ACCOUNTING THEORY
IN THE USA

Until the twentieth century the contribution of the English-speaking world to the development of accounting theory was entirely pragmatic. Even today one can open a book entitled Principles of Accounting and find its author concerned entirely with method. The most virulent controversy before the 1930s, was the dispute which centered on the notorious Jones of Bristol and that one deal with technical aspects of double-entry bookkeeping and the need for the journal.¹

The twentieth century has seen a radical reversal of roles. During this period the English-speaking world (the United States, the United Kingdom, Australia, Canada, and New Zealand in particular) has become a powerhouse of ideas about accounting: what it is and what it should be. In this chapter and the next we shall trace the course of this transformation, with the spotlight mainly on accounting in the United States.²

THE INDUSTRIAL REVOLUTION

A major factor was the industrial revolution and the related technological changes of the nineteenth century. The lengthening of the time period of production which characterized these changes produced a need to account for use separately from acquisition and thus directed attention to the cost allocation problem.

The processes of mass production may be contrasted with those of an artisanal economy. In the latter, manufacture was accompanied by payments at every stage—for materials when they were put in hand and for labor as the work was executed, either in the workshop or in the worker's home. The difference between the money payments and the eventual money receipt when the work was completed was called profit and had to cover the craftsman's expenses, which were virtually all domestic in nature. This concept of profit is still used by economists, even though it is a pre-industrial one. It underlies the analysis of investment situations in terms of cash flows.

In factory production, however, the nexus between acquisition and use and between production and market was broken. The manufacturer produced for an unknown customer, in advance of demand, and therefore,
could not associate the eventual selling price with production. He acquired raw materials, machinery, and often labor in advance of production and therefore could not identify the cost of production without making assumptions about cost flows. The conceptual nature of allocation has been demonstrated by Thomas, who points out the artificiality—he calls it arbitrariness—of all accounting allocations.

We must also be aware of a semantic problem which exists in the United States because of the use of the word “allocation” to refer to three distinct accounting processes. The first of these is assignment, the identification of payments with objects. The second is allocation, tracing the use of objects in a production process. The third is absorption, tracing the use of a production process in the production of a product or service. In this section we are contrasting the simplicity of assignment with the complexity of allocation and absorption.

The immediate problems raised by the necessity to allocate and absorb costs concerned the calculation of depreciation and depreciation accounting, the valuation of inventories of work in process and finished goods and accounting for cost of goods sold, and accruals and deferrals generally, in relation to uses which preceded or followed acquisitions. In course of time the same necessity has led to a vast area of accounting problems, covering virtually the entire field of accounting, and created what one writer has referred to as “explanation strains.”

These strains were rendered more acute by the traditional separation of financial and cost accounting. Because of the critical importance of these allocation decisions for pricing policy, they were often retained by the proprietor of the business long after he had delegated accounting for acquisitions to a clerk.

Cost accounting went through three stages in the nineteenth century. In the first, it was performed by nonaccounting calculations illustrated by the papers of Josiah Wedgewood and Charles Babbage. In the second, the need to create order out of chaos led to the introduction of accounting method and the growth of systems of cost accounts separate from the financial accounts. These separate accounts might be reconciled with the financial accounts, or made to interlock with them through the medium of control accounts: a cost ledger control account in the financial books and a general ledger control account in the cost books. Finally, the integration of financial and cost accounts in one accounting system was achieved. It is perhaps significant that the development of modern accounting theory dates from the beginning of this integration. We should not underestimate the important contribution made by industrial engineers in clarifying and sometimes finding solutions for the accounting problems of the industrial revolution.

THE GROWTH OF THE CORPORATION

Corporations are nothing new; the Romans used them, together with elevators, central heating, and divorce. An extensive world trade was conducted from the fifteenth century on by the chartered corporations formed by rulers and entrepreneurs in the mercantilist period. During the nineteenth century, however, and particularly in the United States, the number of commercial corporations grew at an accelerating pace, from several hundreds to tens of thousands. Laws were passed to facilitate their formation and administration and to render them accountable to the governments which gave them life.

The characteristic features of the corporation are its relatively long life (perpetual succession) and the transferability of its capital. Both of these are the consequence of it being an artificial person, but a legal person, nonetheless. Because the corporation does not die, or become sick or insane, it is a convenient device for executing contracts, including contracts to supply capital for industrial undertakings. Because of the transferability of its capital, it is also an attractive device to businessmen and other investors concerned about their future liquidity needs. Add to these the bonus feature of limited liability, and the corporation becomes the irresistible instrument of business growth.

