties by the business. The equity claims by creditors and stockholders represent claims upon the business rather than direct claims upon the assets of the business. To say it another way, the entity has the right to use certain properties and has an obligation to the providers of those rights. From the viewpoint of the equity interests, the
obligation of the entity to the equity interests represents to them a legal right in the entity.

Regarding the progress of the business, the gains and losses of the business are not considered to be gains and losses to the owners directly. Rather, the entity gains or loses on its own activities. The gains or losses are reflected in an increase or decrease in the net assets of the entity. The gross increase in assets (rights to the use of property) is an increase to the wealth of the entity; correspondingly there is an equal increase in the legal rights of the equity interests in the entity. Thus the point is that the result of enterprise activity is a change in enterprise wealth rather than equity wealth as such.

The business entity principle seeks to define the scope of the entity. The comments above are in terms of the single business as the appropriate scope. In the case of a single business there are assets (resources) devoted to a specific type of economic activity. Broadening the scope of the entity, we may consider a group of affiliated companies acting collectively toward a specific economic activity as an entity separate from the individual entities composing the affiliated group. In this situation a set of "consolidated statements" are prepared for the affiliated group entity; also statements are prepared for the individual companies.

Since under the business entity principle an accounting is made of all the properties dedicated to the activity
of the entity (and likewise properties not so dedicated are not accounted for), the principle is fair to the stockholder and creditor segments. The principle results in a presentation which shows their legal claim upon only the single entity. It follows that all rights in the use of properties should be recorded by the entity in order to fairly present the relative positions of the economy segments in the entity. If some entity rights in property use were not recorded, or if rights were claimed which did not exist, both situations would be misstatements of the entity position and unfair to the society segments.

Management is responsible for the operation and survival of the entity. But the entity is charged with the possession and use of properties. To extend the entity beyond the manager's immediate responsibility would be unfair to him since he has no control over some portions of the enlarged entity. For example, if the entity were conceived as including all the departments of a certain business, a manager of one department could not be held accountable for all of the entity's activities. Accounting statements, therefore, presenting only the rights in properties devoted to the operation of the entity are fair to the management segment which directs and controls the use of only those properties.

The business entity principle is also fair to the labor, customer, government, and general public segments because it provides a basis for identifying resources and
activities with specific enterprises. Labor's interest is in the entity as a source of continuing employment and a fair sharing of the results of its earnings. Customers look to the entity as a source of materials, supplies, and services. Government and the general public are concerned with entities as the source of national progress and welfare. In each of these cases the financial statements based upon the business entity principle present a fair representation of the rights and interests in the entity. This is because the statements show only the activities and position of a certain entity.  

**Going Concern**

A companion principle to the business entity principle is that of the going concern. This concept is usually stated as being an assumption that the firm will continue in active operation for the indefinite future if there is no
evidence to the contrary.\textsuperscript{7} The assumption is normally justified on the basis of convenience in light of an uncertain future, on the basis of the typical experience of businesses, and on the basis of the normal expectation.\textsuperscript{8}

The most significant implication of this principle is that historical cost is the pertinent valuation basis for some assets. Another implication is that since business activity is a continuous stream of activities, it is desirable to periodically break that stream to gain an impression of the position and progress of the firm. Another principle—matching revenues and expenses—is related to the two implications above. These three principles are treated here as they relate directly to the going concern principle and separately in detail later in this or the following chapter.

The going concern principle had its foundation in the change of accounting for single ventures to that of continuous ventures. Early business transactions were on a


one-venture basis; when the venture was completed an accounting was made to the parties involved. The records of the trading were on the assumption that the business was only a temporary affair. When business became a series of continuous transactions and undertakings a new attitude of mind was required of the accountant and his records. There could no longer be the attitude of impending liquidation of the business (venture). Since the project was not to be terminated, accounting reports which reflected termination values were not particularly relevant. Moreover, since the transactions were in a continual series with some requiring completion over a period of time, at any one time a number of transactions would be in different stages of completion. Some other basis for valuation was sought for this new situation. Consequently an accounting method developed which recognized on a continuous basis the use and conversion of assets, payment of liabilities, and results of operations.  

Accounting reports are used as a basis for evaluating past decisions in order to currently formulate a judgment or take some action which will affect the future. The continuity of activities presented in the reports links the past to expected or desired future events—to a continuation of desired activities. As such the realities of existence

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have bearing upon more than just indefinitely continuous enterprise activity. Other considerations include the existing pattern of the legal and political environment, as well as the social concepts and customs. Also, how will the enterprise itself change—objectives, products, geographical coverage, clientele, sales effort, management philosophy? What effect will advances in economic and technological factors have upon the firm? All of these events alter the nature of the continuity of the enterprise.\textsuperscript{10}

Various events and developments such as those above are likely to have a significant effect upon the financial condition and progress of the enterprise at any one time. The logical accounting would seem to be an accounting for the conditions and realities existing at the time. To follow an assumption which would ignore those realities would produce results consistent with the assumption, rather than results consistent with the realities of the situation. In such a case the accounting reports would be unfair to the society segments because they are not able to formulate accurate judgments on the basis of the information presented.

\textsuperscript{10}Cf. Vatter, Fund Theory, p. 5. In this regard May said: "As for the postulate of permanence [going concern], discoveries in atomics and electronics are obviously going to create new industries and render old ones obsolete. How are we going to approach this dawn of a new era?" In another article he said: "This [going concern] postulate is obviously defective but is accepted conventionally for want of a better." Respectively, John Lawler, "A Talk with George O. May," The Journal of Accountancy, XCIX (June, 1955), p. 41; and May, "Authoritative Financial Accounting," The Journal of Accountancy, LXXXII (August, 1946), p. 103.
concerning their relative rights and interests in the enterprise.

The accounting statements should be financial presentations of enterprise data according to the realities of its present existence. Moreover, the presentations should inform the society segments about conditions and expectations of continued existence rather than merely to assume it. Such information is vital in evaluating the desirability of continuing the present association with the enterprise. If the going concern principle (and other principles attendant upon it) applicable to a financially healthy firm were used as a basis for ignoring the reality that the firm in effect was not in such a state, the only conclusion is that the results could not be meaningfully relied upon. The fact of continuous financial health (for this is the essence of the going concern concept) cannot be assumed by rote.

The going concern principle and its major implication were stated very simply in 1902 by Dicksee, one of the pioneers of modern accounting. He said: "It being the primary object of most ordinary undertakings to continue to carry on operations, it is fair that the assets enumerated in the Balance Sheet be valued with that end in view."11 This meant that assets were divided into two types, those

with which the business is carried on (generally, fixed or permanent assets), and those in which the business is carried on (generally, current or circulating assets). Since the business is assumed to be permanent, liquidating or current market values are irrelevant; hence, fixed assets should be valued at their original cost. The fluctuations in the value of fixed assets therefore are ignored since it is their original acquisition value (cost) which is committed to be used up in the operations. (More on this under the cost principle discussion below.) On the other hand, current assets are held for conversion into cash at the earliest possible time, so the pertinent value is their realizable (converted-into-cash) value. Carried to its logical conclusion, both increases and decreases in the value of current assets should be recognized. Accountants have been hesitant to follow through with this phase. Another principle comes into play here--conservatism. Consequently, decreases in the value of current assets are recognized as a loss before actual conversion into cash. But increases in current asset values are ignored--or, at most, disclosed in a footnote to the report. Therefore, accountants say they follow the going concern principle while actually not fully accepting all its facets.

In effect, the going concern principle merely rules out an attitude of imminent liquidation and requires asset
valuation according to intended use.\textsuperscript{12} Is the concept fair to all parties? In regard to its implications of asset valuation, we must defer judgment until we investigate the cost principle as a separate proposition more in detail in the following chapter. If we are able to pose the cost principle as a separate proposition (which we can), then there is actually no need for the going concern principle.

If we do allow the proposition—assume a going concern and rule out thoughts of liquidation—but deny consideration of any attendant propositions (cost as basis, periodicity), the proposition is harmless. That is, it is harmless only if the economic facts are in accord with the proposition. But if the principle is used as a basis for avoiding economic realities of the enterprise in order to present a picture of a going concern, the principle is patently unfair to all society segments. The results produced by applying the principle would be formulated and actions taken upon information which was not representative of actual conditions and expectations about continued existence.

It is submitted, therefore, that the principle of a going concern be rejected. Account for the realities of the enterprise condition. If liquidation of the firm is not imminent or existing, there is nothing which requires an accounting relevant to liquidation. If the firm is in fact

\textsuperscript{12}Storey, "Revenue Realization, Going Concern, and Measurement of Income," p. 237.
existing and growing, no principle is needed to assume this reality.\textsuperscript{13}

**Concerning Recording and Reporting Practices**

Certain generally accepted accounting principles have been formulated which help to coordinate recording and reporting upon enterprise experiences. They are important concepts to the accountant inasmuch as they touch upon almost every accounting situation. These principles include periodicity, materiality, conservatism, consistency, and disclosure; we discuss them in that order.

**Periodicity**

The same conditions which brought about the assumption of a going concern also brought about the principle of the accounting period. When single ventures predominated trade the gain or loss from each venture was calculated easily enough when the venture was completed. As transactions became more numerous and continual, however, complications arose as to computing gain or loss from the series of transactions. At any one time a number of transactions were incomplete; how was the businessman to determine his profit? An accurate determination of profit could be made only upon liquidation of the business.

Since terminating the business was undesirable and

unintended, some approximation had to be made concerning the business situation at any one time. Thus grew the practice of periodically making a "test reading" of the position and progress of the business. At first the intervals were uneven and depended upon the desires of the owner—ten to twenty years were not uncommon. A French law in 1673 gave impetus to more frequent statements by requiring a balance sheet each two years. Gradually customs and laws (e.g., income tax) established the relevant period as one year. Even today custom still holds many businesses to the calendar year instead of the natural business year. The latter is in many cases more convenient and economical as well as enabling more reliable accounting results, yet the use of the calendar year remains dominant.\(^1\)

Determining the financial position and profit of businesses has become a practical necessity. People want to know this information periodically; they cannot wait until the final liquidation of the business. Periodic statements concerning a continuous series of transactions and depicting resources committed to a number of years' operations therefore requires allocations to specific periods.\(^1\) This

\(^{1}\)Problems arise when periods of less than a year are used. For an interesting discussion of them, see Gordon Shillinglaw, "Concepts Underlying Interim Financial Statements," *The Accounting Review*, XXXVI (April, 1961), 222-231; and Paton, "Recent and Prospective Developments in Accounting Theory," pp. 113-124.

\(^{15}\)See William J. Linkous, "Significance of the Period," *Virginia Accountant*, VII (July, 1953), 26-29; Carroll, "Conventions and Doctrines," p. 74; Pyle and White,
necessity of allocation led Gilman to comment: "It is this convention which is responsible for most of the difficult accounting problems."^6

Adherence to this principle makes necessary the allocation of revenues and expenses to certain periods. A number of implications, therefore, flow from the principle. First, we imply that a reasonable allocation in fact can be made. It follows, then, that the expenses and revenues which are allocated to a certain period can be matched and a net difference (profit or loss) determined.^7

A second implication concerns those expenses and revenues which are allocable to future periods. Currently such expenses are in the nature of rights to future uses and therefore have asset status. Conversely, revenues currently received but allocable to future periods actually now represent obligations to render future services and therefore are liabilities.^8

Yet another implication of the periodicity principle is that the periodic statements covering the life of the


^7This idea of "matching" has itself become an accepted principle. It will therefore be discussed separately, in the following chapter.

^8Such an implication touches upon two other principles also discussed in the following chapter, one concerning assets and the other concerning liabilities.
business taken together should show the total effect of all the experiences of the business. Each income statement would represent a small segment of its entire life upon the business' liquidation. One cannot escape the provisional nature of the periodic statements. Not only facts but also estimates and judgments are an integral part of each statement. Any judgments formulated or actions taken on the basis of the statements must therefore be tempered by the reality of the statements' tentativeness.

Since these implications will be investigated below, we will concern ourselves here only with testing the principle as such. The periodicity principle states that the life of a business can be broken into discernible periods and that certain determinations can be made for these periods. That this is done, rather than the nature of the results that are actually obtained, is under scrutiny here. Is the principle fair to all parties?

The stockholder wants to be sure that his investment is intact and growing in value. He wants to view his relative position of interests in the firm, and the principle regularly provides this opportunity. The stockholder is also interested in periodic returns on his investment;

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19 This implication also will be commented upon in the following chapter in the section, "Separating Ordinary from Unusual Items."

periodic statements along with other nonaccounting data are the bases for dividend determination. The stockholder may compare his return with what he judges to be a fair return based upon the information at hand. If he judges that his rights to a higher dividend were ignored, he may decide to switch to other more attractive investments. Inasmuch as the principle provides periodic statements upon which the stockholder may formulate judgments and take actions as to his relative economic rights and interests in the firm, the principle is fair to him.21

Managers need periodic summaries and reports of the financial position and progress in order to show their discharge of responsibility as trustees of the owners. Also the statements give a basis for measuring management's effectiveness of their planning, directing, and controlling of the firm. Managements are able to periodically judge their own position in the firm; that this is possible proves the fairness to management of the periodicity principle.

Employees are especially interested in a periodic review of position and progress of their firm to guide them in negotiating their own compensation. Periodic reports are also needed upon which to base judgments about their security and their future with the firm. The periodicity principle is thus fair to the labor segment.

21 Smith and Ashburne, Financial and Administrative Accounting, pp. 57-58.
Creditors want to assure themselves that the firm will be able to meet both its short- and long-term debts. Creditors expect and need and are entitled to periodic reports which permit them to gauge their present risk on money already committed as well as the risk of committing money in the future in any further business with the firm. Thus, a periodic presentation which indicates the creditors' economic rights and interests in the firm is fair to that segment.

Governments are interested in periodic reports as a basis for taxation and regulation purposes, among others. The principle is fair to the government segment inasmuch as it requires periodic statements to judge the firm's compliance with the laws.

Customers want periodic reports upon which they can judge the fairness of prices and their future relations with the firm. The principle provides this review and thus is fair to the customer segment. It is likewise fair to the general public since periodic publicity of firms' positions and progress tends to keep firms more honest in public dealings than they might if such reports were not required or desired. Moreover, the statements show periodically the firms' discharge of responsibilities to the general welfare and progress of the nation. Thus, the principle of providing periodic reports is fair to all segments of society.
Materiality

The principle of materiality is a criterion which is applied throughout the accounting process and also throughout the audit review of that process. Whether a particular item is to be recorded, and if so, in its own account or a miscellaneous account are decisions affected by materiality. Also in preparing and interpreting the financial statements judgments are made concerning the materiality of the individual items and amounts. The auditor applies the criterion of materiality from the vantage point of hindsight. This is probably a better basis for materiality decisions than is afforded the company accountant who must speculate about the effect of his current materiality decisions upon future accounting results.22 Determining what is material is a matter of judgment and it is not always possible to know in advance how important an item might be to a particular reader of the statements.

What do accountants mean by "material"? James Dohr gave the following definition of the word as used in accounting:

A statement, fact, or item is material, if, giving full consideration to the surrounding circumstances, as they exist at the

time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person. The same tests apply to such words as significant, consequential, or important.23

Thus, materiality is a state of relative importance or relative magnitude of amounts or items, and is dependent in large measure upon individual value judgments. The nature and size, or both combined, must be considered as to whether an item or amount is material. If there is reason to believe that knowledge of the amount or item would influence the judgment or action of a reasonable reader of the statements, then the item must be regarded as material.24

Materiality is a device or criterion by which each item receives the emphasis to which it is entitled. Inasmuch as materiality involves amounts, it is a statistical concept; inasmuch as it involves judgments about those amounts, materiality is also a psychological concept. The yardstick of materiality is risk. If the risk to the report user is negligible, then the item can be considered immaterial.25


Applying the concept of materiality is not a matter of applying fixed rules. Deciding what is and is not material varies according to the company, the circumstances of the transaction, and the expected use to which the information will be put. Comparing relative figures is more reliable than comparing absolute figures, yet there are dangers in using percentages just as there are dangers in using fixed dollar amounts. The primary danger in using fixed dollar amounts is their arbitrariness. Likewise, percentages computed upon variable bases are not much more helpful unless the limitation is realized and compensated for.

Moreover, materiality may be qualitative rather than quantitative. A transaction may be otherwise immaterial in amount but may become material if it is unusual or improper or violates some contract or law. Such a transaction might also be considered material because it indicates a significant change in business practice or a probable course of future events. Therefore, the meaning of "what is material" must rest with an individual's judgment in the light of all the surrounding circumstances.

Can we consider the principle of materiality to be fair to all parties? Our analysis for the principle of materiality is similar to that for the principle of the

going concern. Putting Dohr's definition of materiality in the negative we have: "A statement, fact, or item is not material if . . . its disclosure or treatment would not be likely to influence the decision or conduct of a reasonable person." Whether stated in the positive or the negative, the principle is not unfair to the society segments since their judgments or decisions would not be affected if the item is immaterial and would be not unfavorably affected if the item is material.

However, a decision about materiality should be made only after considering the total effect of all items involved, because a series of individually immaterial items may collectively make a material total. If the principle of materiality were erroneously applied, the resulting presentation would be unfair to all parties. Thus, fairness to all parties would be violated if a distortion or concealment were effected under the name of individual immateriality when in fact the series of small items composed a material total. The principle can never result in fairness to all parties when it is used to justify distortion of the facts.27

Therefore, as the definition stands, the principle of materiality is fair to all society segments because it results in financial presentations which are more meaningful.

27 Whitney, "Comments on 'The Basic Postulates of Accounting,'" pp. 7-8; and Black and Champion, Accounting in Business Decisions, p. 191.
by being uncluttered by unimportant details.

