

SOME ASPECTS OF THE STRUCTURE OF
ACCOUNTING THEORY

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Edwin Cohen

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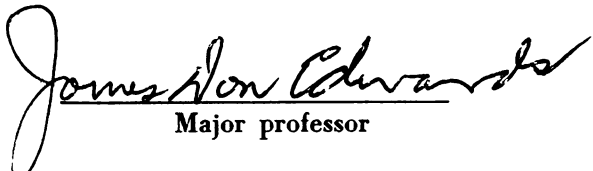
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OF ACCOUNTING THEORY

By
EDWIN COHEN

AN ABSTRACT

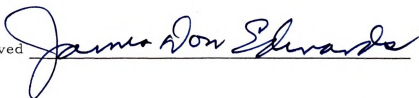
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ABSTRACT

The most basic problem confronting the accounting profession today is that of defining the structure of accounting theory. The phrase "generally accepted accounting principles" is used frequently in written and oral communication both within and outside the accounting profession, without certainty of the existence of such a body of principles. If such principles are assumed to exist, there is no uniformity as to assumptions of their nature. Since the primary purpose of accounting is to provide useful information to many interested parties, a definitive structure of accounting theory is of the utmost importance. In arriving at a sound structure, our present "structure" must be re-examined and "overhauled."

The existing body of "generally accepted accounting principles" and standards has been influenced by several factors, the most important being the thinking and pronouncements of the American Institute of Certified Public Accountants, the thinking and pronouncements of the American Accounting Association, the influence of the Securities and Exchange Commission, the practices and procedures adopted by businesses and employed before any regulatory bodies existed, and the considerable volume of published literature in the area of accounting theory. Despite the fine efforts and many contributions made by the various organizations and individuals, no authoritative or generally recognized structure of accounting theory exists today.

Abstract

Edwin Cohen

Current practices should not serve as the basis for a structure of accounting theory. Instead, such structure should be developed logically with the objective of producing the most informative and useful reports to serve the needs of many interested groups.

The foundation for a structure of accounting theory should be a series of postulates which are formulated on the basis of economic reality and sound reasoning, and not on the basis of the requirements of income determination and balance sheet valuation. Specific postulates determined to exist are: (1) the business entity postulate, (2) the going concern postulate, (3) the periodicity postulate, and (4) the measurability postulate.

A coordinated set of accounting principles should be developed on the foundation of the established accounting postulates. Two such principles which appear to have universal applicability are: (1) the principle of consistency, and (2) the principle of full disclosure.

Organizations requiring accounting reports differ in material particulars, and such individual characteristics should be considered in determining the specific accounting principles applicable to a particular entity. Specific principles should apply to individual characteristics rather than to organizations as a whole. After an organization is defined according to its significant component characteristics, the specific principles applicable to each of its characteristics

Abstract

Edwin Cohen

are combined. The result is a complete and consistent set of accounting principles for each organization; this will produce fair and accurate accounting reports.

The "general acceptance" of accounting principles should be replaced by the "general acceptability" or soundness of such principles, as determined by an independent and highly qualified organization. Such a body could take the form of an "accounting tribunal," which would be professional in nature rather than legal. This independent body would provide a means for establishing new postulates and principles, deleting old ones, and making any changes as would be necessary in order to produce useful accounting reports. Sound accounting postulates and principles, established by such an independent body, would result in accounting reports which would meet the needs of all segments of society.