Use of the corporation as a device for channelling savings into business investment effected a separation between capital and its management, formal in the case of the “one-man corporation,” but very real in the case of those corporations which raised capital from a number of investors. In order to provide these “anonymous partners,” as the French law called them, with some means of ascertaining what was happening to their investment, a succession of Companies Acts was legislated in the United Kingdom which required corporations to keep records and to render account to their stockholders. Most of the English-speaking world has enacted comparable legislation; only in the United States has it proved impossible to make the states, in whom the power resides, exercise social control over corporate officials. The situation is now changing slightly, as the states see the corporations as taxpayers and legislate for accounts to be kept for the purpose of demonstrating taxable capacity.

Typically, a Companies Act would contain sections requiring accounts to be kept and financial reports to be rendered to stockholders. More important, to protect stockholders from the deception of being paid dividends to keep them quiet while the managers were losing the company’s money, the law would stipulate that dividends may be paid only out of profits. This led of necessity to the preparation of period accounts, or annual financial statements, and to problems of allocation similar to those which were raised by the factory system. As the manufacturer required information about depreciation, work in process and finished goods, and cost of sales in relation to specific products or services, so the corporation required this type of information in relation to specific periods. The major problems in financial reporting arise from segmenting the life of the firm into artificial lengths only remotely related to the time period of production. As a consequence, we find accountants adopting the going concern assumption, that raw materials acquired will be put into production, that work in process will be completed in the form of saleable finished goods, and that finished goods will be sold at prices higher than their production costs. The going concern assumption also involves a belief that the business will continue to operate in more or less the same way until it has recovered its investments in fixed assets from its customers as part of the selling prices of its products.
and the combined results of all the corporations of which it consisted. This led to the development of consolidated financial statements as early as 1886, although the first annual report of the United States Steel Corporation in 1902 is usually acknowledged as the prototype of consolidations.

THE RAILROADS AND GOVERNMENT REGULATION

The importance of the railroads in the process of identifying accounting problems cannot be exaggerated. They were the first large-scale enterprises spawned by the industrial revolution. The first capital-intensive enterprises, they presented in unmistakable terms the separation of capital and management, and they provided the first scenario for government regulation of business, including its financial statements. This resulted in large part from the misdeeds of a host of promoters who sold railroad stock and acquired control over railroad assets with no intention other than to enrich themselves.

The New York Stock Exchange dates from before the American revolution, but only in 1866 did it prescribe that listed corporations should file their financial statements. Not until 1900 did this influence become effective. One of the principal reasons for the involvement of the New York Stock Exchange was the tremendous fluctuation in the prices of railroad stocks, a consequence of the ignorance of investors as well as the manipulations of the railroad barons.

The railroads were the center of a historic struggle which resulted in the recognition that these should be accounted for, and not merely acquisition. The railroad managers argued that regular maintenance and replacement of worn equipment would cause the permanent way and the rolling stock to last indefinitely. Depreciation was therefore not a relevant concept, and replacements should be charged to expense as incurred. This solution had obvious attractiveness, since it made the expense a discretionary item—in good years, more; in lean years, less or possibly none.

In 1876 the Railway Commissioners of Massachusetts required railroads to keep accounts, and by 1879 a uniform system of accounting had been adopted nationally on the initiative of the Interstate Commerce Commission (ICC). The Hepburn Act of 1906 authorized the ICC to prescribe railroad accounting, which it did in part by publishing “Classification of Operating Expenses” in 1907 and finally a complete “Accounting Classification for Steam Railroads” in 1914.

The 1907 scheme provided for depreciation to be charged to operating expenses on a monthly basis, but gave individual railroads the option not to do so (or to include accrued expenses if, for example, they were losing money. In 1923 the ICC proposed to make depreciation accounting mandatory; the railroads opposed, using arguments which are still heard today when additional disclosure is sought—that it was unnecessary, deceptive, and impossible to calculate with accuracy. The railroads' opposition delayed the imposition of mandatory depreciation until 1932, when it was immediately suspended because of the depression. It finally came into force in 1943. The omission of depreciation was undoubtedly one of the factors which permitted railroads to operate and attract
capital long after obsolescence and inefficiency had made them a burden on the economy.

The outcome of the struggle just described was irrelevant, because of the development of generally accepted accounting principles in the United States, which required railroads to charge depreciation in their published financial statements. The struggle itself is important because it documents the transition from a pre-industrial to an industrial accounting system. Government regulation in the United States has had some of the effects of the Companies Acts in the United Kingdom and elsewhere, in that a number of commissions besides the ICC (the Federal Power Commission, the Federal Communications Commission, the Federal Aviation Authority, etc.) have prescribed accounting systems for the enterprises they regulate. Although some accounting problems have been identified and solutions found through this process, the consensus is that government regulation has had an unfavorable effect on the accounting of regulated enterprises, through discouraging experimentation and innovation. Further, the accounting systems have ceased to be oriented toward disclosure, as in the unregulated sector, and have increasingly become instruments of politics. This is because the commissions have become rate makers, thus taking the pricing function out of the market. One of the principal means for a government to effect a political purpose is by fixing prices.