**Conservatism**

The principle of conservatism has represented the accountant's "margin of safety." Conservatism appears in a number of forms (actually, applications) but a general statement of the principle currently would go somewhat as follows: In matters of sincere doubt about which one of several equally appropriate (i.e., generally accepted) accounting alternatives should be followed, the choice should be that alternative which produces the least favorable or least optimistic result.\(^{28}\)

Conservatism is an attitude existing as a reaction to the uncertainty of the future. But this attitude has had a subtle and pervasive influence upon accounting theory and practice throughout the years, less now than in the past.\(^{29}\)

In the past accountants were primarily concerned with presenting a balance sheet which showed a conservative picture of the enterprise's financial condition. At the time the conservatively stated balance sheet was the primary

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\(^{29}\)See George R. Catlett, "Accounting Principles--Fact or Fiction" (address before Buffalo Chapter, National Association of Accountants, Buffalo, New York, September 15, 1960), pp. 5-6; Backer, "Determination and Measurement of Business Income by Accountants," p. 212; and Moonitz, "The Basic Postulates of Accounting," p. 47.
statement; a conservative balance sheet, it was thought, necessarily resulted in a proper and conservative income statement. This emphasis upon a conservatively valued balance sheet no doubt resulted from the influences upon accounting of bankers and other credit grantors to meet their needs; other interests were ignored or not recognized as existing. Following the "pounce theory," creditors were primarily concerned with safeguarding their claim and therefore came to look upon conservatism as a virtue.  

The result of the creditors' influence was an extreme form of conservatism. Assets were deliberately understated; for example, building values were written down to some nominal sum, usually $1. The large depreciation charge in the year of write-off, of course, caused profits also in that year to be low and therefore conservative. Or another reflection of ultra-conservatism is the phrase "anticipate no gains and provide for all possible losses." The spirit, if not the letter, of this phrase today still carries considerable weight.

In the last twenty or so years there has been a trend away from ultra-conservatism. A number of causes are responsible for this trend. Stockholders have increased in numbers and have become more dispersed; professional managements have become a reality; creditors have shifted their

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emphasis from pounce values to enterprise earning power.

Moreover, accountants have come to realize the errors of their ways. Balance sheet conservatism more often than not resulted in incorrect and even unconservative income statements. In the example above of the building write-down, because the value of the building was not spread over its use life, subsequent income statements would not contain depreciation charges. Therefore the net income reported in subsequent years would be both incorrect (overstated) and unconservative. Somewhat the same result is obtained by "providing for all possible losses" because future expenses are misallocated to the current period.

Today conservatism is illustrated in the following practices. For example, marketable securities are valued for balance sheet purposes at the lower of cost or market value. If the market value is above cost, the higher value is ignored or shown parenthetically because the gain should not be recognized until realized by sale of the securities. A decrease in market value below cost, however, causes a loss to be currently recorded even though it has not been incurred through sale at the lower value. Another example: certain expenditures are called current expenses even though future benefit from the expenditure is probable. Therefore a large-scale advertising campaign would likely be recorded as current expense because of the inability to prorate
accurately the expenditure over the years benefited.\footnote{31}

Other examples of alternative methods which are currently generally accepted reflect different degrees of conservatism and which tend to result in a more conservative balance sheet are the following:

1. In periods of rising prices, the LIFO method of valuing inventory rather than the FIFO method;

2. Charging research and development costs to expense as they are incurred rather than capitalizing those costs and spreading them over future periods;

3. Accruing pension plan costs fully rather than a partial or minimum accrual;

4. Using the completed-contract method for construction companies rather than using the percentage-of-completion method;

5. Natural resource companies' charging to expense development costs as they are incurred rather than capitalizing those expenses and spreading them over future periods of production;

6. Recording in the accounts tax-sanctioned accelerated depreciation methods rather than the straight-line depreciation method.\footnote{32}

With alternative methods such as these available, the degree of conservatism in the accounting results may be selected as desired.

Can such diverse results as would be produced by any one of the examples above be fair to all parties? Using the

\footnote{31}{Karrenbrock and Simons, \textit{Intermediate Accounting}, p. 48.}

\footnote{32}{See Catlett, "Factors that Influence Accounting Principles," p. 45; and Black and Champion, \textit{Accounting in Business Decisions}, pp. 770-771.}
first example above (LIFO v. FIFO), in a period of rising prices, under LIFO the balance sheet inventory value would be below current values, and the cost of inventory sold would approximate current values thus giving a relatively lower net income figure. Using FIFO in the same situation, the balance sheet inventory value would approximate the current values, and the cost of inventory sold would be lower than current values thus giving a relatively higher net income figure. Generally speaking, LIFO has produced a conservative balance sheet inventory value and a "realistic" net income amount. But the FIFO method has produced a "realistic" balance sheet inventory value and an unconservative and unrealistic net income amount.

The general effects of applying the principle of conservatism in cases of doubt and alternative accepted methods is the understatement of current income and assets and the overstatement of current expenses and liabilities. Such overstatements and understatements are in fact misstatements; such misstatements cannot be fair to all parties. If the misrepresentation favors one society segment, it is necessarily a misrepresentation to the other segments. In all cases where accounting results are influenced by conservatism, the society segments' relative economic rights and interests in the enterprise are misrepresented to some extent. A material misrepresentation is unfair to all parties even though it may put one or more segments in an apparently more favorable position.
If, for example, in the name of conservatism the application of some method produces a low net income figure currently but would tend to increase future years' income figures, decisions may be made which would not otherwise be made. Stockholders, seeing the market value of their stock drop because of lower reported earnings may decide to sell for fear of further drops, or to buy more shares at the depressed value. Management is put in an unfavorable light regarding their performance. Labor may be disinclined to bargain for more wages and benefits that they may be entitled to, or at worst, lose faith in the firm and seek other employment. Or creditors may impose credit standards for the firm that they otherwise would not have considered.33

But unless there are only fixed rules to follow, judgment will always be necessary in selecting the method to follow to implement the particular principle applicable in the situation. Perhaps the principle of conservatism should be worded thus: In matters of sincere doubt about which one of several applicable accounting alternatives should be followed, the choice should be that alternative which

produces the result which is fair to all parties. Hope­fully, this would take the element of misstatement out of the current interpretation; it does not and should not take out the element of caution, however. "A proper degree of caution and prudence in accounting is desirable and neces­sary, since an uncontrolled lack of conservatism [caution] would be disastrous."\(^34\)

**Consistency**

Consistency is an accounting principle\(^35\) based on two related needs. The first need is that if accounting data are to be used in analyzing trends, then the data must be comparable from period to period. The second need is that if distortion in the statements of financial position and progress is to be avoided in a given period and in com­parison with the previous period, then the enterprise accounting principles and rules must be consistently applied.\(^36\)

The importance accountants place upon consistency in accounting reports is indicated by the following wording of the standard audit report. The accounting statements

\(^{34}\)Catlett, "Factors that Influence Accounting Principles," p. 46.

\(^{35}\)"Consistency is a desirable attribute in accounting and the preparation of financial statements, but it does not represent a principle. . . ." (Emphasis added.) Ibid.

"present fairly the financial position . . . [and] operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

(Emphasis added.)

The auditor's report, therefore, states whether in the opinion of the auditor the principles of accounting used in deriving the financial statements have been consistently observed in the current period in relation to the preceding period; during-the-period consistency is implied.37

The application of the principle of consistency gives assurance to statement users that the comparability of financial statements of different periods has not been materially affected by changes in accounting principles or in the rules applying the principles. If there have been changes which materially affect the statements, the principle requires a disclosure of the nature and effects of the changes either in footnotes to the financial statements or in the auditor's report.

Many events can affect comparability of financial statements. In general the comparability of statements as between years is affected by changes in:

(1) accounting principles and rules employed (e.g., changing from FIFO to LIFO inventory valuation);

(2) conditions or events causing only changes in accounting procedures applying the principles and rules (e.g., recognition of a longer machine life than originally estimated); and

(3) conditions and events unrelated to accounting (e.g., acquiring a subsidiary).38

Only the first of these events is usually referred to and elaborated upon in the auditor's report. But both the first and second should require disclosure as to the nature of the change and its effects upon the financial statements (usually in footnotes thereto) under the accounting principle of disclosure. The third change affecting comparability may or may not require footnote comment depending upon the nature of the change. The principle of disclosure, as distinguished from consistency, is investigated in the following section.

The principle of consistency involves changes of the first type above, changes in accounting principles and the rules which apply them. Characteristically a choice by management is involved: to retain the present principle and rule or change to another; for example, to retain the FIFO method (rule) of valuing inventories or adopt LIFO. Management choice is not involved in the second change (above) affecting comparability, and therefore consistency is not at issue. Nor is consistency violated by the third change, which causes certain principles and rules to be newly

38 See ibid., pp. 44-45.
adopted to record the event, but does not involve a change (as such) in principles and rules.

Being consistent in applying certain principles and rules does not mean there can be no change in those principles and rules once they are adopted. It is only presumed that no changes will be permitted unless other principles and rules will make the presentation or estimates more accurate. If these improvements are adopted then the current statement should be made comparable with its predecessor by disclosing the nature and effects of the changes. In this way the reader may convert either statement to the other's basis. The statements are inconsistent in that they each use a different rule in a certain valuation, but they are made comparable by disclosing the information to make either adaptable to the other.

The comments above for the most part relate to the second need for consistency which we mentioned at the beginning of this section—avoiding distortion in the statements of position and progress in or over given periods. The other need for consistency—comparable data to analyze trends—is also important.

Trend information is a major factor to the society segments in making decisions and taking actions regarding their relative economic rights and interests in the enterprise. A single period's financial statements may be sufficient for formulating a judgment about the segment's position relative to other segments. But usually other
information is needed to substantiate that judgment; if the substantiation is conclusive enough, the individual will take some type of action which he believes will place him in a more favorable position. That other data which turns judgments into actions usually are in the form of trend indicators—ratios, percentages, dollar comparisons—for the firm over a period of years. More helpful still is information which indicates the position and trends among the firms in the industry. At the present stage of accounting development, however, accounting consistency among firms in most industries is a situation desired rather than a situation existing. Therefore, comparisons of accounting data of firms within an industry should be attempted only while realizing the limitations of such a comparison.  

Inasmuch as the principle of consistency has an overall effect upon accounting results, therefore affecting all the society segments similarly, and because the overall effect of the principle is more reliable accounting statements and reports, it may be concluded that the principle of consistency is fair to all society segments. Such a conclusion, of course, assumes that the principle is not used to justify the use of other principles or rules which

39 See the comments on this subject in Leonard Spacek, "Can We Define Generally Accepted Accounting Principles?" The Journal of Accountancy, CVI (December, 1958), 42-43; M. A. Binkley, "Limitations of Consistency," The Accounting Review, XXIII (October, 1948), 374-376; and Stephen Chan, "Consistency," New York Certified Public Accountant, XXVII (August, 1957), 533-537.
themselves were unfair to certain society segments.

**Full Disclosure**

The principle of full (or adequate) disclosure is simply stated as the requirement that accounting statements and reports disclose that information which is necessary to make them not misleading.

In the financial statements and their footnotes, in supplementary reports, or in accompanying narrative there should appear significant information which will enable readers to properly understand and evaluate the enterprise's financial position and progress. Admittedly, this is a big order--some think it impossible. The problems of disclosure involve, of course, what information should be disclosed, to whom, and by what means.\(^40\)

Generally speaking, answers to the what, who, and how of disclosure ultimately must be determined by the judgment of the accountant in the light of existing conditions. There exist few, if any, specific guidelines to disclosure.

Under the discussion of consistency above we set out three changes or events which affect the comparability of successive financial statements and which may or may not require disclosure. The first event involves a change in

accounting principles or rules. The second involves events causing changes in accounting procedures. Both of these changes normally require disclosure either in the audit report or in the statement footnotes. The third involves events unrelated to accounting (except that usually the event is ultimately accounted for); this may or may not require disclosure depending upon circumstances. The accompanying narratives customarily include comments upon many of such events.

Another classification of items or events normally requiring disclosure was set out by Moonitz. These include items not in the ordinary or regular activity of the business (e.g., losses on purchase commitments). Also included are items requiring disclosure by contract or statute (e.g., sinking fund provisions), and new activities or major changes in old ones (e.g., stock options).

All these events and changes, if material, normally require disclosure. The principle of materiality was also discussed above; its relation to disclosure is very close. Considerations of materiality inevitably enter into decisions regarding disclosure in any given set of circumstances. Quantitatively, materiality emphasizes the relative magnitude of the item as a basis for determining disclosure; qualitatively, it emphasizes the item's relative importance

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to other items or policies or events and apart from its size.\textsuperscript{42}

To whom disclosure should be made is also not easily answered. Generally, references are to the "prudent investor" (S.E.C.), or the "informed investor" (A.A.A.), or the "standard reader." Generally, such a standard reader is assumed to be interested enough in the data to carefully read the presentation and is reasonably informed on financial matters and commonly used accounting and financial terminology.\textsuperscript{43} Perhaps this assumption is invalid. Certainly more education is needed.

The "how" of disclosure is normally through means of the financial statements, either in the body or by footnotes, in supplementary schedules and reports, and in accompanying or separate narratives. The audience for financial statements, especially published annual reports, includes all segments of society. These general-purpose statements and accompanying data must meet the general needs of those segments. Certain disclosures are directed to providing more detailed information, whereas other disclosures are


\textsuperscript{43}Chetkovitch, "Standards of Disclosure and Their Development," p. 49.
designed to supplement and explain other data.\(^{44}\)

The principle of disclosure also implies the obligation on the part of the accountant to make known to statement readers the effect of alternative methods which would produce significantly different results. This is especially imperative, as was pointed out above, when the alternative has been implemented during the year.\(^{45}\) However, mere disclosure of results under another alternative should not be a means of escaping the obligation to keep the records on a sound basis; this is partly implied by the dictum: "when in doubt, disclose."

When the principle of disclosure in fact does result in information which makes the financial statements and accompanying data not misleading, the principle is thus fair to all parties. The overall fairness of the presentation, of course, is the result of all the principles and rules


\(^{45}\)Maurice E. Peloubet, "Is Further Uniformity Desirable or Possible?" The Journal of Accountancy, CXI (April, 1961), 35.
used to produce the presentation. Disclosure alone does not make the overall presentation fair to all parties, but only contributes to that fairness. The principle of disclosure, correctly applied, results in a financial presentation of the society segments' economic rights and interests. Upon this information they may formulate judgments and take action regarding their position relative to other society segments. From this we may conclude that the principle of disclosure is fair to all society segments.

**Concerning Facilitating and Reporting upon Business Operations**

Certain accepted accounting principles help to coordinate accounting and also to facilitate business operations and the reporting on business operations. The first of these that we discuss is the assumption that the purchasing power of the dollar is stable. Almost the entire business community operates on this assumption. The common denominator of accounting is the dollar; accounting has adopted the business-world assumption of its stability. The second coordinating principle discussed under this heading is the principle of objectivity--commonly thought to be the main factor in professionalizing accounting. The discussion of these two principles completes this chapter on coordinating principles of accounting.
Stable Money Unit

One of the current projects of the AICPA Division of Accounting Research is a study of the problem of price level changes. The basic premise of the project is that it is no longer realistic to ignore fluctuations in the purchasing power of the dollar.\(^4^6\)

Accountants for many years have maintained accounting records and produced financial statements based upon the premise that the purchasing power of the dollar is stable. Accountants have not been oblivious to the economic realities of the unstable dollar, but have chosen for various reasons to do nothing about recognizing price-level changes in the accounts or disclosing the effects in supplementary statements. Some of those reasons include the arguments that actual changes have been so gradual as not to materially distort the accounting results. Another: historical cost is a determinable fact; to tamper with these costs would introduce uncertainty into the accounts and confusion into their interpretation. Moreover, those who maintain

\(^4^6\)"Announcement of Research Projects" (Official Releases), The Journal of Accountancy, CXII (September, 1961), 71. This was also the premise of a major study on business income sponsored by the AICPA in the early 1950s. The Study Group was composed of accountants, lawyers, and economists. Although the Study Group appeared to favor including price-level adjustments in the financial statements, it recommended at the time that the primary income statement should be continued on bases then commonly accepted. But it encouraged the supplementing of primary reports with other reports showing the effect of price-level changes (p. 105). See the Study Group's final report: Study Group on Business Income, Changing Concepts of Business Income (New York: The Macmillan Company, 1952), 160 pp.
that accounting primarily is a tool for management accountability hold to invested (historical) costs as the most relevant amounts in judging management's handling of the resources committed to its use. Or, some feel the traditional objectivity of accounting evidence would be undermined by introducing methods which would modify the accounts to reflect the current price level.  

The effect upon accounting records and statements of the principle of stable dollar is all-pervasive. Accounting is concerned with enterprise data ultimately expressable in dollars; as such the principle affects the basis for all accounting. Moreover, this principle is reflected in other principles. Probably its greatest impact is upon principles concerning determination of net income. Closely allied is its impact upon the predominant acceptance of historical cost as the basis for asset valuation and cost allocations to various periods. The principle is also reflected in the carrying value of debts—at face amounts and unadjusted for variations in purchasing power. Owners' residual equity reflects the principle through the amounts determined for

current and past net income, assets, liabilities, and historically valued investments.

A judgment as to the fairness to all parties must be made in light of the effect of the principle upon the specific reporting situation. In the past, in periods of rising prices the general effect of the principle has been to overstate profits. Reported profits included amounts arising from managerial ability and also amounts arising from specific and general price increases. Inasmuch as these separate profits were material and were not stated, misrepresentation existed. Society segments formulated judgments and took actions based upon financial misrepresentations of their rights and interests in the enterprises; the principle produced results unfair to those segments.

Another general result of the stable dollar principle is the incomparability of successive years' financial statements, other things being equal. Inasmuch as individuals relied upon such incomparable statements as though they were in fact based on constant purchasing power, their rights and interests were misrepresented and they may have taken actions they would not have taken otherwise. Such comparisons are not fair to all society segments.

The problem of fluctuating purchasing power is perhaps the greatest one facing the profession today. Certainly we could not hope to solve it in this study. We can only hope that its unfairness will be sufficiently realized to promote further research on alternatives producing fair
results and on the means to implement those alternatives--and not the least of all, that the profession is willing to reject the stable dollar principle.

Objectivity

The principle of objectivity has meaning in two interrelated areas, objectivity in evidence and objectivity in viewpoint. The latter is normally associated with (though not limited to) the independence of the auditor. Here we shall concentrate upon the first area of objective, verifiable evidence.