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TABLE OF CONTENTS

Chapter	Page
I. INTRODUCTION	1
General	1
Uses of Accounting	5
Managerial or Administrative Accounting	11
Financial Accounting	13
Tax Accounting	17
Accounting: Science or Art, Profession or Craft?	18
Confusion of Principles with Other Terms	20
Objectives of Dissertation	21
Plan of Dissertation	22
II. THE DEVELOPMENT OF ACCOUNTING PRINCIPLES IN THE UNITED STATES--TO 1939	24
Introduction	24
Period to 1929	25
General	25
Effect of Income Tax Law	26
Cooperation of American Institute of Accountants, Federal Reserve Board, and Federal Trade Commission	28
Cooperation of American Institute of Accountants and Stock Exchanges	29
Period 1929-1935	30
Stock Market Crash	30
Cooperation of American Institute of Accountants and Stock Exchanges	30
New Institute Committee on Principles-- "Special Committee on the Development of Accounting Principles	36
Securities and Exchange Commission-- Introduction	37
Securities Act of 1933	38
Securities Exchange Act of 1934	39
Public Utility Holding Company Act of 1935	41

Chapter	Page
Organization of Securities and Exchange Commission	43
Period 1936-1938	46
Contribution of American Accounting Association	46
Activities of American Institute of Accountants	47
Activities of Securities and Exchange Commission	56
Activities of National Association of Cost Accountants	58
A Statement of Accounting Principles-- Sanders, Hatfield, and Moore	59
III. THE DEVELOPMENT OF ACCOUNTING PRINCIPLES IN THE UNITED STATES--1939 TO 1959	61
Period 1939-1946	61
Activities of American Accounting Association	61
Activities of American Institute of Accountants	63
Activities of Securities and Exchange Commission	64
Activities of National Association of Cost Accountants	69
An Introduction to Corporate Accounting Standards--Paton and Littleton	71
Period 1947-1952	72
Activities of American Accounting Association	72
Activities of American Institute of Accountants	79
Activities of Securities and Exchange Commission	79
Period 1953-1959	83
Activities of American Accounting Association	83

Chapter	Page
Activities of American Institute of Accountants	84
Internal Revenue Code	93
Structure of Accounting Theory-- Littleton	93
Summary	94
IV. THEORY OF ACCOUNTING--POSTULATES	103
Introduction	103
Form of a Theory	110
Postulates	111
General	111
General or All-Inclusive Postulates	115
Specific Postulates	120
Business Entity Postulate	121
Going Concern Postulate	125
Periodicity Postulate	131
One-Year Period	135
Measurability Postulate	147
Summary	150
V. ACCOUNTING PRINCIPLES	152
General	152
General Acceptance of Principles	156
An Accounting Court	163
General Principles	169
Introduction	169
Principle of Consistency	170
Principle of Full Disclosure	174
Summary	177
VI. PLAN FOR A STRUCTURE OF ACCOUNTING THEORY..	179
Introduction	179
Objectives and General Structure	183

Chapter	Page
Summary of System	188
VII. SUMMARY AND CONCLUSIONS	191
BIBLIOGRAPHY	201

LIST OF ILLUSTRATIONS

Illustration		Page
I.	Effect of Alternative Generally Accepted Accounting Principles upon Earnings	9
II.	Chronological List of Accounting Research Bulletins 1 through 42	65
III.	List of Supplementary Statements to Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948 Revision Issued by the American Accounting Association	78
IV.	Chronological List of Accounting Research Bulletins 43 through 51	85
V.	Chronological List of Accounting Terminology Bulletins 1 through 4	86
VI.	Industrial and Commercial Failures in the United States: 1956 to 1958	126
VII.	The Business Failure Record: 1958-1960	126
VIII.	Industrial and Commercial Business Failures in Michigan: 1939-1958	127
IX.	General Business Indicators for Transportation Equipment Manufacturers, 1956-1958	138
X.	Graph of General Business Indicators for Transportation Equipment Manufacturers, 1956-1958	139
XI.	General Business Indicators for Textile Mill Products, 1956-1958	140
XII.	Graph of General Business Indicators for Textile Mill Products, 1956-1958	141
XIII.	Sales Volume of Retail Trade (Mail-Order)	142
XIV.	Graph of Sales Volume of Retail Trade (Mail-Order)	143

CHAPTER I

INTRODUCTION

General

In the profession of accounting there exist some very basic and important problems in the area of accounting theory. These basic problems often are overlooked, while many minor but detailed problems receive continuous attention.