Thus, although a number of accounting issues have been raised by the regulation of public utilities, they can be readily explained in the context of the political problems of rate setting and do not form part of the set of issues which accounting theory seeks to explain.6

THE CORPORATE INCOME TAX

Perhaps the single most pervasive influence on the growth of accounting has been the corporate income tax, since it affects all business firms, large or small, incorporated or unincorporated, regulated or unregulated. Here we are concerned with the influence of the corporate income tax on the development of modern accounting theory.

The critical point is that the corporate income tax is a legal structure, and therefore the solutions to tax problems are legal solutions. To the extent that the tax laws recognize accounting solutions, accounting becomes part of the law. There is, for example, no definition of income to be found in the tax code, and the logical tendency of the taxing authority is to tax movements of cash. The first attempt at a corporate income tax in the United States, the 1909 Excise Act and the 1913 Revenue Act, measured net income as cash receipts less cash disbursements, and a battle had to be fought to establish the acceptability of accrual accounting as the basis for income taxation.

A striking illustration of the difference between accounting and taxation is found in the United Kingdom, where the objective is also to tax receipts, and the business accounts are accepted as a point of departure. The tax laws were laid down before the need to charge depreciation was clearly identified, and to this day, depreciation is not deductable in the U.K. However, businessmen were eventually successful in persuading the tax authority that fixed assets may be losing value through time, and the tax laws were amended to introduce capital allowances. These are a quite separate legal system for calculating depreciation for tax purposes, having no connection with accounting depreciation and applicable only to specified classes of depreciable fixed assets; store fixtures and office buildings are excluded. In preparing a business tax return therefore, the U.K. accountant adds back depreciation to net income and deducts a different amount, calculated according to the law.

This illustration serves to remind us that although business net income is a point of departure for arriving at taxable income, the two are essentially distinct concepts. It appears that the original intention of Congress in the United States was to establish a concept of taxable income which corresponded with business net income, but the harmonization of the two has become impossible. In the first place, tax avoidance through technical accounting methods created loopholes which led to legislation forbidding certain tax accounting practices; the valuation of inventories at prime cost, for example, is not permissible, however logical this might be in a specific context. In the second place, use of the income tax laws to affect a redistribution of wealth and to promote political objectives has led to the enactment of a multitude of provisions concerning what is or is not to be included in taxable income, and what may or may not be deducted therefrom.

We should not look, therefore, to the corporate income tax as a source of modern accounting theory. Its importance lies in:

1. Extending the need for accounting to many businesses which would not otherwise have prepared financial statements.
2. Influencing many businesses to adopt tax rules or guidelines for the recognition of items of revenue or expense, because of the complications involved in operating two accounting systems.
3. Stimulating debate on such questions as depreciation and inventory accounting, accrual and deferral, and asset and liability valuation, by revealing alternatives to conventional practices.
4. Introducing a new subset of accounting problems, accounting for taxation, which have strained the ability of accountants to explain the application to them of accounting principles developed in a different context.
5. Distorting accounting to conform with taxation where the tax laws provide that a particular deferral or deduction may be claimed only if the requisite tax treatment becomes also the financial statement treatment. This is the situation in the United States with regard to the use of the LIFO method of determining cost of goods sold. In some countries (France, Germany) many of the items in the financial statements are there because of the requirements of the tax laws.
6. Providing a false trail for accounting theorists, such as the rule in Eisner v. Macomber (Chapter 7), which have been tempted to adopt legal explanations for practices found outside the legal framework.
THE ECONOMISTS

Until the early nineteenth century most economists were political economists; their preoccupation with the production and distribution of wealth centered on the source of political power. By the end of the nineteenth century, however, economists had begun to appreciate the role which industry played in the production and distribution of wealth. Such noted economists as Alfred Marshall in England, Böhm-Bawerk in Austria, and J.B. Clark in the United States conducted studies of businesses enterprises and attempted explanations of concepts such as income, capital, and cost, which are the subject of accounting theory also. Sombart pointed out that the ideas of economists on these matters originated in accounting, but the victory of the marginalist school resulted in new definitions which gradually moved economics and accounting further apart.