Objectivity focuses upon the origin of the information which is recorded in the accounts and ultimately appears in summary form on the financial statements and supplementary reports. When accounting information and facts are verifiable by contractual or other independent evidence and have been free from personal bias in their development, those accounting data are said to be objective.\(^48\)

Since accounting is concerned with some financial aspects of economic activities, objectivity acts as a guide in determining which of the financial aspects are subject to entry into the accounting records. Moreover, the principle of objectivity helps to guide when they are entered and the

dollar amounts that are entered into the records. Objectivity is a consideration not only of value flows in and out of the accounting entity, but also of the value flows from one stage to another within the accounting unit (such as parceling out the lump sum machine cost to the products produced). Objectivity therefore has a significant effect upon the financial statements.\(^4^9\)

In his article cited above, Arnett summarized the accountant’s strict interpretation of the requirements for objective data. Thus, financial information is objective when:

1. It is free from personal opinion and bias, which further requires
   a. that there actually be an exchange of something for something, both having "value," and
      (1) this exchange be the result of an arm's length transaction between independent parties,
      (2) this exchange be capable of being accurately measurable in dollars,
      (3) that one of the negotiating parties in the exchange be the unit for which the accounting is being done.

2. It is substantiated or capable of being substantiated by an independent investigator.\(^5^0\)

Many of the normal business transactions satisfy these

\(^4^9\)Harold E. Arnett, "What Does 'Objectivity' Mean to Accountants?" *The Journal of Accountancy*, CXI (May, 1961), 64.

\(^5^0\)Ibid., p. 65.
requirements for objectivity from the accounting viewpoint. Moreover, the requirements are satisfied if a cash-equivalent price can be accurately determined by using fair market values of the item given up or received; fair market value is thus not excluded on grounds of subjectivity.

But accountants appear to question the strict requirements for objectivity in some cases. Objectivity is abandoned when its strict use is judged to distort the meaningfulness of accounting statements and reports. For example, accountants consider the arm's length transaction to be a guide rather than a requirement in determining the objectivity of data. If the data are considered useful in reflecting the accounting entity's events, the data need not be from bargained exchanges between independent parties as long as the same effect is the result. Moreover, transactions between two parties external to the accounting entity can result in objective data which are acceptable for entry into the entity records (for example, using "market" figures in valuing inventory at the lower of cost or market). Therefore, the accounting entity in some cases need not be a party to the bargained exchange; the results of the exchange are acceptable to the entity records as long as the results would have been the same as if it had been a party to the exchange.51

Flexibility in the strict interpretation of the requirements for objectivity also appears to arise from other considerations bearing upon the recording. For example, if market prices are thought to be objective data, then higher-than-cost prices are just as relevant as lower-than-cost prices. But because of the principle of conservatism, higher-than-cost values are ignored and only the lower-than-cost prices are thought to be relevant for entry into the records. Conservatism currently outweighs objectivity in other cases, such as allowing for periodic depreciation because it results in a better matching of costs against revenues; strict objectivity would not allow prorating costs over service life.52

Therefore, accounting data must still be impersonal to be objective, but "impersonal" is given a more flexible interpretation. So, apparently "... any data which are considered useful are objective to accountants, provided they are substantiated or capable of being substantiated by an independent party."53

Is the current concept of objectivity fair to all


53Arnett, "What Does 'Objectivity' Mean to Accountants?" p. 68.
parties? It seems that the relevance of the data reported is often more important to the society segments than the adherence to the strict interpretation of objectivity. Yet the data reported should still meet the tests of reliability and be capable of being verified or substantiated by other means or parties. The data are considered reliable and verifiable if sound accounting methods are used, and used consistently, and by having the data compiled and reviewed by competent authority. In this manner the statement user is in part assured that the reported data are free from personal bias even though along the way subjective decisions may have affected the objective and verifiable data.\(^{54}\)

Inasmuch as the current concept of the principle of objectivity contributes to more relevant and reliable data, it is similarly fair to all society segments. Again, objectivity alone does not make fair-to-all-parties financial statements but only contributes to the overall fairness. Personal bias is rightly eliminated, yet subjective decisions temper strict objectivity to make the accounting data more relevant in showing the society segments' relative economic rights and interests in the enterprise. With more relevant data the segments are better able to formulate judgments and take actions concerning their relative rights. In this manner the current interpretation of a "liberalized" principle of objectivity is fair to all parties.

CHAPTER VII

ACCOUNTING PRINCIPLES BASED UPON THE POSTULATE:

APPLICATION PRINCIPLES

This chapter continues the analysis begun in the previous chapter. In the previous chapter we investigated a number of "coordinating principles" of accounting selected from the body of currently generally accepted accounting principles. These coordinating principles are thought to be the traditional and fundamental accounting concepts which coordinate the various financial accounting activities into a body of practice. To these coordinating principles—currently accepted largely on the basis of usefulness—we applied the test of fairness to all society segments. This test of fairness we feel should be the basic standard (criterion) by which to judge the acceptability of principles, rules, and procedures. These subordinate propositions (principles, rules, procedures) are but means to achieving the objective of financial accounting. Any propositions not meeting the criterion of fairness to all parties, we contend, should not be accorded a place in the structure of financial accounting theory herein formulated.

The present chapter continues the analysis of certain generally accepted accounting principles. But here we
concentrate on "application principles." These principles are the "broad guides to accounting action" upon which specific rules and procedures are based. The appropriate application principle, rule, and procedure are applied to the specific set of facts for a specific accounting situation. Our investigation of these application principles centers around their meeting the test of fairness to all parties, rather than their historical development. A brief survey of the latter is essential in some cases, however, to bring into focus their fairness to all parties. That investigation comprises the first part of the chapter.

In the second part of this chapter we present an example of the use of a selected application principle. From this principle we derive the subordinate rule and procedure and comment upon their role. Then, using the basic standard of fairness to all parties, we present an example of employing the appropriate principle, rule, and procedure in a hypothetical accounting situation.

**Application Principles of Accounting**

The application principles we investigate may be conveniently divided into two sections. The first section deals with those broad principles which mainly concern the income statement.¹ We say "mainly" because the effects of

¹Some of the more technical terms of accounting which are frequently used in this chapter have not been heretofore specifically defined, such as liabilities,
any one principle are not confined solely to the income statement, but also affect in various ways other reports as well. The second section concerns application principles underlying the balance sheet. Likewise, the effects of these principles are reflected in reports other than the balance sheet.

**Principles Underlying the Income Statement**

The broad application principles underlying the income statement which we study include matching related revenues and expenses to determine periodic net income and, second, when the net income should be recognized as being earned. Third, what should be shown on the income statement, the effects of both ordinary and extraordinary events? We take these ideas in that order, formulate specific propositions (principles) concerning them, and test them against the postulate of fairness to all parties. Unless otherwise indicated, the following discussions assume a stable price level in order not to complicate the principle under review.

For convenience we will adopt those definitions set out by Sprouse and Moonitz appearing in Appendix C. In those definitions, revenues are distinguished from gains and expenses are separated from losses. The AICPA has previously defined revenues and expenses as including gains and losses. See AICPA, Accounting Research and Terminology Bulletins; Final Edition; also see American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision, pp. 5-6.
Matching Revenues and Expenses

In the previous chapter we concluded that it is appropriate and fair to account for the continuous activities of a business in discrete time intervals, normally a calendar or fiscal year. The approximations of a periodic "test reading" of enterprise position and progress are thought to be preferable to an exact determination which would be available only at the end of the business' life.

A determination of the periodic net income of a business is a determination of its progress—a reckoning of the efforts against accomplishments. Broadly speaking, efforts are the expenses and accomplishments are the revenues. An excess of revenues over the expenses is an indication of the management's effectiveness as well as a necessarily tentative indication of the firm's progress. The principle of matching revenues and expenses is the most important principle in the determination of net income.  

The matching principle usually refers to the "accrual basis" of accounting; in most writings they are considered as synonymous. The main alternative to the accrual basis is the "cash basis," which also encompasses a set of rules and procedures for matching revenues and

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expenses. Under the cash basis, in its simplest form, expenditures become expenses when paid for and receipts become revenues when collected. The resulting net income under the cash basis is little more than the increase (or decrease, if a loss) to cash. In some small businesses the cash basis is adequate and gives a fair indication of efforts and accomplishments.³

In most business situations, however, the cash basis does not give an effective and reliable measurement⁴ of efforts and accomplishments whereas the accrual basis does. The accrual basis, generally speaking, attempts to allocate revenues to the periods in which earned (regardless of when received) and to allocate expenses to the periods in which benefits are derived (regardless of when disbursed).⁵ In


⁴We hesitate to use the word "measure" (see the discussion in Chapter IV) but yield for lack of a more expressive term. It should be understood, however, that we are not using the term in the sense of an inherent ability on the part of the accounting system to place "values" on items: only people, outside the system as such, are capable of this.

⁵Another alternative is the "cash receipts basis," which is actually a hybrid of the cash and accrual bases. Revenue is recognized according to cash receipts (cash basis) and expenses are allocated to the periods benefited (accrual basis). A major use of this method is the accounting for installment sales. See William A. Paton, Advanced Accounting (New York: The Macmillan Company, 1941), pp. 444-446. Regarding the cash and accrual bases, the latter is actually an historic outgrowth of the former. The impetus to develop accrual accounting was the desire for a more realistic matching of revenues and expenses. Concerning this, Copeland said: "... I suggest that the
the following discussion all references to the principle of
matching expenses and revenues should be understood to mean
the accrual basis.

We may formulate the following proposition as the
"matching principle." "In order to determine the net income
from operations of a particular period, the costs expired
(expenses) in producing the revenue should be subtracted
from the revenue earned during the period." Or, put more
simply: "Income is measured by matching revenues earned
against costs consumed."\(^6\)

\(^6\)Dilley, "An American Viewpoint on Accounting Con-
cepts," p. 544. The latter definition assumes a broad
concept of revenues (i.e., including gains not from opera-
tions) and a broad concept of costs consumed (i.e., includ-
ing expenses outside regular operations—losses). The first
definition excludes gains and losses in producing net income
from operations; matching revenues, expenses, gains and
losses would give overall net income. Since the first
formulation follows the definitions being used here, the
following discussion relates to that definition. Under the
definitions used here, in the income statement would appear
the following broad categories (subject to the qualifica-
tions on gains and losses discussed in the "Separating
Ordinary from Unusual Items" below). See also footnotes 29
and 31 below. Grady states the principle in the following
manner:

"A-2. Costs of sales and expenses should be
These statements do not say what income is (except that it is a residual amount), nor do they say how to determine the proper period to which to allocate revenues and expenses. The statements, however, do imply subsidiary propositions concerning the elements of revenue, expense, and income. Without putting these subsidiary propositions in propositional form at this time, we may distinguish the following considerations implied by the statements above:

Concerning revenue:

(1) Timing: What type of event signals that revenue can be recognized as having been realized?

(2) Amount: How to determine the money amounts associated with the event signaling revenue recognition?

Concerning expenses:

(3) Timing: What type of event signals that costs have been consumed or have expired?

appropriately matched against the periodic sales and revenues. It follows that there must be proper cutoff accounting for inventories and liabilities for costs and expenses at the beginning and end of the period or periods.

A-3. Appropriate charges should be made for depreciation and depletion of fixed assets and amortization of other deferred costs. A-4. Proper distribution of costs should be made as between fixed assets, inventories, maintenance and expense. Direct costs are usually identifiable and common costs applicable to more than one activity should be distributed on appropriate cost incurrence bases such as time or use factors." Paul Grady, "The Quest for Accounting Principles," The Journal of Accountancy, CXIII (May, 1962), 47-48.
(4) **Amount:** How to determine the money amounts associated with the event signaling cost expiration?

If income is to be considered a residual amount after matching revenues and expenses (in effect, a net revenue), then we may distinguish the following considerations concerning income:

(5) **Timing:** What type of event signals that income can be recognized as having been realized?

(6) **Amount:** How to determine the money amounts associated with the event signaling income recognition?

One further consideration we might mention at this point:

(7) Should net income be determined by matching against revenues both operating expenses and losses or only operating expenses? What about gains—should they affect net income?

Each of these seven considerations must be answered and tested against the fairness standard before we can judge the overall fairness of the matching principle. Actually, each of the considerations has in practice been formulated into statements themselves having the status of accepted accounting principles. We should, therefore, test each principle separately as to its contributing to the fairness of the overall presentation. But space does not permit our

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analyzing all of them; instead we will concentrate upon those more difficult considerations which coincidentally dominate current discussions. These are numbers (1), (4), (5), and (7).

Numbers (1) and (5) may be treated together, in a sense. Because net income can be considered as the net revenue after matching revenues and expenses, the event which signals that income has been earned also signals when revenue has been earned. Surely net income does not arise only with the calculation of subtracting expenses from revenues. Therefore, what is discussed in the following section on the timing of income realization also applies to the related problem of the timing of revenue realization.

The problem of allocating expired costs (number 4) to the appropriate periods is perhaps the most perplexing and debated problem in current accounting theory and practice. The problem revolves around using the historical cost as the basis for asset valuations and assigning the expired assets (expenses) to the appropriate periods. This phase of revenue-expense matching will be discussed in a later section of this chapter.

Consideration number (7) above involves the nature of net income. Should net income and therefore the income statement reflect only current operating revenues and expenses? Or should the net income figure reflect all ordinary and extraordinary items of revenue, expense, gain, and loss? This aspect of income is also discussed in a
Later section of this chapter.

Let us assume for the moment that the principles concerning the timing and amount of the revenue and expense elements of the matching principle do in fact meet the test of fairness to all parties. If this be so, does the matching principle itself meet the criterion of fairness to all society segments? Before attempting an answer to this, to place the question in perspective a few words are in order about revenue, expense, and income generally.

It seems the whole problem of determining periodic net income has its roots in the fact of the future's uncertainty. The results of current business decisions lie in the future, and until all the results are known, net income can only be estimated. Moreover, the continuing nature of business decisions further complicates the problem by intermingling the results in any particular period. As the result of this uncertainty the accountant has come to rely on principles of disclosure, consistency, and objective evidence (among others) in his periodic matching of revenue and expense in order to estimate income.\(^8\)

Nevertheless, estimating income still involves relating revenues to cash receipt and expenses to cash disbursements—in short, relating income to cash movements. Generally speaking, the total cash received from operations

during the business' life is equal to total revenue; likewise, total cash payments during its life equals total expense. To pick out a particular interval within the life, however, makes the accountant's problem one of reconciling cash receipts with earned revenues and cash disbursements with current expenses. For every cash receipt not appropriately allocated as revenue to the current period, that receipt represents an obligation to give future services; therefore, a liability must be recorded. Likewise, for every cash payment not appropriately allocated as expense of the current period, that payment represents the right to receive future services; therefore, an asset must be recorded. Conversely, for every expense properly recorded but not paid for in cash during the current period, a liability of equal value must be recorded (or an asset reduced). 

Should revenues be matched against expenses, or expenses against revenues? Actually, either way; one thing certain, however, is that they could not be assigned to particular periods totally independent of one another. Either revenue or expense must be considered the prime

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factor and the other then associated (or matched) with it. Cost outlays are considered to be made for the service potential of the right acquired. Moreover, the service potential is acquired for its ability to produce revenue. Revenues (generally, sales) are the accomplishments; service potentials expired are the efforts. The effort expended, therefore, is usually considered to be matched against the accomplishments produced. Accountants thus hold revenue to be the controlling factor. Revenues are assigned to the appropriate periods first, then the expenses which produced the current revenues are matched against them to compute current net income. The expenses associated with revenues assigned to future periods are actually "prepaid" and therefore have an asset status. That is, revenues and expenses allocated to future periods do not enter into current income, but will do so in the periods to which they were allocated. For example, inventory is purchased for resale. That inventory which is sold becomes the current expense to be matched against the sales price; the unsold inventory is therefore allocated to future periods and is thus considered an asset.

Now to return to the question deferred. Is the matching principle fair to all parties, assuming all the subsidiary propositions as set out above to be fair to all parties? To say it another way, only the fact of periodic income determination is under scrutiny at this point. The particular amount of income attained is governed by other
principles which in turn must meet the fairness test.

The matching principle produces an estimated net income figure because, as we said, only at the end of the business' life can the total net income be calculated with any degree of accuracy. But in spite of its tentativeness, the society segments have come to rely upon such periodic income estimations as an indication of the progress of the enterprise.

Periodic income determinations are fair to the stockholder segment because the net income figure is an indication of the increase of their rights and interests in the firm. The reported net income is an indication of the amount the stockholder may expect to be paid in dividends, considering expectations, conditions, past dividend policy, accumulated retained earnings, and the like. Also, income is a factor in the stockholder's decisions concerning his position relative to others in the stockholder segment and to other segments. Based upon his judgment about the adequacy of income and/or dividends from income, the stockholder may take action to increase or decrease his holdings. There are many forces at work, of course--economic, social, political, psychological--but reported income is an important factor helping to shape these forces. The stockholder formulates judgments about the adequacy of profits in relation to the resources that management had to work with, and also his own contribution to these resources. Moreover, reported profits have a significant effect upon the market
value of his stock holdings which, again, indicates his economic rights and interests in the firm. Also, reported net income is an important gauge of the overall effectiveness of management as the trustee of the stockholder's funds. Inasmuch as reported net income provides these and other indications of the firm's progress, the matching principle is fair to stockholder segment.  

The matching principle is likewise fair to the management segment of society. As noted above, reported net income indicates the effectiveness of management and therefore indicates their individual rights and interests in the firm. Their continued association with the firm is based upon their ability to meet the enterprise's objectives, not the least of which is an adequate net income. Income is also a good indicator of management's ability to meet the socially oriented goals of the enterprise. Sustained adequate income confirms their meeting these goals. Management has a right, therefore, to periodic net income estimates as a basis for judgments about their relative position and future connections with the firm.  

Employees likewise have a vital interest in reported


net income. Their individual job security depends upon net income being produced. Employees, of course, are concerned with the possibility of higher wages and improved working conditions. They are concerned with the future progress of the firm and their sharing in that progress. Profit margins reflect consumer acceptance of the firm's products and of competition from other firms. Through reported income amounts, the labor segment is able to formulate judgments concerning their economic rights and interests in the firm and its income, and take actions in that regard to better their position and enhance their rights. The matching principle, thus, is fair to the labor segment.