The most basic problem facing the accounting profession is one dealing with the nature of accounting theory and its structure. The phrase "generally accepted accounting principles" is used quite frequently in written and oral communication by the accounting profession-- public accountants, industrial accountants, governmental accountants, and accountants in the field of education. Yet when the employers of such phrase are asked what these principles are or what they represent they are lacking for an answer and seem somewhat confused.

The phrase "generally accepted accounting principles" is included in the usual short-form of certified public accountants report,^{1, 2}

¹ Reasonable uniformity in the manner of stating an opinion is considered desirable, both as to the certified public accountant who assumes responsibility in expressing his opinion and to those who rely on his findings. Therefore, a standard short-form report was adopted by the American Institute of Certified Public Accountants (known as the American Institute of Accountants to June, 1957).

² The "report" is also called "certificate," "opinion," and "report and opinion."

which is attached to financial reports, both published and unpublished.

The wording of the short-form of accountant's report follows:

We have examined the balance sheet of X Company as of December 31, 19__ and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.³

The wording of the accountant's short-form report states that in his opinion the statements have been prepared in conformity with "generally accepted accounting principles." However, if confronted with the problem of what these "principles" represent few accountants can present a definitive answer. In other words, independent public accountants are rendering opinions that the financial statements conform to a body of accepted accounting principles without really knowing if such a body of principles do, in fact, exist. If they are assumed to be in existence, there is no uniformity among accountants as to what such principles are and as to where they can be found. This approach, certainly, is not one to be assumed by a profession.

³American Institute of Accountants, Codification of Statements on Auditing Procedure (New York: American Institute of Accountants, 1951), p. 16.

If no definite principles appear to exist, perhaps it would be much better for all concerned to amend the opinion paragraph (second paragraph) of the short-form report so as to contain no reference to "generally accepted accounting principles." This would be a much more honest statement of opinion and a much more realistic presentation to the persons who rely on financial statements than to state boldly that the financial statements conform to a body of principles, when we are not sure of the existence and nature of such principles.

Industrial accountants and governmental accountants have the same problem as do the public accountants. They often refer to this same body of accounting principles without even making sure whether such principles really exist, and if they do exist, what they are. In the field of education the same problem is prevalent. Students graduating from universities, colleges, and business schools enter the business world with the idea that a certain body of accounting principles exist, and that these principles must be followed religiously. Upon interrogation, these accounting graduates cannot justify the idea of the existence of principles in accounting theory. These young graduates received this erroneous impression from their professors and instructors, and also from their textbooks. It appears that even many educators are not very clear on accounting principles and, therefore, cannot really impart knowledge on the subject to their students.

Accounting is regarded as a profession, and as a profession it is composed of persons with a high degree of integrity and intelligence.

Professional accountants should be capable of forming a body of definite principles. Any results produced by a member of a profession is looked upon by a great many people as if those results bore the sanctity of law. Yet in accounting we state that the statements have been prepared in conformity with "generally accepted accounting principles," when no such universally accepted body of principles exists.

The phrases "accounting principles" and "generally accepted accounting principles" appear so often in print and are so often referred to in oral communication, that today these terms are being used and referred to by many persons and organizations outside of the accounting profession. Business managements, stockholders and bondholders (present and future), partners and proprietors, bankers, creditors, brokers, governmental agencies (federal, state, and local), employees and their organizations, courts of law, attorneys, customers, and the general public all refer to such principles in some way. In fact, persons who one least expects to refer to such principles occasionally do refer to them. The wide distribution of published corporate financial reports is one of the major reasons that many persons come into contact with these "principles," on which the statements are supposed to have been constructed. The question immediately comes to mind as to whether all these persons of such varied talents really understand the true nature of the principles of which they speak. From current literature and observations, it appears that they do not. If the accounting profession

is itself confused, how can the layman be expected to understand accounting principles ?

"Generally accepted accounting principles" has been a subject of controversy among theorists for many years, but it has just recently started to receive the attention that it so rightly deserves. Defining these principles in understandable terms and building a structure that can be used as a guide in the formulation and testing of principles are problems which must be solved, and in the near future. In my opinion, the future direction of the accounting profession depends to a great extent on the solution of these problems.