Nevertheless, the apparent similarity of the subject-matter of economic studies led some early accounting theorists to assume that the disciplines of accounting and economics were essentially one, so that accounting problems could be solved within the framework of economic theory. This assumption pervades much of the contemporary literature on accounting theory, and its origins can be traced to books written in the early years of the twentieth century:

The interests of economists lie primarily in macro-economics, the study of the national income and its generation, and their work in micro-economics, the study of economic behavior at the level of the firm, is designed to support the major field of interest. For this reason, economists have never made the transition from the pre-industrial model of the firm, where acquisitions and uses, and capital and assets, cannot be distinguished, where financial institutions as sources of money can be disregarded, and where time can be reduced to an input or output entirely as a significant variable. As we have noted, this transition was accomplished by accountants in the nineteenth century and resulted in the valuation method we call allocation.

One notable exception to the failure of economists to adapt to the industrial and post-industrial realities was J.M. Clark. Clark recognized the existence of situations in which economic valuations could not be made by imputing marginal amounts to production inputs or outputs; he dealt specifically with the imputable overhead costs of manufacturing firms. Another American economist who attempted to adapt micro-economics to the industrial scene was Thorstein Veblen. Unfortunately the pioneering work of these theorists proved abortive, as their colleagues were unwilling or unable to abandon the Ricardian images on which their science was based.

THE AMERICAN SCHOOL OF ACCOUNTING THEORY

Much the same sequence of events can be identified in other countries. The situation in the United Kingdom, where the industrial revolution and the corporate income tax originated, can be contrasted with that in the United States, where government regulation played a unique role. The Anglo-American jurisdictions can be contrasted with those jurisdictions which forced financial accounting to conform to tax accounting. Neverthe-

less, it is noteworthy that the responses of accountants in different parts of the world to similar situations was highly comparable. By the beginning of the twentieth century the form and content of financial statements did not differ to any considerable extent throughout the Western world.

From 1930 on, however, special factors have caused the U.S. to act as a trail-blazer in the development of accounting theory. There is a distinct "American School of Accounting Theory." The characteristics of this school are 1) the involvement of a relatively large number of academicians and practitioners in defining, researching, and debating accounting issues; 2) the existence of institutions which publicize and focus attention on the views of accounting theorists, e.g. the AICPA and the AAA; 3) the general acceptance of the neo-classical economic theory of investment, as adapted by scholars in corporation finance; and 4) an experimental approach to accounting aimed at producing a framework which will justify and explain a more significant social role for the accountant than he has appeared to play in the past.

Because of the absence of a legal framework to which accounting questions could be referred, early American textbook writers displayed a tendency to look for reasons behind their expositions of accounting practices. The prevalence of the proprietary theory approach impelled Baker to attribute its origins to these writers, although we now know this theory to have originated in Europe.

The first author to identify himself clearly as an accounting theorist was Paton, whose seminal work was originally published as a doctoral dissertation in 1916. It was Paton who emphasized the entity theory, which earlier American writers had used and Littleton has identified in nineteenth century European publications. Paton pointed out in the preface to his book that "The conception of the business enterprise as in all cases a distinct entity or personality—an extension of the fiction of the corporate entity—is adopted, although not without important qualifications..."

A.C. Littleton was another accounting scholar of this period whose works took an explicitly theoretical form and whose ideas contributed significantly to modern accounting thought. Both Paton and Littleton made a number of important contributions to the literature between 1925 and the latter's death in 1974; Dr. Paton is still at work in this field. The two contributed to produce a influential monograph widely regarded as an accounting classic.

The principal features of Littleton's contribution to accounting theory have been summarized as:

1. The inductive approach to the development of accounting knowledge
2. The historical method of relating accounting practice to its social and economic development
3. The development of the idea of general purpose financial statements which permitted the initial development of an organized structure of accounting thought
4. The view of accounting theory construction as explanations of varying levels of validity of relations among concepts
5. The comprehensive view of accounting as one common interrelated body of knowledge to be studied and examined as a single discipline. 14

Littleton is now viewed as a figure of the past; current accounting scholarship adopts contrary assumptions on virtually every point. Nevertheless, his definitions and interpretations have not yet been demonstrated false in practice, and for that reason are still part of accounting theory. During this period a number of other accounting writers occupied themselves with theoretical questions. Some, such as G. O. May, Maurice E. Peloubet, Wilmer L. Green, Thomas Henry Sanders, and Perry Mason, concentrated on explaining current financial accounting practices and their origins. S. Paul Garner performed a similar service for cost accounting. D. R. Scott attempted to reconcile accounting with statistical method; John B. Canning with the economic theories of Irving Fisher. Henry W. Sweeney investigated the problems of accounting in a time of changing price-levels. Robert H. Montgomery attempted to develop a theory of auditing, Stephen Gilman to produce agreed definitions of accounting terms and a common concept of income.