Creditors have come to look upon net income as their best indicator of the ability of the firm to meet its future obligations. Reported income is evidence of earning power and solvency, and judgments about future earning power and present solvency are a prime basis for decisions to lend money or to extend credit for purchases of materials, supplies, acquisitions, and expansion generally. Bondholders are especially interested in net income because of their preferred status for interest payments. Inasmuch as net income is calculated and is a financial representation of the creditors' rights and interests in the firm, upon which

they may make decisions regarding those interests, the matching principle is fair to the creditor segment.

Customers and the general public are interested in reported profit, also, from the viewpoint of the whole society's progress and welfare. Reported income indicates the fairness of management policies concerning pricing products and public relations. An adequate profit is a gauge of the firm's contribution to the national product and its productive capacity. Enterprise profit also helps to allocate the national resources into and out of firms and industries depending in large measure upon the reported income. Customers and the general public have such economic rights and interests in the firm's progress; that the reported profit is a representation of these interests, the matching principle is fair to those segments.13

The government segment looks to enterprise income as a major source of its taxation revenues. Normally the taxable income is calculated differently than accounting net income; nevertheless, the accounting net income indicates the government's interest in the firm's operations as a source of revenue. Reported profits serve other purposes connected with the government interest, of course, such as being the basis for rate regulations or calculations, or to

judge compliance with certain laws, to name only two of the most obvious. The matching principle is fair to the government segment, therefore, because it permits certain judgments and actions to be taken concerning its rights and interests in the firm.

The principle of matching revenues and expenses to produce a periodic net income amount, therefore, is fair to all parties and helps to achieve the financial accounting objective by communicating data which gives in part a financial representation of the relative economic rights and interests of the economy segments, in order that they may formulate judgments and take actions thereupon.

**Income Realization Timing**

As we pointed out above, recognizing the time that income is realized\(^\text{14}\) is one facet of the overall problem of

\(^{14}\) We select "realized" here instead of "earned" on the basis of majority usage. The two words, especially the former, are used inconsistently and in different ways in various situations in accounting terminology. The 1957 Revision gives the following definition of "realization," which we will adopt for our discussion here: "The essential meaning of realization is that a change in an asset or liability [thus evidencing revenue and income] has become sufficiently definite and objective to warrant recognition in the accounts. This recognition may rest on an exchange transaction between independent parties, or on established trade practices, or on the terms of a contract performance of which is considered to be virtually certain. It may depend on the stability of a banking system, the enforceability of commercial agreements, or the ability of a highly organized market to facilitate the conversion of an asset into another form." For an explanation of the various ways that accountants use the concept of "realization," see Floyd W. Windal, "The Accounting Concept of Realization," *The Accounting Review*, XXXVI (April, 1961), 249-251.
matching revenues and expenses to determine the periodic net income. Accountants generally agree that the income is attributable to (or, earned over) the entire process of business activity. But, depending upon the situation, accountants recognize that income is realized either over a time segment in the entire process of business activity or at a specific time point within the entire process of business activity.

The concept of realization—whether applied to revenues, expenses, gains, losses, income, assets, or liabilities—is a concept of the timing of some event. In the normal course of business operations, transactions are continually occurring. But within each of these transactions we may distinguish a cycle of events or activities. There are at least six significant activities within each

15 Because the concept of realization is so broad we limit our discussion here to income derived from normal operations, thus excluding nonoperating transactions involving gains and losses (however, the same analysis would also apply to the latter, in general).


transaction cycle and therefore six different views as to when income is realized. These views are:

1) throughout the complete transaction cycle, from acquisition of production facilities to fulfilling product warranties;

2) throughout the production process equally;

3) at the times when the production stages are completed;

4) at the time when production is totally completed;

5) at the time when the sale is made (or at delivery, or when legal title passes);

6) at the time of collection (or when a legal claim arises, if different from number 5).

As indicated above, these activities may be further categorized into activities which occur over a time period (numbers 1 and 2), and into activities occurring at a specific time point (numbers 3 through 6). The vital question is: Of all these activities within the transaction cycle, which activity should signal that income has been realized?

No one activity (to the exclusion of the other five) has been agreed upon by accountants. Generally speaking, it appears accountants have chosen from among the alternative realization views that one which best suited the situation, given certain criteria for "best suited." In any particular business there usually can be selected (even if arbitrarily) that event or activity which appears critical (or necessary) to the complete transaction cycle. Thus the "critical
event\textsuperscript{18} or "significant activity" theory has been developed to explain the point of income realization. Depending upon the particular business situation, then, income would warrant recognition in the accounts at (or over) the time of the most significant activity.

For most businesses the sale is the critical event of the transaction cycle. As a consequence accountants have extended the realization-at-sale concept to be the general case, and speak in terms of "exceptions to the general rule" for situations warranting profit recognition at other points in the transaction cycle.\textsuperscript{19} Some "departures from the sale basis" which are generally accepted recognize profit as realized at points either before or after the sale—the sale having become the focal point.

The "production basis" (alternatives 2, 3, 4 above) is used in certain cases meeting the criteria for realization and therefore warranting the recognition of income in the accounts. Alternative (2) is used in the production of gold and silver; for recording conveniences, however, alternative (4) is normally followed. These products are highly marketable at a guaranteed price and no formal selling effort is needed. When the product reaches disposable form,


\textsuperscript{19} See American Institute of Certified Public Accountants, \textit{Accounting Research Bulletins}, p. 11.
therefore, profit is as good as realized and is recorded as such. The income realization of other basic metals normally follows the sales basis rather than the production basis because the same circumstances of guaranteeability do not surround their production. The same analysis generally applies to agricultural products; although some guarantees exist, the sales basis is considered preferable.

The income from long-term construction contracts normally is realized on a production basis, under either alternatives (3) or (4) depending upon the situation. If income realization is deferred until the contract is completed, in effect the sales basis is being used, since upon completion the title passes after little or no time lag. So the only real departure from the sales basis on long-term construction contracts is when income is realized according to various stages of completion (alternative 3). Here the critical event is production of the structure, rather than the formality of the original contract or title passage. As each stage is completed a portion of the contract price is billed, making income sufficiently certain to warrant recognition in the accounts.

Recording income under alternative (4) for long-term construction contracts is usually required when uncertainty exists in significant areas. For example, the total cost may be very hard to accurately estimate; or costs incurred may vary significantly from stages of completion, thereby eliminating the basis for billing. In these cases
accountants feel that recording income on a completed job basis is preferable to other alternatives.

After-the-sale income recognition (alternative 6) is normally justified in situations where title passes upon the final collection or where the uncertainty of collection is high. An installment sale is the typical example. Here, income is realized pro rata over the period of collection. Collection becomes the critical event.\(^{20}\)

The biggest problem concerning realization—one continually discussed—is that of appreciation in value. Should increases in asset values be recognized as realized income? Accountants generally say no. The current concept of realization says that an unrealized increase in asset value may not enter into the computation of net income. For some asset items (e.g., marketable securities, inventories) current value may be relatively certain and objective. Conservatism is the overpowering force, however, which usually outweighs the realization principle.

The realization of income principle, therefore, encompasses the selection of the most significant activity within the transaction cycle as the pertinent point at which to recognize in the accounts that income has been realized. The selection of the most significant event is usually rationalized, its selection being based upon certain criteria surrounding the income realization. What are these criteria?

A clue to the criteria of realization is given in the American Accounting Association definition cited above: "a change in an asset or liability has become significantly definite and objective to warrant recognition in the accounts." In the discussion above we have alluded to the related criteria of certainty and measurability.

For an item to be sufficiently objective it must not be subject to different interpretations by different people. The item must appear substantially the same to all accountants inspecting it. If the quality of measurability exists, if the item can be measured with reasonable accuracy by various people, then objectivity is largely assured. This assurance of objectivity exists in spite of certain subjective decisions which may enter into the measurement. Objectivity is not destroyed because those decisions by various people are similar, being based on similar interpretations of the item by the decision-makers.

21 See footnote number 14 of this chapter.
The second criterion of certainty relates to the definiteness or permanence of the change. The change must appear unlikely to be reversed in some way in the future. The accountant's judgment must enter here regarding certainty, as it also does with objectivity.22 Combining the criteria for recognizing the change with the item changed, we have the overall test for realization of income:

1. The monetary amount of the income can be definitely determined or can be estimated with a reasonable degree of accuracy.

2. One of the following is true:

   a. An exchange transaction has taken place with an independent, outside party and
      (1) Cash or marketable securities have been received in the amount of the increase or
      (2) In the accountant's judgment, the completion of the transaction is virtually certain.

   b. A contract or commercial agreement has been entered into, and the service related to that contract or agreement has been utilized.

   c. The enterprise has been legally relieved of some of its liabilities.

   d. In the accountant's judgment, it is

22These criteria of measurability and permanence were adapted from Windal, The Accounting Concept of Realization, pp. 75-76; see also the criteria of certainty and objectivity which are discussed in Myers, "The Critical Event and Recognition of Net Profit," pp. 528-532.
a virtual impossibility that an asset increase will be reversed.\textsuperscript{23}

Reflecting upon these criteria we can readily see why accountants do not accept the first two views presented above as to when income is realized.\textsuperscript{24} The changes in the item throughout the production and transaction process are indeed real, but the utility value added is not sufficiently definite nor can it be objectively measured accurately enough to satisfy the accountant.

Such, then, is the current principle of income realization. Is it too strict to produce results fair to all society segments? It would seem that the principle produces income results which similarly affect all society segments.

The argument of the realization principle is that until the most significant activity takes place and certain criteria of definiteness and objectivity are met, income should not be regarded as realized. In these cases the amount of income is sufficiently indeterminate to preclude

\textsuperscript{23}Windal, "The Accounting Concept of Realization," p. 256. The author applies these criteria to revenue and income. The only change the present writer would suggest would be in 2a(1), to read "cash or other valid assets..."; see Paton and Littleton, \textit{op. cit.}, p. 46. Cf. the tests in Sprouse and Moonitz, "Broad Accounting Principles," pp. 14-15.

\textsuperscript{24}Generally, economists hold that income is earned and realized according to the first two alternatives, i.e., throughout the complete transaction cycle or throughout the production process equally. Obviously the difference in the accountant's and economist's views lies in what each means by "realized." See the related discussions in Bedford, "Accounting Measurements of Economic Concepts," pp. 58-60; and Windal, \textit{The Accounting Concept of Realization}, pp. 8-20.
making reasonably accurate estimates of it. Just where to draw the line is a matter of judgment.

As a practical matter, approximations may be made (however accurate) to show that the bulk of the income was earned in a period other than that of realization. From the vantage point of hindsight this is true; looking at it from the other direction is entirely different--the realization may never take place. Thacker correctly pointed out\(^25\) that the period in which the cost efforts actually produced the income appeared to be immaterial. Persons interested in enterprise earning power, he concluded, are primarily interested in the precise timing of revenue and income recognition, rather than in a principle which assumes the precise timing to be insignificant. These arguments cannot be denied. The question reduces itself to this: Is an approximate income figure during the period when the change in value takes place more useful--and more fair--than a figure bearing a greater degree of definiteness and objectivity recognized at a later date.\(^26\)

At the present stage of accounting development the income realization principle produces results which cannot be considered unfair to the society segments, in our


judgment. We feel, however, that there is room for great improvement in techniques of utility value added measurement. When these techniques are produced and a new principle of income realization formulated, they should be subjected to the same test of fairness to all parties. If it is judged to produce results fairer than the current principle produces, the new principle should replace the current concept. In the meantime, perhaps supplementary reports could show approximations of unrealized profit, adequately spelling out the assumptions under which the approximations were derived. Such presentation would probably increase the utility of the general-purpose statements to the user of those statements and enable him to obtain a better picture of his relative economic rights and interests in the enterprise.

Another alternative would be to devise methods which would allow the change in value to be reflected in the asset or liability, but not to affect current income. The corresponding adjustment would be directly to an equity adjustment account so labeled in the owners' equity section of the statement. But since it is beyond the present scope to develop and test alternatives to currently accepted practices, we will not pursue the point further.

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27 See Sprouse and Moonitz, op. cit., pp. 42-44, for a similar proposal. This suggestion has been made for many years by various writers; for example, see Alfred Grey, "'One Economy' Concept of Financial Accounting and Reporting," The Accounting Review, XXVII (January, 1952), 121; and Paton, "Recent and Prospective Developments in Accounting Theory," pp. 129-130.
Separating Ordinary from Unusual Items

In discussing the validity of matching expired costs (expenses) against earned revenues, we pointed out that a causal relationship was presumed to exist between those two factors. Moreover, accountants presume that revenues and expenses occur in a regular pattern through normal business operations. Perhaps most important of all, they assume the revenues and expenses can be determined with a reasonable degree of accuracy.

Certain events occur, however, which seem to have no causal relationship to current operations and which are usually nonrecurring, yet affecting the financial health of the firm to an extent which can be measured relatively accurately. Typical events not coming within the normal revenue-expense matching process, and therefore are "extraordinary," include fire losses, gain or loss from sale of capital assets, corrections of prior period errors, or an advantageous settlement of liabilities.28

An important question is: Should these extraordinary events be included or excluded from the calculation of current net income?

28Backer, "Determination and Measurement of Business Income by Accountants," p. 244. See also Gilman, Accounting Concepts of Profit, pp. 132-133. The AICPA defines "extraordinary," as used above in the following manner: "... items which in the aggregate are material in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period." American Institute of Certified Public Accountants, Accounting Research Bulletins, p. 63.
As the question suggests, there are two opposing general views concerning its answer. One view (the "all-inclusive" concept) holds that all items of gain and loss and prior years' corrections should be included in the computation of net income.\(^{29}\) The opposing view (the "current operating" concept) holds that "all items of profit and loss recognized during the period are to be used in determining the figure reported as net income," except that there will be excluded items meeting two tests, (1) "items which in the aggregate are material in relation to the company's net income" and (2) "are clearly not identifiable with or do not result from the usual or typical business operations of the

\(^{29}\)Referring to the income statement outline in footnote number 6 above, the item "net income" would therefore include extraordinary items. This generalization may not be representative. In its 1957 Revision, the American Accounting Association made the distinction between "net income to shareholders" and "enterprise net income" in the following paragraphs:

"The realized net income of an enterprise measures the effectiveness as an operating unit and is the change in its net assets arising out of (a) the excess or deficiency of revenue compared with related expired cost and (b) other gains or losses to the enterprise from sales, exchanges, or other conversions of assets. Interest charges, income taxes, and true profit-sharing distributions are not determinants of enterprise net income.

"In determining net income to shareholders, however, interest charges, income taxes, profit-sharing distributions, and credits or charges arising from such events as forgiveness of indebtedness and contributions are properly included. . . ." (P.S.) In its earlier statements no such distinction was made. In our opinion the basic all-inclusive concept has not been abandoned by this distinction. For further comments, see Staubus, "Comments on ibid.," pp. 19-21; and Mautz, "1957 Statement of Accounting and Reporting Standards," p. 552.
Thus, such extraordinary items would be excluded from the net income computation (i.e., increase or reduce retained earnings directly) when their inclusion in the net income figure would impair its significance so that misleading inferences might be drawn from that figure.\textsuperscript{31}

At the present time there appears to be a sort of stalemate between the opposing camps. One's arguments are pitted against the other's. There can probably be no reconciliation between the two until there is a compromise of each's view as to what, fundamentally, is (or should be) the nature of "net income" and the purpose of the income statement.

Proponents of the all-inclusive concept see the income statement as a historical report and as such should be a complete history of what happened within the year. On the other hand, current operating performance proponents see the income statement as disclosing ordinary income attributable to a particular period, and therefore an indicator of the earning capacity of the firm. Thus in the latter's view, the chief utility of the income statement lies not in its historical nature but as an aid to estimating future

\textsuperscript{30}American Institute of Certified Public Accountants, \textit{Accounting Research Bulletins}, p. 63.

\textsuperscript{31}Ibid. Thus, again referring to footnote number 6 above, the categories of "gains" and "losses" would include nonoperating items judged not extraordinary enough to be excluded from the net income computation.
income. Their opposing arguments ultimately can be traced to this fundamental distinction.

We may summarize the opposing arguments in the following manner: Advocates of the all-inclusive concept argue that:

(1) mere size, unusualness, or timing should not be allowed to change what would otherwise be an item of revenue, expense, gain, or loss into something else;


(2) the sum of reported net incomes for a series of years should be the aggregate net income for those years;

(3) charging retained earnings with certain gains and losses implies nonrecurrence; in fact, business history reveals that they do recur and that over the years the losses have exceeded the gains, thus the current operating concept would have exaggerated enterprise earning power;

(4) often it is a matter of opinion as to whether an item is operating or extraordinary; this causes inconsistent treatment of like items within the business and between businesses. Moreover, earnings per share may vary widely because of such inconsistencies;

(5) some so-called extraordinary items are closely related to operations of a series of years; permitting corrections or other adjustments to retained earnings creates an opportunity for manipulation in computing net income;

(6) many statement users are not aware that, under the current operating concept, they must go to the retained earnings statement to get the remainder of the story on events occurring in the year reported upon.

Conversely, the proponents of the current operating concept hold that the income statement should show revenue and expense items applicable to the regular operations of the current period. Their arguments to support their position are along the following lines:

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34 Stans, in "Modernizing the Income Statement," p. 7, reports that "in one company the earnings per share for one particular year could have been reported as either $2.86, $3.11, $3.87, $3.90, $4.12, $4.15, $4.91, and $5.16, depending upon whether certain items were considered to be material or distortive."
(1) Net income from normal operations during the year is the most important of all the figures on the income statement. Although only one of numerous figures to be considered in judging earning power, the net income should reflect what happened during the year as a result of normal operating transactions. Including only normal items makes trend comparisons easier and more valid for one company and between companies.

(2) Distortion of the reported net income results under the all-inclusive concept if material corrections are allowed to affect the current income calculation. Moreover, the distortion is in the opposite direction of the original error, which presumably distorted some prior year's reported net income. Trend indications are therefore misleading.