Since 1950 the number and quality of contributions to accounting theory have increased rapidly as the subject of accounting has been firmly placed in the mainstream of academic life in American universities. In part this has been a function of an increase in the number of Ph.D.'s in accounting, since the Ph.D. is generally regarded as a research degree and carries the moral obligation to continue to explore and publish after the completion of the doctoral dissertation. But many practitioners and accounting teachers who did not acquire this degree have also contributed richly to the expanding body of accountancy knowledge. It is impossible to provide a complete list in a book of this kind, but reference will be made to the work of many individuals at appropriate places. In my case, it is clear that the world has never seen a comparable concentration of talents on the problems of accounting as that in the United States during the past seventy years.

Much of this work was made possible by institutional arrangements which were ahead of the rest of the world by many decades. Public accountants established foundations which awarded funds for research and publication: Sanders, Hatfield, and Moore, for example, were commissioned by the Haskins and Sells Foundation. The American Institute of Accountants, and its successor body, the American Institute of Certified Public Accountants, sponsored research often ignored by their committees responsible for promulgating accounting principles, and provided a forum for ideas in an official publication, the Journal of Accountancy. The American Accounting Association's quarterly publication The Accounting Review, founded in 1925, quickly became the leading vehicle for exposing new ideas and discussing theoretical problems. The AAA created a committee structure for scholars with similar research interests, who were encouraged to work together and publish jointly-authored papers. The AAA also established its monograph series, permitting outstanding scholars to publish works of high quality which would be unlikely to attract the support of a commercial publishing house. Similar support

...to that provided by the AICPA and the AAA was available to scholars interested in cost and management accounting from the National Association of Cost Accountants (now the National Association of Accountants) and through its journal the NACA Bulletin, (now called Management Accounting). In recent years these institutional arrangements have increased, and many other sources of support are now offered to accounting theorists in the United States.

THE ACCEPTANCE OF NEO-CLASSICAL ECONOMIC THEORY

At the beginning of the period under discussion the primary influence on accounting theory was legal in nature. The modern profession of accountancy owes its origins to the law and has never forgotten the fact—to the bankruptcy and company laws of nineteenth century England and to the taxation and regulatory laws of twentieth century United States. The search for accounting principles was invariably referred to a framework analogous to that of the law; writers contrasted the conventional principles of law and accounting with the immutable principles of the sciences. 15

Beginning with Canning in 1929, however, we find an increasingly explicit effort to establish accounting as a science in the mold of economics. 14 Canning was a disciple of Irving Fisher, whose important work on income and capital theory will be discussed in Chapter 7, and attempted to translate Fisher's ideas into a form useful to accountants. Fisher and Canning taught at Californian universities, and we can identify a "California School" of accounting theorists formed by their views. Maurice Mookna is the current leader of the California School. 17

Paton was also exposed to the models of economic theory and taught economics as a young man at the University of Michigan, but he attempted to distinguish accounting from economics rather than to integrate accounting into a framework of economic theory. The younger generation of accounting theorists appears to have been more ready to espouse this integration, and from about 1936 until the present day the acceptance of economic theory in its neo-classical form, the form in which it is usually taught in American universities, has become more general. This is not to denigrate Fisherian and Keynesian economics, which have been skillfully interwoven into the neo-classical fabric during the past forty years.

The acceptance of economic theory has had several effects on the development of accounting theory. In the first place, the rigor which characterizes the formulation of economic propositions and the construction of economic models and their use to derive theorems and to deduce principles and rules has been widely accepted as a desirable standard for parallel work in accounting theory. The almost theological tone of previous generations of accounting writers has been replaced by the voice of reason. Secondly, many definitions and concepts used by economists have been taken over by accountants (as earlier economists adopted accounting terms and ideas), which has opened up fruitful lines of inquiry and permitted the formulation of new research problems. Examples of this are accountants' use of such economic concepts as marginal cost, sunk cost,
present value and uncertainty. Indeed, accounting has at times appeared to be a branch of economics, or vice versa.31

Thirdly, and in particular, the development of a theory of corporate finance based on the investment theory of economics has presented accounting theorists with a challenge and an opportunity. It is clear that finance and accounting are inextricably interwoven, and we have pointed out the similarity between the basic equations of the two disciplines. To produce a theory of accounting compatible with the theory of finance would appear to be a useful goal. We shall demonstrate later how this objective underlies APB Statement No. 4, the most comprehensive statement of accounting theory to come from the accountancy profession.