(3) Management and accountants are better able to judge what is ordinary or extraordinary, granting the difficulty of such a determination. Under the all-inclusive concept the reader is left to his own devices to judge the extraordinary and nonrecurring nature of the item in determining what is attributable to normal operations.

(4) The disclosure of all material extraneous and extraordinary items and corrections should be full, but made in such a way as to avoid any possible distortion and confusion on the reader's part concerning regular operations of the firm during the year.

Which view is followed in current practice? In its Bulletin 43, the AICPA Committee on Accounting Procedure reiterated an earlier bulletin which supported the current operating concept of net income and the income statement.35

A prominent practitioner summed up the prevailing practice

35See footnote number 30 above and the accompanying text.
in the following paragraphs:

A-5. Nonrecurring and extraordinary gains and losses should be shown separately from the ordinary and usual operations.

A-6. There is a strong presumption that all gains and losses will be included in periodic income statements unless they are of such magnitude in relation to revenues and expenses from regular operations as to cause the statements to be misleading.

Does this practice help to produce results that are a financial representation of the relative economic rights and interests in the enterprise of the society segments? Further, are the results fair to all segments?

Our analysis would be similar to that presented above for matching revenues and expenses, coupled with the arguments given above in support of the opposing views; these ideas need not be repeated in detail here. Generally, the income statement must be meaningful and useful to the individual. The emphasis, then, should be on the content of the statement; preferably the final figure should be a representation of the normal operating results for the period. Necessarily there must be judgment (depending upon the circumstances) as to the nature and materiality of the item in question. The materiality of the extraordinary item must be judged in view of the complete income statement rather than the final figure alone, for all the operating

results may have occurred under abnormal conditions during the year. As pointed out above, a single year's net income figure does not in itself indicate earning capacity. This judgment must be the product of a study of the items in a number of years' income statements.37

Advancing the current operating concept's case for fairness, in our opinion, is the fact that there is full disclosure of all extraordinary items in a way in which distortion is eliminated (granting that this relies upon judgment). We feel that the net income figure which excludes material extraordinary items results in a more meaningful interpretation of the individual's rights and interests in the firm. Likewise we feel such a presentation avoids confusion on the part of the reader, to the greatest extent possible.

Our answer, then, is a "yes" to the first question above relating to the principle's meeting the accounting objective. On the second question concerning the fairness of the principle, we conclude from the discussion above that the current operating concept produces results which are not unfair to all parties. Consciously using the concept to manipulate the figures to the desired net income result would, of course, be unfair to all sectors of the economy, since those results are a misrepresentation of the sectors' rights and interests.

37See the discussion on "Significance of Net Income" in Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession, pp. 27-32.
interests in the firm.

**Principles Underlying the Balance Sheet**

In the section above we discussed some of the broad application principles underlying the income statement. These included principles involving matching revenues and expenses, when net income is considered as realized, and the exclusion of extraordinary items from the net income computation.

We continue our discussion of certain broad application principles, now turning to those underlying the balance sheet. Concerning the balance sheet, Brasseaux pointed out that:

> The balance sheet has evolved to include an array of unexpired costs, monetary resources, and liquidation-valued assets and these are equated with maturity-valued claims, original owner investment and retained earnings. The statement does not represent nor is intended to represent the sum total of invested costs, nor the present market or reproduction value of the resources, nor the value of the enterprise in case of liquidation. The assets admitted for balance sheet purposes contain rather a variety of items whose values have been determined by means of various assumptions and objectives. . . . Liability claims, i.e., generally those with definite maturity date, are stated usually at maturity value. Residual ownership interests are stated partially at legal amount invested and partially at the amount of accumulation of computed income which has been retained since inception. 38

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This passage suggests a number of broad application principles underlying the balance sheet and its elements of assets, liabilities, and owners' equity. Likewise, within each element we can distinguish a number of principles. Because each of these balance sheet elements has many facets whose effects are far-reaching, we will be able to concentrate in the discussions below only on certain selected principles underlying two elements. The first concerns assets and their valuation; the second involves liabilities. Fairness to all parties remains our basic standard for acceptance of the principles.

**Assets Recorded at Cost and Allocated to Periods Benefitted**

In its 1957 Revision, the American Accounting Association distinguished between monetary assets and nonmonetary assets. Concerning the former, it said:

Monetary assets—cash or claims to cash—should be expressed in terms of expected cash receipts adjusted for collection delay where significant. Other claims to cash may require adjustment to measure current realizable amounts. In every case, however, the amount of monetary assets should be based on discernible, measurable, and reasonably certain collection and availability of cash.

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39 For a substantial list of principles underlying assets, liabilities, and owners' equity elements, see Grady, "The Quest for Accounting Principles," pp. 48-49.

Nonmonetary assets, however, have other bases of valuation. It is to this nonmonetary group of assets that the following discussion relates. Further, the heading of this section—assets recorded at cost and allocated to periods benefitted—in common usage is the greater part of the "cost principle"; we shall adopt this latter terminology for convenience in reference.

The cost principle has been stated by Pyle and White to encompass the following:

1. All assets and services acquired by a business enterprise are measured at date of acquisition by the cost incurred to secure the asset (or service) and place it in position or condition for business use.

2. Costs incurred are measured by the amounts invested on a cash or cash-equivalent basis. If the consideration given for the particular asset is cash, the measure of cost incurred is the entire amount of the cash outlay made to secure the asset and get it ready for use. If the consideration given was other than cash, the measure of the consideration is the cash-equivalent value of the consideration, or the fair value (on a cash-equivalent basis) of the thing received, whichever is the more clearly evident.

3. Costs incurred should be so classified as to facilitate subsequent accounting for these costs.

4. For each accounting period the amount of costs absorbed in producing revenue or otherwise expired, should be determined and deducted from revenue in the determination of net income for the period.41

41 Pyle and White, Fundamental Accounting Principles, pp. 724-725. In addition to historical cost's generally
In their more compact version of the cost principle, Finney and Miller embody essentially the same concepts as are in the two quotations above:

Subject to generally recognized exceptions, and excluding cash and receivables, cost is the proper basis of accounting for assets and expenses, and accounting records should reflect acquisition costs and the transformation, flow, and expiration of these costs.\(^2\)

Thus, the cost principle bears upon "cost outlays" in four stages or forms: acquisition, conversion, expired, and unexpired. First, cost is the monetary expression of the properties and services acquired in external exchange underlying asset valuation, it can also be extended in concept to liabilities and owners' equity accounts, as in the following: "Assets ... [generally, as in the quotation above]; liabilities representing the receipt of cash or its equivalent should be carried in the statements at the amount of the proceeds, with adjustments of discount or premium from period to period to reflect the approach to maturity; stockholders' equity should be carried at the amounts paid in by stockholders or contributed by others plus or minus the cumulative results of operations and distributions."

Henry T. Chamberlain, "Accepted Accounting Principles," in Ohio State University, College of Commerce and Administration, Proceedings of the Fourth Annual Institute on Accounting (Columbus: Ohio State University, 1941), p. 4. Actually, these applications of the cost principle to liabilities and owners' equities are but the other side of the asset valuation coin as expressed in numbers (1) and (4) in the quotation above. However, this serves to point out the all-pervasive nature of the cost principle. See also Paton and Littleton, op. cit., pp. 37-43.

\(^2\) Finney and Miller, Principles of Accounting--Intermediate, p. 169. Regarding the exceptions mentioned, probably the most noteworthy is the inventory valuation rule of "lower of cost or market." A departure from cost is justified in the case where the utility of the goods is no longer as great as its cost. See AICPA, Accounting Research Bulletins, chapter 4, and the related discussion in Sprouse and Moonitz, op. cit., pp. 30-32. See also the section on conservatism in our previous chapter.
transactions. Second, these properties and services may be combined to produce new forms; the costs of the combined factors thus attach to the new forms. Third, the properties and services acquired are left in their original state or their converted form, but whatever their form, they expire either in the current period or in a future period. Those costs that expire in the current period, whether producing revenue (an expense) or deriving no benefit (a loss), become part of the net income calculation (assuming them to be not distortive) and are shown on the income statement. Fourth, those properties and services expiring in a future period (that is, expected to produce revenues in a future period) currently have asset status and thus are shown on the balance sheet.\footnote{See American Accounting Association, "Report of the Committee on Management Accounting," pp. 528-529; and A.A.A., Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision, pp. 4-5, 6; Paton and Littleton, op. cit., pp. 13-14; 24-45, 66-68; William A. Paton, "Cost and Value in Accounting," The Journal of Accountancy, LXXXI (March, 1946), 192-199; ATCPA Research Department, "Corporate Accounting Principles," The Journal of Accountancy, LXXX (October, 1945), 259-266.}
depreciation thereon, and that current costs are irrelevant. The matching principle pits revenues against expenses, but of itself does not specify the make-up of the expenses in terms of current or historical cost figures. Some expenses may represent current costs (e.g., wages) whereas other expenses may represent currently expiring historical costs (e.g., depreciation).

In spite of the apparent relation of the going concern and matching principles to the cost principle, the actual basis for the almost exclusive use of historical costs in the accounts is the income realization principle. The income realization principle maintains (generally) that only income which has been realized in the current period may be included in and reported as net income for the period. Thus appreciation in value is ignored as long as it remains unrealized; historical cost becomes the basis for income calculation. Historical cost, then, applies to inventories as well as other assets; only the latter was ostensibly included under the going concern concept. Therefore, until the nonmonetary assets are allocated to the periods benefitted, they are deferred historical cost items having no relation to current costs. An additional argument is the practical expediency of carrying forward unexpired costs on the books from period to period, without adjustment, until they are allocated to a particular period.44

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44Engelmann, "In Search of an Accounting Philosophy," p. 389; Broad, "Applicability of Generally Accepted..."
Therefore, the problem of asset valuation cannot be separated from the problem of expense determination for net income calculation, and the realization principle demands that historical cost be used for both phases of the cost outlay.

How do accountants know when an asset has changed to an expense? As we noted above, expenses are incurred for the purpose of generating revenue. Revenue generated in a certain period would thus have matched against it the expense bringing about that revenue. For example, the cost of the product sold is matched against the revenue generated by its sale. Usually, however, there is not such a direct relationship between specific expenses (expiring costs) and revenues generated. If a direct relationship cannot be established, the cost is considered to become expired when the service potential inherent in the cost is "used up" and thus contributes toward earning the revenue in general.

Cost expirations may thus be classified into two broad categories, "product" costs and "period" costs. The former includes those cost expirations relating to the


Besides product and period costs other classifications may be noted, such as direct and indirect, variable and fixed. Although normally these have their own definitions and overlap in certain areas, we may consider them as synonymous for our purposes here.
product being produced and sold, and consequently being directly affected by the volume of business activity. The category of period costs includes those cost expirations related to time, rather than to business activity. Within each category those costs expiring which generate no revenue are called a loss, and those generating revenue are called an expense.

Generally speaking, probably the most significant item within the product expense category is that of cost of goods sold; in the period expense category, most significant usually is depreciation. It should be noted at this point, therefore, that the various methods for valuing cost of goods sold for income determination purposes (LIFO, FIFO, average, etc.), and that the various depreciation methods of allocating costs of fixed assets (straight line, sum of the years' digits, declining balance, etc.) are in effect alternative rules by which to apply the cost expiration phase of the cost principle. Since they are rules, they are outside our present scope, which is to investigate the broad principles. We should emphasize, however, that since they do represent alternatives by which to apply the broad principle, each alternative should be tested against the postulate of fairness to determine the propriety of its being included within the accounting structure.

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As we discussed above, the general criteria for realization of income included measurability and permanence. These criteria also apply to cost expirations. Thus, expenses may be considered incurred when the service represented by the cost has been utilized in earning revenue. Likewise, losses are considered incurred when the service represented by the cost has diminished and has not benefited the revenue-producing activity of the firm. In both cases, the expired cost has no discernible future benefit to the firm since the service potential has been utilized or lost.\(^4\)

What, then, in light of the discussion above, are the general results of the cost principle? For the moment we must isolate the cost principle and assume a stable price level.

Generally speaking (i.e., ignoring monetary assets and the effects of specific inventory valuation and depreciation rules), the cost principle produces a balance sheet and income statement composed of amounts stated at historical costs rather than current costs. In the balance sheet, nonmonetary assets are stated at historical cost less whatever allowance has accumulated to reflect depreciation or other expiration of useful or recoverable cost. Liabilities are stated at the amount of the proceeds or obligation, with

\(^4\)See Windal, The Accounting Concept of Realization, pp. 75-82.
adjustments for discount or premium periodically to reflect the periods benefitted in its approach to maturity. Owners' equity is stated at the amounts paid in by stockholders or contributed by others, plus or minus the cumulative results of operations and distributions.48

In the income statement current revenue has matched with it expenses which include both current cost expenses and historical cost expenses. But since we here assume a stable price level, current expenses would be the same as the expenses which reflect the historical costs that have expired in the present period.

With such results and under such conditions we submit that the cost principle is fair to all parties, since it permits a financial representation which indicates the relative economic rights and interests in the enterprise of the society segments. With such information an individual can make judgments and take actions based upon his interpretation of his relative position.

However, remove the condition of a stable price level and the results produced by the cost principle are not fair to all parties. Since many of the costs incurred are applicable to and benefit many future periods, when those historical costs are matched against current revenues, comparability may be invalidated because of price-level

48 Chamberlain, "Accepted Accounting Principles," p. 4.
changes. Dollars of different purchasing power are matched to give a net income result of questionable significance.49

Likewise the balance sheet becomes a set of heterogeneous purchasing-power dollar amounts. Granted, historical costs do represent amounts actually expended for costs applicable to future periods; they are objectively determined and historically factual. Objectivity may be diminished somewhat, however, by subsequent allocations to periods benefitted. These arguments do not outweigh the usefulness of current costs, in our opinion.

In time, however, [historical] cost may lose its significance as a result of changes in customs, changes in markets or currency inflation or deflation. It may also become less useful as a measure of accountability where accretion has occurred.50

The society segments need current information upon which they can determine their relative position and make judgments and take actions regarding the rights and interests. Under conditions of a changing price level, the historical cost principle does not provide this basis for

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judgments, so we must find the principle unfair to the society segments.\textsuperscript{51}

\textbf{Actual and Contingent Obligations}

\textbf{Recognized When Existing}

As stated in the definitions above, liabilities are obligations to convey assets or perform services resulting from past or current transactions and requiring settlement in the future. Liabilities represent the legal claims against the firm with each liability having a definite or reasonable determinable maturity date. Also, each liability has an independent value which is known or is reasonably measurable. Depending upon the agreement, settlement of the obligation may be by payment in cash or in other assets, performance of services, substitution of another liability, or on occasion by conversion into an ownership interest.\textsuperscript{52}

The questions of timing and amount arise in

\textsuperscript{51}A number of alternatives have been suggested that would present current information. These include supplementary information not incorporated into the accounts, and index numbers applied to the historical cost data, among others. Their presentation and testing, however, are beyond our present scope. For excellent arguments on the pro and con of historical costs, see Willard J. Graham, "The Effect of Changing Price Levels upon the Determination, Reporting, and Interpretation of Income," The Accounting Review, XXIV (January, 1949), 15-26; C. R. Niswonger, "The Interpretation of Income in a Period of Inflated Prices," The Accounting Review, XXIV (January, 1949), 27-32; and A. C. Littleton, "Significance of Invested Cost," The Accounting Review, XXVII (April, 1952), 167-173.

\textsuperscript{52}Sprouse and Moonitz, "Broad Accounting Principles," p. 37.
considerations of liabilities, just as they do for assets, expenses, and revenues. Again the criteria of objectivity and permanence apply. Usually neither the maturity date nor the amount of the obligation needs to be known exactly for the obligation to be recognized as a liability of the enterprise. Nor does the party to whom payment will be made need to be immediately or specifically identifiable (e.g., as in product warranties). Thus, the liability should be recorded as it becomes sufficiently definite and objective, even though the actual legal liability has not yet arisen.⁵³

From these observations on the nature of liabilities, we may formulate a broad application principle. The two following definitions from the literature are especially expressive of such a principle:

All known liabilities should be recorded regardless of whether the definite amount is determinable. If the amounts cannot be reasonably approximated, the nature of the items should be disclosed in the face of the summary of liabilities or by footnote.⁵⁴

Equities [creditors' and owners'] should be accorded accounting recognition in the period in which money, goods, or services are received on obligations incurred, and should be measured initially by the agreed cash consideration or its equivalent. The elimination

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⁵³Windal, The Accounting Concept of Realization, pp. 70, 85; and Sprouse and Moonitz, "Broad Accounting Principles," p. 37.

⁵⁴Grady, "The Quest for Accounting Principles," p. 49, paragraph D-1.
of an equity should be recognized in the period in which it ceases to exist.\(^55\)

From this broad principle, then, would flow subsidiary propositions concerning specific types of liabilities (such as current, long-term, contingent) and the valuation of those liabilities.\(^56\) All of these subsidiary formulations and their attendant rules and procedures would have to be subjected to the test of fairness to all society segments.

Our main concern here, then, is with the broad application principle of recognizing and recording the obligations of the business in the period incurred and removed in the period in which they cease existing. Is it fair to all parties?

The stockholder segment has the residual claim upon the assets of the business after the claims of the creditors. Creditors' claims represent various types of financing and therefore may exist in different forms; the total financing pattern is completed by the stockholders' investment. The stockholders need to know the prior claims on the firm's assets so that they can properly appraise those claims in relation to their own. All information concerning the firm's liabilities and pertinent to the stockholder's appraisal, therefore, should be shown in the

\(^{55}\text{American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision, p. 7.}\)

\(^{56}\text{For example, see Grady, "The Quest for Accounting Principles," p. 49, paragraphs D-2, D-3, D-4.}\)
balance sheet in order to show a fair representation of the stockholder's rights and interests in the enterprise. From this presentation the stockholder may formulate judgments and take actions regarding his position with respect to other stockholders and creditors. Whatever his judgment or action, it must be made with an adequate knowledge of the facts about the firm's obligations. Thus, inasmuch as this broad principle provides the facts about all liabilities, the principle is fair to the stockholder segment.

Stockholders judge the management segment, which is responsible for both the obligations incurred and the assets under its control. Only by including all the firm's assets and obligations in the representation of the firm's financial position may the results achieved by management be fairly judged. Information regarding all rights to the use of property and the corresponding right of creditors and stockholders is essential to formulate opinions about management's performance. From the other view, while the failure to record some liabilities may put management in a more favorable light, such a procedure would be unfair to management as well as to the other society segments. This is because a misrepresentation of interests is made and the judgments based upon it would be different had the misrepresentation not been made. Moreover, management's own welfare is based upon the progress and position of the firm; a fair presentation thereof is essential to their continued association with the firm. Therefore, the recognition of the
significant obligations that are incurred is essential to a financial accounting which is fair to management.

The labor segment likewise needs to be kept informed about the firm's obligations. Facts about the firm's obligations and its ability to meet them are very important to the welfare of the employees, and are a substantial element in management-labor negotiations. The interest of labor in the obligations of the firm is from the viewpoint of their continuing employment, increased wages, and better working conditions. Their interest in the production facilities which makes possible their enhanced welfare therefore causes an equally intense interest in the claims upon those facilities. Liabilities are an important part of the overall financial condition of the firm, and a full recording of these liabilities is necessary for a fair accounting for the rights of the labor segment. The principle, therefore, is fair to the labor segment.

The liabilities of the firm represent the claims upon the business of the creditor segment. The individual creditors owed by the firm are interested in the firm's financial position and progress, both as an indication of its ability to pay outstanding debts and as an indication of the earning capacity of the firm. Upon these factors judgments are formulated about the creditor's relative interest and whether additional credit should be extended. Unless all existing obligations are reflected in the balance sheet, it cannot be a basis for judgment and therefore would be
unfair to the creditors. Since the principle requires full recognition of existing obligations, the principle is fair to the creditor segment.

Also the firm's customers are interested in its obligations. Customers are concerned with the prices they pay and the quality of the products and services purchased. They are also concerned with a continuing source of supply at reasonable prices. In certain cases there may be an interest in the size of profits made on customer purchases, continuing guarantee arrangements, and adequate financing for effective operation. Customers are interested in the firm's obligations from the viewpoint of their being a part of the financial structure of the firm. A strong financial structure, in light of existing and expected conditions, gives an indication of how well the firm may be able to live up to its agreements with customers. A full statement of the firm's liabilities is necessary, therefore, for an informed judgment on the part of customers. So the principle produces results which are fair to the customer segment.

The interests of the government and general public involve essentially the same considerations as presented above for the other five segments and that the financial representations of the firm's position and progress are fair to those segments. In this way the principle is also fair to the government and general public segments.  

Use of a Principle in Specific Problems

We demonstrated in the section above that the application principle requiring recognition and recording of the firm's liabilities in the period incurred and eliminating them in the period when they cease to exist is fair to all society segments. Similarly, in the previous sections of this chapter and in the previous chapter, we pointed out why certain other application and coordinating principles were fair or unfair to the society segments. The next step then is to apply the particular principle to a specific accounting situation.

Rules and Procedures: Their Derivation and Role

The propositions which apply the principle to the specific situation are rules and procedures. Accounting principles are those generalizations and concepts which act as broad guides to action, whereas a rule is a directive detailing the manner in which the principle should be applied to a specific situation. A procedure is a group of step-by-step instructions by which the rule is accomplished. Of course, all three levels of abstractions are the means of obtaining the objective.

Since most accounting situations are repetitive in nature, the propositions which apply the principle to the situation have become more or less standardized. But, complicating matters, there are alternative rules and
procedures to implement the principle. For example, one may select from the alternative rules of LIFO, FIFO, average, or specific identification (to name only a few), in applying the cost principle to the valuation of inventories. Further, within each rule there may be alternative procedures, although normally this is of little consequence because procedures are largely of a mechanical nature and merely carry out the directive (rule). Where there are alternative rules to apply the principle, however, each alternative should be tested against the postulate of fairness to all parties.

The role of rules and procedures, therefore, is to implement the particular principle in a specific accounting situation. The derivation of rules is largely propositional. Consider the cost principle, for instance. Various rules which implement the cost principle in the area of inventory valuation (LIFO, etc., as above) are only different interpretations of what is cost, being stated in the form of propositions. Procedures are more related to rules in their derivation than rules are to principles. Procedures are step-by-step instructions--actually elaborations on the rule's inherent mechanics--detailing how to apply the rule to the facts of the situation. Procedures are necessarily co-extensive with rules in the nature and scope of the subject matter, therefore.
Example of Propositions' Use in an Accounting Situation

The relationship between the principle and the subordinate rules and procedures which implement it and their roles will be demonstrated in the following example.

The accounting situation selected to illustrate the use of a principle and its rules and procedures involves the matter of long-term leases. The situation is not new; for many years managements have decided to lease productive or service facilities rather than to buy them. Leasing facilities has become more important in recent years, however, because leasing has become a major method of financing, especially in certain industries. The decision to lease rather than to buy involves consideration of many business factors and much accounting data, but the decision is one for management, and not for accountants, to make. Our interest here is not in the factors bearing upon the decision to lease; rather, it is in the accounting for the lease once the decision has been made.

Contracting to lease certain properties creates rights to their use and, concurrently, the obligation to pay for those rights. Clearly, two broad application principles are involved here. Since, by our definition, assets

58 Whether the contract is actually a long-term lease or a purchase agreement depends upon the facts of the situation and the conditions of the contract. For purposes of brevity in our illustration, let us assume that the entire amount of the rental payments is for the acquisition of
are the rights to the use of properties from which to derive future economic benefits, and since liabilities represent the obligations to pay for those rights, then the broad principles concerning assets and liabilities (which were set out above) are applicable to the accounting for the leasing situation. In the discussions above these principles were demonstrated to be fair to all society segments (disregarding the effects of price-level changes). The problem now is to implement these principles in the accounting for a particular lease agreement.

In current practice there are alternative rules which may be used to implement the principles involved. Myers discusses in detail the two basic methods (or rules) of handling lease transactions in the accounting statements. 59 Most common is the first rule of reporting the cash outlay as an expense of the period to which it pertains property rights, and therefore that no purchase per se is involved. Further, whether the lease is the result of a sale-leaseback agreement or a conventional lease is of no consequence to the illustration. Moreover, our illustration only considers the lease accounting from the viewpoint of the lessee; naturally it assumes that the lease in question is material in nature and amount. Concerning the provisions which would be determining to differentiate between a lease agreement and a purchase agreement, see John H. Myers, "Reporting of Leases in Financial Statements," Accounting Research Study No. 4 (New York: American Institute of Certified Public Accountants, 1962), pp. 4-5, 71-82.

59 Ibid., pp. 34 et seq. Actually here we are simultaneously dealing with alternative rules and procedures each implementing both the asset and liability principles. To avoid repetition we will not separate the alternative rules and procedures pertaining to assets from those pertaining to liabilities.
and to ignore an actual accounting for any commitments to make future payments or the rights acquired to the use of properties. In this case the details of the agreement would be disclosed to some extent in a statement footnote or by other means such as a letter to stockholders.

The second method (rule) to account for long-term leases is to consider the agreement as a financial transaction in which an asset is acquired and an obligation is created. Accordingly, the asset and related liability are recognized by accounting for them in the company's records and then including them in the balance sheet among other asset and liability items. The property rights and lease liability would be amortized according to some lease life estimate and payment schedule, both depending upon circumstances and provisions of the agreement. In addition to the balance sheet effect from recording the asset and corresponding liability, the income statement would also be affected by the second method. When the leased assets are carried on the accounting records and reflected in the balance sheet at the present value of the obligation (in order to eliminate the effect of interest), there will be a periodic charge to income for the amortization of the asset value and also a charge for the current interest due. Both elements, amortization and interest, need not necessarily equal the periodic rental payment (since the latter is a matter of contract), although both would be a current expense to be matched against revenues. However, over the
period of the lease the sum of the periodic charges would be equal to the sum of the rental payments.  

A third alternative may be mentioned, that of making no disclosure of the existence of a long-term lease agreement other than the expense item for the current cash outlay being shown in the income statement. This alternative may be dismissed at the outset, however, as being unfair to all society segments because it does not result in information which indicates the segments' rights and interests in the firm.

The procedures which would carry out the rules (the two basic methods, as above) would involve pro forma journal entries and statement forms detailing in step-by-step fashion the amortization and presentation of the asset, liability, and expense items relating to the lease, and the supplementary information that should be contained in the footnote to the statements.  

The question now is which rule results in a fairer presentation of the leasing agreement, the first which shows the expense in the income statement and details of the

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60Ibid., p. 34. In his Chapter 4, Myers presents the case for balance sheet disclosure, to which the reader is referred.

61See Myers, "Reporting of Leases in Financial Statements," pp. 56-62, and Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession, pp. 23-25, for pro forma procedures relating to the second rule. See also American Institute of Certified Public Accountants, Accounting Research Bulletins, pp. 125-127, for procedures relating to the first rule.
obligation in the statements' footnotes, or the second rule which shows the expense in the income statement and the present value of the asset and liability in the balance sheet?

Despite certain economic and legal consequences pointed out by Myers, we judge that the second rule results in a fairer presentation of the society segments' rights and interests.

The consequences cited as reasons for excluding the present value of leases within the balance sheet (i.e., arguments against the second rule) generally pertain to difficulties of objectively determining the statement amounts, the contingent legal liability of public accountants, and the "possible catastrophic effect upon management, stockholders and creditors under outstanding indentures, current and changing tax laws, and regulation of industry." 62 Other objections revolve around the possible extension of the lease-disclosure rule to other commitment items, the difficulties attendant to any transition period, and the adverse effect upon the lessee's credit standing. 63

No doubt some of these fears are real, but most

62 Alvin Zises, "Disclosure of Long-Term Leases," The Journal of Accountancy, CXI (February, 1961), 47. Also see other "disadvantages" cited by Zises and summarized by Myers, "Reporting of Leases in Financial Statements," pp. 53-54. Pertaining to these disadvantages, see within the Myers study the comments on pp. 68-70.

63 Myers, "Reporting of Leases in Financial Statements," p. 53.
objections to balance sheet inclusion appear to be rationalizations, or if valid, exaggerated to some extent. Myers answers the above objections and points out that the most important consequence (which in our judgment outweighs all the listed adverse consequences) is that disclosing future lease rentals on the balance sheet would "represent a more complete accounting for financial position. 'Financial position' as shown by the balance sheet and the various ratios typically computed from it," he continues, "will be a function of the economic position of the business and not of the legal forms used to acquire the use of property." Moreover, "decisions on financial position will not have to rely upon the validity of adjustments made by the user of the balance sheet to overcome an accounting deficiency."64

Under the first rule cited above (footnote disclosure only), the statement user is largely left to his own devices to reconstruct a financial picture of the firm that will make possible intelligent appraisals of the adequacy and utilization of capital assets, of the managerial results, and of the user's relative rights and interests in the firm. With the property rights and related obligations not being shown within the body of the balance sheet, the statement user would have inadequate information for judging whether the rights acquired do actually constitute assets similar to legally owned assets or whether the related

64Ibid., p. 52.
obligations are in substance debt of the firm. 65

For an individual within any of the society segments to make a realistic appraisal of his rights and interests in the firm and to make decisions and take actions regarding his position relative to other individuals and segments, he must have complete and reliable information about the firm's assets and liabilities. When the lessee acquires a property right under a long-term lease agreement, and correspondingly incurs a determinable obligation, these items of asset and liability should be recorded in the accounts and reflected in the balance sheet and income statement (in the latter, showing the current amortization of the asset). In so doing, management discharges its responsibility for the financial reporting of material assets and liabilities more adequately than if only a footnote were used. The role of footnotes should be to provide supplementary facts and explanatory narratives; the footnote should not be the primary source of data, especially for important data bearing heavily upon the existence of some of the firm's assets and liabilities. Besides being fair to management, the rule directing accounting recognition and balance sheet presentation of significant leased properties and attendant obligations is also fair to the other society segments because it

65 John L. Hennessy, "Recording Lease Obligations," The Journal of Accountancy, CXI (March, 1961), 43. This article takes the opposite view of the article by Zises cited above.
permits their more accurate appraisal of their relative position and the making of more dependable decisions than they would make if they did not have that asset-liability information and presentation.66

Summary

This and the previous chapter presented a number of generally accepted accounting principles selected from the body of accounting literature. To these accounting principles--categorized as coordinating and application principles according to their nature--we applied the test of fairness to all society segments. Each of the principles are propositions which, when implemented by rules and procedures, advance the objective of accounting. To illustrate the implementation of a particular principle, an accounting situation was posed in the previous section of this chapter. The situation specifically and directly involved two application principles. Also, although not developed in the illustration, a number of coordinating principles that were discussed in the previous chapter bear upon the illustration in a general way. To the rules implementing the principles we applied the criterion of fairness to all parties. The objective of accounting is the chief aim, but the focus in attaining that goal is fairness to all parties.

66See ibid., p. 46.
CHAPTER VIII

OVERVIEW AND SUMMARY OF CONCLUSIONS

Interdependence, mutual responsibility, and mutual accountability are all bywords of the world in which we live. In the area of financial and economic relationships, the profession of accountancy has been established to record the effects of those relationships and ultimately to report on the carrying out of one's responsibilities and accountabilities.

Over the years a framework of theory and a body of practice have evolved for recording and communicating the financial and economic relationships of people and firms. That great advances have been made is evident when one compares currently accepted accounting principles with the practices of the early 1900's. Yet, despite these advances, the profession cannot claim a truly coordinated and authoritative structure of accounting theory and a sound and uncontradictory body of practices built upon that theory. The integrating force between coordinated theory and sound practices seems to be lacking in the current structure of accounting.

In addition to the lack of an integrating force,
complications arise in the development of the structure of accounting from unsettled terminology and disagreements over the scope and nature of accounting principles. There is no doubt that accounting is in a period of great transition; now is the time to settle terminology differences and to introduce and develop that now-lacking integrating force which will give consistency, cohesion, and balance to the overall structure of accounting theory and practice.

The integrating force we feel should be the postulate (or basic standard) of fairness to all parties. This postulate should be the test for all the propositions which purport to advance the ultimate objective of accounting, thus integrating the "why" of theory with the "how" of practice.

The structure of enterprise financial accounting theory may be characterized as a series of levels of abstractions, each subordinate level having a narrower scope than the level above it. The highest level of abstraction in the structure would be the objective of enterprise financial accounting. Thus, every subordinate proposition would in some way help to attain the objective to be worthy of being included within the structure. The subordinate propositions include principles, rules, and procedures. As pointed out above, the postulate of fairness is the integrating force between these abstractions and serves as the basic criterion by which to test the results of propositions which implement the objective. In limiting our scope for
this investigation, we have selected what we believe should have the first emphasis, the foundation of financial accounting. Included in this foundation are the objective, the postulate, and broad principles.

In proposing a structure of accounting based upon levels of abstractions coordinated by the postulate of fairness, the first step we must take is to see what effect that proposition would have upon what is done in current practice. This study, therefore, develops the objective of financial accounting and the postulate of fairness to all society segments as a basis for the structure, then applies that basis to some currently generally accepted accounting principles. A completion of this first step (which is outside the scope of our study) would involve applying the same basis to the rules and procedures which implement the currently followed principles.

The second step in developing an accounting structure based on fairness would be to test those principles, rules, and procedures which have been proposed but which are not now accepted in current practice. As the third step, other principles, rules, and procedures would have to be formulated and tested against the basic standard of fairness to all society segments. The second and third steps are also outside the scope of our study. Whatever the step, the main point to keep in mind: the accounting environment and social customs and modes of thought are constantly changing; accounting propositions reflecting these factors must also
be in a process of evolution. As propositions become outmoded and unfair, new ones, also judged by the criterion of fairness, should take their place.

The Perspective of Accounting Environment

To gain a better understanding of the reasoning underlying a structure of accounting based upon fairness to all parties, we presented discussions designed to put that structure in its proper perspective. The first factor which gives perspective is the environment in which accounting operates; certain elements of that environment help to shape the discipline of accounting.

The first element of the accounting environment is that of our language. It presents both a blessing and a burden: a blessing because it enables people to communicate and share knowledge; a burden because many words do not have a definite enough meaning to avoid ambiguity. The accountant's stake in language is that it is his means of recording and reporting to all the society segments upon the financial and economic aspects of the resources committed by society to satisfy its wants.

Accounting is commonly referred to as "the language of business." This means that accounting is a medium of expression by which the many events and relationships of a financial and economic nature of an enterprise are communicated to interested parties. Being a language, accounting involves the three elements of communication: the communication object (business activities and results of decisions);
the communicatee (outside parties receiving and using financial statements); and the communicator (management, giving an accountability report in the form of financial statements).

Probably the most influential factor in the accounting environment is the relation of accounting to other disciplines. Accounting is basically an information system and, as such, is influenced and shaped by economics, statistics, law, and social and moral attitudes.

Accounting and economics have the same objectives of knowledge; both examine the individual economic unit as well as the entire economic body of a country; both investigate the administration of scarce resources and the determination of income. In brief, the existence and changes in wealth are the focus of both disciplines. That focus, however, is from slightly different viewpoints. Economics is largely concerned with the society as a whole and wealth in general, whereas accounting is largely concerned with the individual society units and the wealth of each unit (especially of the individual enterprise). This observation was followed by a discussion of the similarities and relationships between accounting and economics.

Both accounting and statistics involve methods of quantifying data; their scopes are the major distinguishing factor. Statistics is concerned with the collection, tabulation, analysis, presentation, and interpretation of any type of quantitative data. Accounting, on the other hand,
is concerned only with data which ultimately may be quantified in money terms.

Accounting exists within the environment of law because accounting is vested with the public interest. Both disciplines are "human-service institutions" and thus are interested in public policy to the extent that the rights and interests of all parties must be considered. The legal influence is felt by accounting through many avenues: prescribed procedures relating to recording financial transactions, regulatory agencies, tax regulations, and court rulings.