METHODOLOGY OF ACCOUNTING THEORY FORMULATION

The view that accounting theory should consist of principles "relatively few in number" was accepted by the AICPA’s Joint Committee with the New York Stock Exchange. We may infer that economics provided the inspiration, where the law of demand is deduced from the postulate of utility maximization and the law of supply from the postulates of the production function and profit maximization.

This view contrasts sharply with the inductive approach favored by Littleton. Littleton saw the derivation of accounting principles from the observation of good accounting practices; good business practices were accompanied by good accounting practices. Although the formal structure of postulates, principles, and rules did not appear explicitly in this process, the Littleton-Chambers debate suggests that a set of normative postulates underlie Littleton’s reasoning; to him, accounting was what accountants should do.

Paton, on the other hand, summarized the postulates on which his theory was based.

1. The separate existence of the business entity from its owners or managers
2. The going concern assumption of continuity as the normal case
3. The balance sheet equation, Assets = Equities
4. The exhaustive nature of financial condition, in which every significant fact is expressed in dollars
5. The stability of the measuring unit (dollars)
6. The equivalence of cost and value on original entry
7. The transitivity of cost, which "passes over and attaches"
8. The accrual of costs, their expiry over time and attachability to production

A more formal approach is that taken by Mattessich, who starts with a definition:

Accounting is [a discipline concerned with] the quantitative description and projection of [the] income [circulation] and [of] wealth [aggregates] by [means of] a method based on the following set of assumptions...32

There are eighteen assumptions, specifically:
1. Monetary valuation
2. Time
3. Structure (accounting as a closed system)
4. Duality (double-entry)
5. Aggregation (algebraic operations)
6. Economic objects (scarce resources)
7. Inequity of monetary claims (stability of the measuring unit)
8. Economic agents (human actors)
9. Entities (social institutions)
10. Economic transactions (movements of values)
11. Valuation (operational rules for measuring movements of values)
12. Realization (operational rules for measuring income)
13. Classification (operational rules for analyzing movements of values)
14. Data input (operational rules for bookkeeping)
15. Duration (operational rules for relating entities to time)
16. Extension (operational rules for consolidating entity accounts)
17. Materiality (operational rules for identifying data)
18. Allocation (operational rules for imputing values to parts of entities)

In spite of the elements of overlap, this is the most precise statement of assumptions which has been presented as such by an accounting theorist and from which explanations of accounting practices have been derived. Nevertheless, it could be viewed as incomplete, because it does not contain any reference to user needs (behavioral assumptions concerning the actor) and because it omits other postulates which appear to have general acceptance, particularly relevance, consistency, continuity, and objectivity.

Another approach to methodology is that taken by Sterling. Sterling adopts expressly and by reference economic theories of income (Chapter II), price theory (Chapter III), information and communication theory (Chapter IV), and measurement theory (Chapters V and VI). Because of the contradictions inherent in any theoretical framework it would have been preferable for Sterling to specify more closely which definitions, assumptions, and models were used in the construction of his theory, particularly because Sterling’s theory is normative in nature.

APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" lies somewhere between these two extremes, including as it does both specific postulates and the adoption of general frames of reference as integral parts of the expositions.33

APB STATEMENT NO. 4

Whereas the need for a formal structure of accounting theory has been apparent to academics since the 1920s, it was not until 1958 that the American accountancy profession was ready to accept such an objective. The then president of the AICPA called for the Institute to provide an
adequate research organization continuously to reexamine basic accounting assumptions and to develop authoritative statements. In the event, the APB did not live up to these expectations, and the first attempts to state postulates and principles were rejected by the APB. In spite of the return to a piecemeal approach to pronouncing on accounting principles, the search for broad fundamentals went on and resulted in the publication in 1970 of APB Statement No. 4. The aims of the Statement were both educational and developmental; the latter intended to provide a basis for guiding the future development of financial accounting. But the two aims were essentially distinct. The developmental part contained general propositions about the environment, objectives, and basic features of financial accounting. The educational part contained a description of the then generally accepted accounting practice. The contradiction between these two approaches was nowhere acknowledged; it was avoided by eliminating deduction and relying entirely on induction.

The part on generally accepted accounting principles divided them into three classes:

1. Pervasive principles which underlie other principles (but are restricted by modifying conventions)
2. Broad operating principles, of recording, measuring, and communicating
3. Detailed principles of practical application

Classes 2 and 3 will be discussed in subsequent chapters on measurement and disclosure and when the individual financial statements are examined in detail. Here we shall analyze the developmental part of the statement and the pervasive principles, to demonstrate the relevance of economic theory to the former and its irrelevance to the latter.