Another important factor shaping the environment of accounting is the operation of the economy and the entities within it, and the interrelationships between the two. Organizations are a coordinated association of individuals. This association is built upon three elements: cooperation in the activities of people; rational coordination of those activities; and an accounting entity concerned with the activity, however broadly conceived.

A further aspect of the economy as a factor in the environment of accounting is that a standard unit of currency is used in the economic system, and this standard unit serves as the common denominator of all accounting records. Moreover, money is used as a medium of exchange, generating prices in the market for goods and services exchanged. Thus the price system existing within a market economy is a part of the accounting environment.
As the economy has grown, the major entities within the economy, business enterprises, have evolved from one form to another. Generally speaking, in that changing environment accounting theory and practice have followed the evolution of business forms. Today the corporation is in the dominant role and as a consequence public accountants have become established as having a special responsibility to outsiders as well as to the corporation management. To a large extent accounting data represent information in which all segments of society have some right or interest; therefore, those data can no longer be considered secret and available only to a few "insiders."

The Perspective of Accounting Theory

In addition to the environment in which accounting is practiced, there exists an environment in which accounting theory is developed. By surveying the past and present of accounting principles we obtain a perspective on accounting theory.

In 1953 the AICPA Committee on Terminology defined an accounting principle as a "general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice." Postulates were subordinated and described as unproved principles derived from experience and reason. Eventually, if accepted as useful and widely used, they attained the status of generally accepted accounting principles.
A different view of the nature of a postulate was taken by Moonitz in his *Accounting Research Study No. 1*, in which he defined postulates as "the basic assumptions upon which principles rest." Thus he described aspects of the accounting environment (such as discussed in our Chapter II) as postulates to be accepted as self-evident facts. That analysis was extended in the Sprouse-Moonitz *Accounting Research Study No. 3*, in which was formulated a tentative set of broad accounting principles for business enterprises.

The approach in this dissertation to a general framework of financial accounting theory is slightly different. We begin with a stated objective of accounting, then formulate a basic postulate which is conceived as being the basic standard by which all subordinate propositions are judged. Those propositions include principles which are broad guides to action, rules which are instructions detailing the manner of applying the appropriate principle to a specific situation, and procedures which are step-by-step directions that apply the rule to the facts of the situation.

We mentioned above that the postulate should be fairness to all society segments. The standard currently in use by the profession is "general acceptance" based upon "usefulness in the situation." The discussion of the criteria of "soundness" and "usefulness" lead to the conclusion that the criterion of usefulness cannot be considered superior to the alternative criterion of soundness.

The perspective of accounting theory is completed by
a brief survey of some significant contributions to the literature. There we discussed works by Gilman; Sanders, Hatfield, and Moore; Paton and Littleton; Littleton; the American Accounting Association; and the American Institute of Certified Public Accountants.

**Broad Objectives of Enterprise Accounting**

The objective of accounting is our starting point for a coordinated and consistent structure of accounting. It is the broadest generalization and comprehends all the propositions subordinate to it.

After a survey of the evolution of accounting objectives, we formulated a broad objective of all accounting. This objective is based on the conviction that accounting responsibilities transcend service to the owners and managers of enterprises to the service of society. Accounting, we believe, expresses economic facts and relationships through the media of financial statements, and communicates the contributions and relative economic rights and interests of the society segments. The society segments are stockholders, management, labor, creditors, customers, government, and general public. All of these segments must be able to rely upon a fair and impartial accounting of the firm's operations and position.

From this social concept of accounting responsibility and the relation of accounting to other disciplines, the following was adopted as a definition of accounting in its
broadest sense: "... accounting is a synthesis of concepts, rules, and techniques designed to facilitate understanding and control of economic activity." From this definition could be derived definitions for each stratum of accounting. Our concern is with the stratum of enterprise accounting, and within that, the area of financial accounting. Thus, we next formulated the definition of enterprise accounting to be as follows:

**Enterprise accounting is a control and communication system which involves gathering, compacting, interpreting, and disseminating economic data for purposes of judgment formulation or action taking.**

Then, after surveying a number of statements by writers concerning what they felt to be the objective of enterprise accounting, we formulated the following **objective** as the basic generalization of the enterprise accounting structure:

**The objective of enterprise accounting is to provide an information-communication system by gathering, compacting, interpreting, and disseminating economic data, in order to facilitate judgment formulation or action taking by the economy segments.**

The two areas of enterprise accounting are the financial and the managerial. Our view of managerial accounting is that it includes all aspects of the development, presentation, interpretation, and communication of economic data for the information and guidance of managers at all levels of the enterprise. From this concept and the overall enterprise accounting objective (as above), we
formulated an objective for managerial accounting. But since our study is primarily focused upon the financial area, the objective of the managerial area was stated solely for illustrative and comparative purposes.

Assimilating the ideas previously presented concerning the relation of accounting to the disciplines of economics, statistics, and law, and upon the statement and discussion of the objective of enterprise accounting, we arrived at the following objective for the financial area:

The objective of financial accounting is to provide an external information-communication system by gathering, compacting, interpreting, and disseminating economic data which gives a financial representation of the relative economic rights and interests of the economy segments, in order to facilitate judgment formulation or action taking by those economy segments.

Enterprise financial accounting is conceived by this writer to have an essentially historical character and to serve as a service tool to the present and the future. Thus, in the statement of the objective we emphasize the determination and communication of the accumulated enterprise experience in the ultimate form of the economic rights and interests of society segments. Moreover, emphasizing the social nature of accounting, in the objective we stress the society segments, rather than the equity interests of creditors and stockholders. The latter have equity claims but the society groups have economic rights and interests which are just as valid and important. No one society segment is subordinated to another.
As an alternative to our stated objective, we then discussed the view predominant in today's practice of accounting that the determination of net income is the objective of enterprise financial accounting. This view was developed and finally rejected on the primary grounds that the concept of income determination was within the field itself, whereas we believe the objective should focus upon a concept outside the field of accounting. The latter belief is derived from the very nature of accounting: a service tool for the present and future; it is not an end in itself.

The Accounting Postulate:
Fairness to All Parties

With the objective of financial accounting as the starting point from which to formulate a theory framework, we then turned to those subordinate propositions composing the framework: the postulate, principles, rules, and procedures. The basic guideline to attaining the objective is the postulate. Conversely, the objective and postulate together serve as a frame of reference for formulating principles, rules, and procedures.

The nature of postulates was discussed, concluding that in order to be the basis for judging principles, the postulate should be demonstrable and provable from a study of the environment and modes of thought and customs of all segments of the business community. Thus, self-evident postulates to be taken for granted could not serve as our
criterion. The postulate, then, serves as an essential prerequisite to be met by the subordinate propositions.

The postulate of fairness to all society segments was selected as the most pertinent to our social concept of accounting and the environment of accounting. This postulate was selected after considering possible alternative postulates of usefulness in the situation, justice, and truth. Other alternatives, based upon the characteristics of the environment, were discussed in Chapter II.

The concept of fairness is a social concept, finding its expression in the forms of laws, customs, business conduct, administrative decisions, religious beliefs, and the like, of the time and place. Economic rights and interests of the society segments are based upon mutual interdependence, and arise out of the social and legal environment and the customs, conduct, decisions, and beliefs of the society segments. Accounting, therefore, adopting the collective social concept of fairness, would apply that concept in the accounting for and reporting upon the various entities in society to the holders of the economic rights and interests in those entities.

The entity's financial statements and supplementary reports are the media through which accounting gives a financial representation of the society segments' relative economic rights and interests in the entity. Since each segment is entitled to a fair statement of its relative position regarding its interests, no one segment is to be
favored at the expense of the others. The structure of interests in an entity is constantly changing as a result of decisions and actions on the part of individuals in the segments; each decision and action is for the purpose of bettering the individual's relative position. The nature and amount of items in the financial statements vitally affect each group, therefore. A misstatement of one segment's interests necessarily causes a misstatement of the other segments' interests; an unfair reporting (either favorable or unfavorable) to one is necessarily unfair to the other.

The accountancy profession has developed as the attester to the fairness of financial statements. The current wording of the standard audit report, however, uses the words "present fairly" in a manner which is devoid of any ethical content. In other words, the audit report means that given the current set of generally accepted accounting principles, and based upon them, the financial statements present a "pretty good picture" of the financial position and income of the firm for the period. The concept of fairness advocated in this study very definitely has an ethical content, objectively determined by the collective opinion of society. Further, fairness is advocated here to be the criterion for principles ultimately shaping the financial statements, rather than the usefulness-general acceptance criterion followed in practice today.

Society segments acquire their economic rights and interests in enterprises by virtue of laws and social
customs; how they were acquired is beyond the scope of accounting. The role of financial accounting is to determine the rights and interests as they already exist in the enterprise. Those rights and interests attach to the society segments because of their association with the enterprise in the capacities of stockholder, manager, employee, creditor, customer, government, or general public. Therefore, the enterprise is a concentration of economic rights and interests, and the enterprise financial statements are a portrayal of those relative interests—a fair portrayal if meeting the test of fairness to all parties.

Such a portrayal will enable each individual to formulate judgments or take action on his position relative to other individuals and groups. By evaluating the results of past decisions and his current position he has the basis to change his current position if he judges it undesirable. But to be reliable as a basis for evaluation, the financial representation must be fair to all parties. Therefore, accounting principles and rules must be demonstrated to meet the test of fairness to all society segments.

**Accounting Principles Based upon the Postulate:**

**Coordinating Principles**

Accounting principles are those broad guides to action according to which enterprise data are marshaled into meaningful statements and reports. The first of the two classes into which principles may be conveniently
categorized is that of coordinating principles. These principles include those traditional accounting concepts which have coordinating accounting activities into a body of practice.

The coordinating principles discussed concerned three broad areas of accounting activity: the concept of the business, recording and reporting practices, and guides which facilitate business operations and reporting on business operations.

In the first area there are the principles of the business entity and the going concern. The principle of the business entity means that, for accounting purposes, the ownership of the business rests in a fictional entity, regardless of the legal reality. Furthermore, the accounting records and reports pertain only to the activities of that fictional entity. After a discussion of the principle and its effects upon the financial statements it was concluded that for all segments of society the financial statements based upon the business entity principle present a fair representation of the rights and interests of those segments in the business entity. (Here, as with the analyses of the other principles, we assume other things as being equal.)

A traditional companion to the business entity principle is the principle of the going concern. This concept is usually stated as being an assumption that the firm will continue in active operation for the indefinite future if there is no evidence to the contrary. Following this
statement was an analysis of the going concern principle based upon its historical development. We concluded that the principle no longer has any basis for existence since, considered only by itself (i.e., apart from its connotations), the principle merely rules out an attitude of imminent liquidation and requires asset valuation according to intended use. We believe that an accounting should be made for the realities of the enterprise condition. The fact of continued financial health cannot be assumed as a matter of course. Further, if liquidation of the firm is not pending or existing, there is nothing which requires an accounting relevant to liquidation; if the firm is in fact existing and growing, no principle is needed to assume this reality.

The second area of accounting activity concerning recording and reporting practices includes the coordinating principles of periodicity, materiality, conservatism, consistency, and disclosure.

The principle of the accounting period also grew out of the conditions spawning the going concern principle. The periodicity principle states that the life of a business can be divided into discernible periods and that certain determinations can be made for these periods. An investigation led us to the conclusion that the principle of providing periodic reports is fair to all segments of society.

The principle of materiality involves a consideration of the existing surrounding circumstances to determine if a
statement or fact or item is of such a nature that its disclosure or its method of treatment would be likely to influence the judgment and conduct of a reasonable person. Materiality is a state of relative importance, therefore, depending in large measure upon individual value judgments. Is the principle fair to all parties? The principle we concluded is not unfair to the society segments since their judgments or decisions would not be affected if the item is immaterial and would not be unfavorably affected if the item is material.

Conservatism is an attitude existing as a reaction to the uncertainty of the future; the principle of conservatism represents the accountant's "margin of safety." The principle may be currently stated that in matters of sincere doubt as to which one of several equally appropriate (i.e., generally accepted) accounting alternatives should be followed, the choice should be that alternative which produces the least favorable or least optimistic result. The general effects of applying this concept of the conservatism principle are the understatement of current income and assets and the overstatement of current expenses and liabilities. Such overstatements and understatements are in fact misstatements; they cannot be fair to all parties. In all cases where accounting results are influenced by conservatism, the society segments' relative economic rights and interests in the enterprise are misrepresented to some extent. But since there is doubt, there cannot be certainty in the results,
and judgment will always be necessary in selecting the method to follow to implement the particular applicable principle. The current concept and application of the principle of conservatism, therefore, produces results which are unfair to the society segments. A reformulated principle is needed which would retain the element of caution but eliminate the element of unfairness.

The application of the principle of consistency gives assurance to statement users that the comparability of financial statements of different periods has not been materially affected by changes in accounting principles or in the rules applying the principles. If there have been changes which materially affect the statements, the principle requires a disclosure of the nature and effects of the changes either in the statement footnotes or in the audit report. A discussion of this principle pointed to the conclusion that it is fair to all society segments.

The principle of full (or adequate) disclosure is simply stated as the requirement that accounting statements and reports disclose that information which is necessary to make them not misleading. In the financial statements and their footnotes, or in supplementary reports, or in an accompanying narrative there should appear significant information which will enable readers to properly understand and evaluate the enterprise's financial position and progress. Following the statement of the principle, we investigated the problems of what information, to whom, and
by what means disclosure should be made. The conclusion was that the principle, correctly applied, results in a financial presentation of the society segments' economic rights and interests. This is information upon which an individual may formulate judgments and take action regarding his position relative to other society segments. Thus, the principle is fair to all parties.

The third area of accounting activity includes two principles which facilitate business operations and the reporting thereon. First, we discussed the principle of the stable money unit, and second, the coordinating principle of objectivity.

Accountants have for many years maintained accounting records and produced financial statements based upon the premise that the purchasing power of the dollar is stable. Following this principle, accountants assume that the change in the purchasing power of the dollar is so small as to have immaterial effects upon the financial statements. A current project of the AICPA Division of Accounting Research is a study of price-level changes, with the basic premise being that accountants can no longer realistically ignore purchasing power fluctuations. Judgments about the fairness of the principle must be made in the light of its effects upon the specific reporting situation. Generally speaking, however, in periods of rising prices the effect has been to overstate profits (i.e., cause "paper profits"). Another general effect is that of rendering uncomparable successive years'
financial statements. Both of these effects are unfair to all parties, and from this we may conclude that, generally, the principle of the stable dollar is unfair to the society segments.

Objective, verifiable evidence means that the information and facts are verifiable by contractual or other independent evidence and have been free from personal bias in their development. A strict interpretation of objectivity is abandoned, however, when the result is a distortion of the meaningfulness of accounting statements and reports. Thus, market values may be acceptable for the firm's records even though those values were not determined in bargained exchanges involving the firm. Based upon the analysis of the current interpretation of the principle, it was concluded that the principle of objectivity contributes to more relevant and reliable data, and is similarly fair to all society segments.

Accounting Principles Based upon the Postulate: Application Principles

The second of the two classes into which principles may be categorized is that of application principles. These principles are the broad guides to action upon which specific rules and procedures are based. The application principles investigated were divided into two sections, those underlying the income statement and those underlying the balance sheet.
The first income statement principle was that of matching revenues and expenses for a periodic determination of net income. From this matching principle we distinguished some considerations implied in it. These considerations involved determinations of the timing and amount of the three elements: revenues, expenses, and net income. Each of the seven considerations mentioned would have to be answered and tested against the fairness standard before we can judge the overall fairness of the matching principle. Actually, each of the considerations has been formulated into statements having the status of generally accepted accounting principles. Therefore, each of the principles should be tested separately for its contribution to the fairness of the overall presentation.

A brief discussion of the elements of revenue, expense, and income followed. Then, assuming the timing and amount considerations of those elements did meet the test of fairness, the question of the fairness of the matching principle was posed. The matching principle produces an estimated net income figure (the particular amount is governed by other principles); estimated, because only at the end of the firm's life can the total net income be accurately calculated. Despite the tentativeness of the net income determination, the society segments have come to rely upon such periodic estimations as an indication of the progress of the enterprise. A discussion of the uses of the estimate to the various society segments followed, from which it was
concluded that the matching principle was fair to all interests. This is because it helps to achieve the financial accounting objective by communicating data which give in part a financial representation of the economic rights and interests of the society segments, upon which they may formulate reliable judgments.

The second income statement principle, income realization, is one of the considerations mentioned above, and is one facet of the overall problem of matching revenues and expenses. Accountants generally agree that income is earned over the entire process of business activity. But, according to the circumstances, accountants say that income is realized either over a time segment or at a time point in the transaction cycle. Various alternatives as to when income is realized, and the circumstances surrounding the "critical activity" were then investigated. The realization of income principle, therefore, encompasses the selection of the most significant activity within the transaction cycle as the pertinent point at which to recognize in the accounts that income has been realized. Certain criteria are used in the selection. Among them are sufficient definiteness and objectivity in the change in an asset or liability; related to these are the criteria of certainty and measurability.

The argument of the realization principle is that until the most significant activity takes place and the criteria of definiteness and objectivity are met, income should not be regarded as realized. Judgment is necessary
in determining when the criteria are met. The basic question is really: Is an approximate figure during the period when the change in value takes place more useful and more fair than a figure bearing a greater degree of definiteness and objectivity recognized at a later date? At the present stage of accounting development, the income realization principle produces results which in our judgment cannot be considered unfair to the society segments.

Third among the income statement principles discussed, was that of separating ordinary from unusual items in determining net income. The matching principle provides for ordinary revenues and ordinary expenses, elements having a causal relationship between them. On the other hand, events also occur which seem to have no causal relationship to current operations, yet occasionally affect the financial health of the firm to a significant degree. Should the results of these events, extraordinary gains or losses, be allowed to enter into the net income calculation? The opposing views of the all-inclusive concept and the current operating concept were analyzed. In current practice the latter view is followed, and the principle may be stated as "all gains and losses will be included in the determination of periodic net income unless they are of such magnitude in relation to regular operating revenues and expenses as to cause the statements to be misleading." Based upon the arguments presented for both views we arrived at the conclusion that the results produced by the principle were not
unfair to the society segments.