We have examined the new definition of accounting put forward by the Statement (Chapter 1). While it does not help identify the kind of problems with which accounting is concerned, it nevertheless puts accountants firmly in their places, as the servants of those who make economic decisions. The many planning roles of the professional accountant in modern society are not recognized by this definition. Financial accounting is viewed as the production of "a continual history quantified in money terms."

The Statement treats financial accounting as a continuous history of economic resources and obligations and of economic activities that change those resources and obligations. While the word "economic" is frequently used in a layman's sense as a synonym for business, subsequent evidence indicates that this is not the case here, and that "economic" is a reference to the subject-matter of economic theory. That these two concepts are different will be explained more fully in Chapter 7; suffice at this point to mention that economic theory abstracts from the institutional framework; there are no businesses in economic theory, only entrepreneurs.

The following environmental postulates are then introduced:

1. Financial accounting information is used by a variety of users for diverse purposes. (The Statement expressly refrains from distinguishing information from data.)

2. There is a presumption that a significant number of users need similar information.
3. All societies engage in production, income distribution, exchange, consumption, saving, and investment.
4. In the United States most productive activity is by investor-owned business enterprises of a complex kind. This complexity is a function of
   a. Continuity of economic activity (underlying the need for allocation)
   b. Jointness of products (underlying the need for arbitrary assumptions)
   c. Uncertainty
5. Modern economies function within a stabilizing framework of law, custom, and tradition affecting corporate existence and contractual rights and obligations.

The Statement provides the following definitions:

1. Economic resources—Scarcely consists of productive resources (owned and leased), products, money, claims to money, and ownership interests in other enterprises.
2. Economic obligations—Present responsibilities to transfer economic resources to other entities in the future.
3. Residual interests—Economic resources minus economic obligations.
4. Economic events—Acquisition and disposal of resources, incurring and discharging of obligations, and changes in the utility or prices of resources held. These are classified into external and internal events; the former include exchanges and noneconomic transfers, and the latter, production and casualties. Although the classification is intended to be complete and to avoid overlapping, it will be observed that there is no place for waste (economic theory likewise abstracts from waste), and casualty losses could as readily be classified as external events.
5. Cost—Economic cost is the sacrifice incurred in economic activities.

What these assumptions and definitions appear to do is to transform certain propositions used by economists into a form in which they can be related to other propositions used by accountants. It is also interesting to observe the survival of the proprietary theory in the form of the equation: residual interest equals economic resources minus economic obligations, and in the proposition that "Net income or loss can result from each of the types of events listed except transfers between an enterprise and its owners." Net income is not otherwise defined.

The Statement lists the basic features and basic elements of financial accounting which are shown on Table 3-1. The similarity of the features to Patch's and Matteis's assumptions is apparent, as is also the absence of a method whereby they can be combined with objectives to produce financial statements.
TABLE 3-1 APB STATEMENT NO. 4

<table>
<thead>
<tr>
<th>Basic Features of Financial Accounting</th>
<th>Basic Elements of Financial Accounting</th>
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</thead>
<tbody>
<tr>
<td>1. The accounting entity</td>
<td>Assets</td>
</tr>
<tr>
<td>2. The going concern</td>
<td>Liabilities</td>
</tr>
<tr>
<td>3. Measurement of economic resources and obligations</td>
<td>Owners' equity</td>
</tr>
<tr>
<td>4. Time periods</td>
<td>Other Balance Sheet elements</td>
</tr>
<tr>
<td>5. Money measurement</td>
<td>(commitments, contingencies and other financial matters)</td>
</tr>
<tr>
<td>6. Accrual</td>
<td>Revenue</td>
</tr>
<tr>
<td>7. Exchange price as the “basis” for financial accounting measurements</td>
<td>Expenses</td>
</tr>
<tr>
<td>8. Approximation (allocation)</td>
<td>Net income (net loss)</td>
</tr>
<tr>
<td>9. Judgment required</td>
<td></td>
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<tr>
<td>10. General-purpose financial information</td>
<td></td>
</tr>
<tr>
<td>11. Fundamentally related financial statements (double entry system)</td>
<td></td>
</tr>
<tr>
<td>12. Substance over form</td>
<td></td>
</tr>
<tr>
<td>13. Materiality</td>
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</table>

PERVASIVE PRINCIPLES AND MODIFYING CONVENTIONS

Since generally accepted accounting principles are found by inquiry and not deduced from postulates, we would not expect them to lie snugly within the framework established in the developmental part of the Statement. However, they are said themselves to form a hierarchy, pervasive principles being “few in number and fundamental in nature.” The Statement emphasized that “No attempt is made . . . to indicate specific relationships between principles” nor indeed, between postulates, objectives, basic features and elements, as these terms are used in the Statement. The pervasive principles “establish the basis for implementing accrual accounting” and determine 1) the types of events to be recognized, 2) the bases on which to measure the events, 3) the time periods with which to identify the events, and 4) the common denomination of measurement. The pervasive principles are six in number:

P-1. Initial recording of assets and liabilities “generally . . . on the basis of events in which the enterprise acquires resources . . . or incurs obligations . . . the assets and liabilities are measured by the exchange prices at which the transfers take place.” (emphasis supplied) The events do not include own construction of assets.

P-2. Revenue recognition requires 1) that the earning process be complete and 2) that an exchange has taken place. [Note: this is a new realization assumption and does not correspond with current generally accepted accounting principles.]

P-3. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. (The matching principle)

P-4. In the absence of a direct cause and effect measurement some costs are allocated to periods using a systematic and rational relationship to benefits.

P-5. Some costs are expenses because no future benefits are likely, or allocation between periods seems pointless.

P-6. The U.S. dollar is the unit of measure in the United States. Changes in its general purchasing power are not recorded in the basic financial statements. [This is an example of a principle which is clearly incompatible with the economic theories referred to in the developmental section, and the Statement refers to the use of LIFO and accelerated depreciation in the USA as attempts to minimize the effects of not recording changes in purchasing power.]

The modifying conventions have evolved to mitigate the unwanted effects of rigidly applying these pervasive measurement principles. They are: conservatism (understatement of net assets and net-income preferred to overstatement); emphasis on income (the income statement takes precedence over the balance sheet); judgment of the accounting profession may modify the principles, by approving measurements which are in direct conflict with the fundamental, pervasive, accounting principles of measurement.

LOOKING TO THE FUTURE

The Statement concluded by pointing to ways in which generally accepted accounting principles might change, even the pervasive and broad operating principles, in response to changes in economic and social conditions, technology and user demands. Orderly change depended upon the consistency of proposed principles with the general tenor of the Statement.

Suggestions for change included 1) eliminating differences in accounting practices not justified by differences in circumstances, 2) making accounting principles more consistent internally, 3) improving their effectiveness, and 4) reflecting more adequately the economic activities represented. Specific proposals related to including commitments, contracts, and leases in financial statements as assets and liabilities; developing unique methods for charging costs, including depreciation, against revenue; recording revenue under the accretion method; substituting output values for input values; recognizing price-level changes; and including budgets as part of the basic financial statements.

Other proposals concerned new financial statements; use of ratios in place of money amounts; more effective visual communication by graphs.
and charts. The *Statement* also pointed toward the development of international accounting standards, the world equivalent of generally accepted accounting principles.

**CONCLUSION**

By no stretch of the imagination can the postulates, objectives, basic features and elements, and pervasive measurement principles identified in the *Statement* be consistent with the radical changes in definitions, valuation, and presentation covered by these last proposals. We are witnessing a process of rationalization, of finding explanations for conduct which are reasonable but false.

It is arguable that explanations of accounting should not proceed from the economist's view of society. Economists and accountants are both studying the same phenomena, but for different purposes. To proceed from economic theory is therefore to pile concept upon concept, a dangerous intellectual exercise. A more fruitful approach to explaining business accounting would be to describe the business world as its participants see it, rather than as economic theorists see it.

A critical factor in this process is the interpretation of economic reality. Those who use this phrase refer to some underlying phenomenon perceived dimly through the "veil of money": replacement cost, or current selling market price, or net cash flow, or physical production of goods and services, or "real values," whatever these may be.

By restricting their attention to the markets in which financial securities are traded, theorists simplify the task of constructing a normative theory of accounting. Economic reality is confined to those transactions and events which are represented in the real world by decisions to buy or sell securities, or to hold securities in times of changing market conditions and price-levels.

These theories include the efficient market hypothesis, which will be discussed in Chapter 6, together with other theories revolving around the measurement of cash flows, which are the primary realities of financial investment. There is also an influence from portfolio theory, which incorporates statistical measurements of risks of different kinds in the evaluation of financial securities.

**ENDNOTES**


2. For additional details, see Michael Chafffield, *A History of Accounting Thought*, Hinsdale, Ill.: The Dryden Press, 1974, Chs. 8-11.


**SELECTED ADDITIONAL READINGS**

Development of Accounting Theory


The Economists


Influence of Income Taxation


Michael Chatfield, op. cit., Ch. 15.


The American School