The second category of application principles includes the principles underlying the balance sheet. Two of these broad principles were discussed; the first concerned assets and their valuation and the second involved liabilities.

Paraphrasing one of the quotations cited in the previous chapter, we may state the cost principle as: "For nonmonetary assets, cost is the proper basis of accounting for assets and expenses, with accounting records reflecting acquisition costs and the transformation, flow, and expiration of these costs." A discussion of this cost principle brought out that the actual basis for the almost exclusive use of historical costs in the accounts is the income realization principle. This principle maintains (generally) that only income which has been realized in the current period may be included in and reported as net income for the period. Therefore, appreciation in asset values are ignored as long as they remain unrealized; historical cost becomes the basis for income calculation. Therefore, the problem of asset valuation cannot be separated from the problem of expense determination for net income calculation, and the realization principle demands that historical cost be used for both of these phases of cost outlays.

Generally speaking, and ignoring the effects of an unstable price level, the cost principle produces financial statements composed of amounts stated at historical costs.
However, under a stable price level, historical costs would equal current costs. Under this condition the principle permits a financial representation which indicates the relative rights of the segments. But remove the condition of a stable price level and the results produced by the cost principle are unfair to all parties. Comparability of amounts within a period and over periods is diminished, if not destroyed. Dollars of different purchasing power are matched to give a net income result which is of questionable significance. Also the balance sheet becomes a set of heterogeneous purchasing-power dollar amounts. Under conditions of a changing price level, the historical cost principle does not provide current information which the individual must have to accurately determine the relative position of his rights and interests. Therefore, we concluded that under the current conditions of an unstable dollar, the cost principle produces results which are unfair to all segments.

The second of the balance sheet principles studied concerns liabilities. The broad principle may be worded: "All known liabilities should be recorded regardless of whether the definite amount is determinable; if it cannot be reasonably approximated, the nature of the item should be disclosed by footnote or by other means." A survey of the importance of recording all the obligations of the business was then made for each of the society segments. The conclusion from this survey was that the principle is fair to all parties.
Following the presentation and subjection to the test of fairness of a number of generally accepted accounting principles (under the titles of coordinating and application principles), there was posed an accounting situation. For this situation (accounting for long-term leases) we determined the applicable principles and investigated alternative rules which applied the principles. The effects were analyzed in order to determine the fairness of the alternative rules, and the rule providing the fairest presentation was selected. The situation was posed as an example of the application of principles to the specific facts by means of rules and procedures, since only a testing of the principles was within the scope of this dissertation.

The First Step

As we pointed out at the beginning of this chapter, three steps are involved in formulating a theory structure based upon the postulate of fairness. This dissertation deals with a part of the first step. As a basis for the reformulated structure of accounting, the various areas were outlined and objectives set. Then, concentrating upon the enterprise financial accounting area and its objective, we derived, justified, and presented the postulate of fairness to all society segments. This postulate provides the basic standard by which to judge the propriety of all propositions seeking to advance the accounting objective. The broadest of these propositions (excluding the objective), coordinating and application principles, were investigated and tested.
Tremendous progress has been made by the accountancy profession since the beginning of the present century, and accounting is now in the process of growth and transition. The future promises the accountant an even larger role in the affairs of business and the national economy. We believe that only by putting the theory and practice of accounting on a basis rooted in ethics—society's concept of fairness—can the profession advance at maximum speed to fulfill its rightful role in society.
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APPENDIX A

Excerpts from the "Charter Rules" of the American Institute of Certified Public Accountants

Accounting Principles Board¹

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 of 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. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues.

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.

¹As quoted from "Report to Council of the Special Committee on Research Program," The Journal of Accountancy, CVI (December, 1958), 62-68. (Emphasis added.)
Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, 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. Also, the Institute should encourage co-operative study with other representative groups to determine that its understanding and interpretation of the postulates are valid and to provide a forum which will command sufficient respect to bring about a change in the postulates when any of them become outmoded.

A fairly broad set of co-ordinated accounting principles should be formulated on the basis of the postulates. The statement of this probably should be similar in scope to the statements on accounting and reporting standards issued by the American Accounting Association. The principles, together with the postulates, should serve as a framework of reference for the solution of detailed problems.

Rules or other guides for the application of accounting situations, then, should be developed in relation to the postulates and principles previously expressed. Statements of these probably should be comparable as to subject matter with the present accounting research bulletins.
They should have reasonable flexibility.

Adequate accounting research is necessary in all of the foregoing. Pronouncements on accounting matters should be based on thoroughgoing, independent study of the matters in question, during which consideration is given to all points of view. For this, an adequate staff is necessary, to carry out detailed investigations, evaluate data, formulate conclusions, and draft reports setting forth results. Research reports or studies should be carefully reasoned and fully documented. They should have wide exposure to both the profession and the public. This is an effective way to stimulate and crystallize thinking on accounting matters.
APPENDIX B

The Basic Postulates of Accounting

Related to the Environment of Accounting:

Postulate A-1. **Quantification**. Quantitative data are helpful in making rational economic decisions, i.e., in making choices among alternatives so that the actions are correctly related to consequences.

Postulate A-2. **Exchange**. Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers.

Postulate A-3. **Entities** (including identification of the entity). Economic activity is carried on through specific units or entities. Any report on the activity must identify clearly the particular unit or entity involved.

Postulate A-4. **Time Period** (including specification of the time period). Economic activity is carried on during specifiable periods of time. Any report must identify clearly the period of time involved.

Postulate A-5. **Unit of Measure** (including identification of

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the monetary unit. Money is the common denominator in terms of which goods and services, including labor, natural resources, and capital are measured. Any report must clearly indicate which money (e.g., dollars, francs, pounds) is being used.

Related to Accounting Itself:

Postulate B-1. Financial Statements. (Related to A-1.) The results of the accounting process are expressed in a set of fundamentally related financial statements which articulate with each other and rest upon the same underlying data.

Postulate B-2. Market Prices. (Related to A-2.) Accounting data are based on prices generated by past, present or future exchanges which have actually taken place or are expected to.

Postulate B-3. Entities. (Related to A-3.) The results of the accounting processes are expressed in terms of specific units or entities.

Postulate B-4. Tentativeness. (Related to A-4.) The results of the operations for relatively short periods of time are tentative whenever allocations between past, present, and future periods are required.

The Imperatives of Accounting:

Postulate C-1. Continuity (including the correlative concept of limited life). In the absence of evidence
to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

**Postulate C-2. Objectivity.** Changes in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like, should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms.

**Postulate C-3. Consistency.** The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

**Postulate C-4. Stable Unit.** Accounting reports should be based on a stable measuring unit.

**Postulate C-5. Disclosure.** Accounting reports should disclose that which is necessary to make them not misleading.
APPENDIX C

A Tentative Set of Broad Accounting Principles for Business Enterprises

This study is an extension of Accounting Research Study No. 1. (Maurice Moonitz, "The Basic Postulates of Accounting." 1961.) It extends the analysis contained in "Basic Postulates" by applying it to the broad area of accounting for business enterprises. As a result, the emphasis in the postulates study on the measurement of wealth in the hands of economic entities becomes more specific in this study as an examination of the assets and liabilities, and related revenues and expenses, gains and losses, of business enterprises. The concept of profit becomes the focus of attention which leads to an examination of assets and liabilities in order to find the appropriate bases for measuring the results of operations for relatively short periods of time.

In accordance with the emphasis in the postulates study, this study of broad principles takes the position

that ideally all assets (and liabilities) should be recognized, as well as all changes that can be objectively determined. In addition to those changes which result from explicit transactions with other entities, this study recommends the recognition of price-level changes, of movements in replacement costs, and of changes from other causes, again provided that the evidence is objectively determinable.

The principles that are listed below are those recommended by the authors of this study, and have not been reviewed by the Accounting Principles Board of the American Institute of Certified Public Accountants. Before stating the principles that are recommended by the authors, certain definitions are given of key terms and concepts.

Definitions

Financial statements are those which purport to show financial position and results of operations, including supporting schedules, elaborations of special aspects of business activity, rearrangements of underlying data, and supplementary statements.

Assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction.

Cost is a forgoing, a sacrifice made to secure benefits, and is measured by an exchange price.

Depreciation accounting is the process of allocating the cost or other basis of measurement of the services
rendered by items of plant and equipment to the products or periods that used those services. Depreciation for any given period is the cost or other basis of the services used up in that period.

Liabilities are obligations to convey assets or perform services, obligations resulting from past or current transactions and requiring settlement in the future.

Owners' equity is represented by the amount of the residual interest in the assets of an enterprise.

Invested capital is that portion of stockholders' equity which arose from the commitment of assets to the corporation or from the conversion of retained earnings and which will not be withdrawn or reduced except as permitted by law. Retained earnings (earned surplus) is the portion which arose from operations and has not been converted into invested capital.

Net profit (earnings, income) or net loss for an accounting period is the increase (decrease) in owners' equity, assuming no changes in the amount of invested capital either from price-level changes or from additional investments and no distribution to the owners. Revenue is the increase in net assets of an enterprise as a result of the production or delivery of goods and the rendering of services. Expense is the decrease in net assets as a result of the use of economic services in the creation of revenues or of the imposition of taxes by governmental units. Gains are increases in net assets other than those resulting from
additions to invested capital or from revenues. Losses are decreases in net assets other than those resulting from reductions in invested capital or from expenses.

The term "distributions" refers to transfers of assets or of claims to assets to owners.

**Summary of Principles**

The principles summarized below are relevant primarily to formal financial statements made available to third parties as representations by the management of the business enterprise. The "basic postulates of accounting" developed in *Accounting Research Study No. 1* are integral parts of this statement of principles.

Broad principles of accounting should not be formulated mainly for the purpose of validating policies (e.g., financial management, taxation, employee compensation) established in other fields, no matter how sound or desirable those policies may be in and of themselves. Accounting draws its real strength from its neutrality as among the demands of competing special interests. Its proper functions derive from the measurement of the resources of specific entities and of changes in those resources. Its principles should be aimed at the achievement of those functions.

The principles developed in this study are as follows:

A. Profit is attributable to the whole process of
business activity. Any rule or procedure, therefore, which assigns profit to a portion of the whole process should be continuously re-examined to determine the extent to which it introduces bias into the reporting of the amount of profit assigned to specific periods of time.

B. Changes in resources should be classified among the amounts attributable to

1. Changes in the dollar (price-level changes) which lead to restatements of capital but not to revenues or expenses.

2. Changes in replacement costs (above or below the effect of price-level changes) which lead to elements of gain or of loss.

3. Sale or other transfer, or recognition of net realizable value, all of which lead to revenue or gain.

4. Other causes, such as accretion or the discovery of previously unknown natural resources.

C. All assets of the enterprise, whether obtained by investments of owners or of creditors, or by other means, should be recorded in the accounts and reported in the financial statements. The existence of an asset is independent of the means by which it was acquired.

D. The problem of measuring (pricing, valuing) an asset is the problem of measuring the future services, and involves at least three steps:
a. A determination if future services do in fact exist. For example, a building is capable of providing space for manufacturing activity.

b. An estimate of the quantity of services. For example, a building is estimated to be usable for twenty more years, or for half of its estimated total life.

c. The choice of a method or basis or formula for pricing (valuing) the quantity of services arrived at under b, above. In general, the choice of a pricing basis is made from the following three exchange prices:

(1) A past exchange price, e.g., acquisition cost or other initial basis. When this basis is used, profit or loss, if any, on the asset being priced will not be recognized until sale or other transfer out of the business entity.

(2) A current exchange price, e.g., replacement cost. When this basis is used, profit or loss on the asset being priced will be recognized in two stages. The first stage will recognize part of the gain or loss in the period or periods from time of acquisition to time of usage or other disposition; the second stage will recognize the remainder of
the gain or loss at the time of sale or other transfer out of the entity, measured by the difference between sale (transfer) price and replacement cost. This method is still a cost method; an asset priced on this basis is being treated as a cost factor awaiting disposition.

(3) A future exchange price, e.g., anticipated selling price. When this basis is used, profit or loss, if any, has already been recognized in the accounts. Any asset priced on this basis is therefore being treated as though it were a receivable, in that sale or other transfer out of the business (including conversion into cash) will result in no gain or loss, except for any interest (discount) arising from the passage of time.

The proper pricing (valuation) of assets and the allocation of profit to accounting periods are dependent in large part upon estimates of the existence of future benefits, regardless of the bases used to price the assets. The need for estimates is unavoidable and cannot be eliminated by the adoption of any formula as to pricing.

1. All assets in the form of money or claims to
money should be shown at their discounted present value or the equivalent. The interest rate to be employed in the discounting process is the market (effective) rate at the date the asset was acquired.

The discounting process is not necessary in the case of short-term receivables where the force of interest is small. The carrying-value of receivables should be reduced by allowances for uncollectible elements; estimated collection costs should be recorded in the accounts.

If the claims to money are uncertain as to time or amount of receipt, they should be recorded at their current market value. If the current market value is so uncertain as to be unreliable, these assets should be shown at cost.

2. Inventories which are readily salable at known prices with readily predictable costs of disposal should be recorded at net realizable value, and the related revenue taken up at the same time. Other inventory items should be recorded at their current (replacement) cost, and the related gain or loss separately reported. Accounting for inventories on either basis will result in
recording revenues, gains, or losses before they are validated by sale but they are nevertheless components of the net profit (loss) of the period in which they occur.

Acquisition costs may be used whenever they approximate current (replacement) costs, as would probably be the case when the unit prices of inventory components are reasonably stable and turnover is rapid. In all cases the basis of measurement actually employed should be "subject to verification by another competent investigator."

3. All items of plant and equipment in service, or held in stand-by status, should be recorded at cost of acquisition or construction, with appropriate modification for the effect of the changing dollar either in the primary statements or in supplementary statements. In the external reports, plant and equipment should be restated in terms of current replacement costs whenever some significant event occurs, such as a reorganization of the business entity or its merger with another entity or when it becomes a subsidiary of a parent company. Even in the absence of a significant event, the accounts could be restated at periodic intervals,
perhaps every five years. The development of satisfactory indexes of construction costs and of machinery and equipment prices would assist materially in making the calculation of replacement costs feasible, practical, and objective.

4. The investment (cost or other basis) in plant and equipment should be amortized over the estimated service life. The basis for adopting a particular method of amortization for a given asset should be its ability to produce an allocation reasonably consistent with the anticipated flow of benefits from the asset.

5. All "intangibles" such as patents, copyrights, research and development, and goodwill should be recorded at cost, with appropriate modification for the effect of the changing dollar either in the primary statements or in supplementary statements. Limited term items should be amortized as expenses over their estimated lives. Unlimited term items should continue to be carried as assets, without amortization.

If the amount of the investment (cost or other basis) in plant and equipment or in the "intangibles" has been increased or
decreased as the result of appraisal or the use of index-numbers, depreciation or other amortization should be based on the changed amount.

E. All liabilities of the enterprise should be recorded in the accounts and reported in the financial statements. Those liabilities which call for settlement in cash should be measured by the present (discounted) value of the future payments or the equivalent. The yield (market, effective) rate of interest at date of incurrence of the liability is the pertinent rate to use in the discounting process and in the amortization of "discount" and "premium." "Discount" and "premium" are technical devices for relating the issue price to the principal amount and should therefore be closely associated with principal amount in financial statements.

F. Those liabilities which call for settlement in goods or services (other than cash) should be measured by their agreed selling price. Profit accrues in these cases as the stipulated services are performed or the goods produced or delivered.

G. In a corporation, stockholders' equity should be classified into invested capital and retained earnings (earned surplus). Invested capital should, in turn, be classified according to source, that is, according to the underlying nature of the transactions giving rise to invested capital.
Retained earnings should include the cumulative amount of net profits and net losses, less dividend declarations, and less amounts transferred to invested capital.

In an unincorporated business, the same plan may be followed, but the acceptable alternative is more widely followed of reporting the total interest of each owner or group of owners at the balance sheet date.

H. A statement of the results of operations should reveal the components of profit in sufficient detail to permit comparisons and interpretations to be made. To this end, the data should be classified at least into revenues, expenses, gains, and losses.

1. In general, the revenue of an enterprise during an accounting period represents a measurement of the exchange value of the products (goods and services) of that enterprise during that period. The preceding discussion, under D(2), is also pertinent here.

2. Broadly speaking, expenses measure the costs of the amount of revenue recognized. They may be directly associated with revenue-producing transactions themselves (e.g., so-called "product costs") or with the accounting period in which the revenues appear (e.g., so-called "period costs").

3. Gains include such items as the results of
holding inventories through a price rise, the sale of assets (other than stock-in-trade) at more than book value, and the settlement of liabilities at less than book value. Losses include items such as the results of holding inventories through a price decline, the sale of assets (other than stock-in-trade) at less than book value or their retirement, the settlement of liabilities at more than book value, and the imposition of liabilities through a lawsuit.
VITA

James Wilson Pattillo, the son of Reuben Terry and Ruby Margaret Pattillo, was born April 17, 1937, in Robstown, Texas. He was graduated from Corpus Christi Academy, Corpus Christi, Texas, in May, 1954, and the following September entered St. Edward's University, Austin, Texas. In June, 1958, he received the degree of Bachelor of Science in Commerce from St. Edward's University. From September, 1958, to August, 1959, he served as Teaching Fellow, and received the Master of Business Administration degree in August, 1959, from Texas Technological College, Lubbock, Texas.

In September, 1959, he entered the graduate school of Louisiana State University, Baton Rouge. From that date he was a graduate student and also taught in the Department of Accounting as Graduate Assistant and as Instructor of Accounting. He was granted a CPA certificate from the State of Texas after having passed the May, 1962, Uniform CPA Examination. In September, 1962, he joined the Department of Accounting of the University of Southern California, as Assistant Professor.

He is currently a candidate for the Degree of Doctor of Philosophy at Louisiana State University.
EXAMINATION AND THESIS REPORT

Candidate: James Wilson Pattillo
Major Field: Accounting
Title of Thesis: The Foundation of Financial Accounting

Approved:

[Signatures of approved individuals]

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures of committee members]

Date of Examination: December 13, 1962