Uses of Accounting

Accounting and the resultant financial statements are essential tools of business. It is the aim of accounting to record and summarize in a systematic manner transactions which occur within a business enterprise; to interpret and report to the owners and to the management of the business the results of the transactions in the form of reports; and to provide useful financial information to interested outside parties. The construction of the financial statements falls mainly to the accountant, but the analysis and interpretation of the financial statements is the concern of many parties. For every accountant who is involved in the preparation of a financial statement, there are many persons who are interested in using this statement for a great variety of reasons.

The over-all purpose of accounting is to provide useful information to many interested groups. Following is a listing of groups using the financial reports for a variety of reasons:

- I. Managerial or administrative accounting--serves management in a wide variety of ways, as a tool to help operate efficiently.
- II. Financial accounting--the published statements that are used by the following groups:
 - a. Stockholders (also partners and individual proprietors),
 - b. Bondholders,
 - c. Bankers,
 - d. Creditors (includes merchandise creditors),
 - e. Brokerage firms and other firms in the investment and financial fields,
 - f. Governmental agencies (federal, state, and local),
 - g. Employees and their organizations,
 - h. Courts of law and attorneys,
 - i. Customers,
 - j. General public.
- III. Tax accounting--serves management in meeting the various federal, state, and local governmental taxing requirements.

It would be well, at this point, to elaborate on some of the points in the foregoing outline. The management or executives of a business enterprise rely on the financial and operating data in making important business decisions; the bankers must have sufficient data on which to rely upon in deciding whether or not to make a loan, and if the decision is positive, the amount of the loan; likewise, credit managers must have enough information on which to make sound judgments regarding the extension of credit; the investors must rely on financial and operating information in deciding whether they should purchase,

sell, or hold certain securities in various companies; many governmental authorities are interested in the financial statements for purposes of taxation and regulation; labor organizations must consider information of a financial nature in deciding future courses of action. It can be seen from the foregoing discussion that many groups are interested in the financial statements of a business enterprise for a great variety of reasons. The accountant certainly must bear in mind the necessities of each group in constructing and presenting the financial statements, so as to give all interested parties all needed information in a clear and fair manner. The report of the accountant should be presented in such a manner as to be of maximum usefulness to any party analyzing and interpreting the statements, whoever such party may be.

It appears that the intended uses of the financial statements should be seriously considered when developing "generally accepted accounting principles"; in other words, the usefulness of the financial statements depends, to a large degree, upon the underlying principles which govern its everyday applications. Since it is evident that there are many interested users of financial statements for a great variety of purposes, there should be developed some definite accounting principles which the users of the statements could rely upon in making their analysis and interpretations. Without such principles the users of the statements can never rely on the statements with a full degree of confidence.

In its most elemental sense, accounting reporting is essentially a system of business and financial communication. Today

these communications, in the form of reports, are subject to a wide divergence of presentation and interpretation. To minimize the possibility of such widely differing results on the financial reports from the same set of facts, it appears that carefully and specifically defined methods and objective standards would be required. However, no such methods and/or standards have been established to the present day, and their absence multiplies many-fold the probability of misinterpretation.⁴

Illustration I on the following page illustrates how the use of alternative generally accepted accounting principles might affect the earnings reported in a given period. Column 1 shows the results of operations of Company X. Columns 2 through 4 show the effect of alternative accounting principles that are also generally acceptable. Column 5 shows Company Y's earnings, with no difference in operations as compared to Company X, except in the application of alternative methods of accounting followed. Although both companies have the same operating conditions, Company Y reports net profits of over three times the net profit of Company X. Actually there is no real difference between the two companies; the difference in net profits was artificially produced by the difference in accounting principles followed.

⁴ Leonard Spacek, "Business Success Requires an Understanding of Unsolved Problems of Accounting and Financial Reporting" (address before Financial Accounting Class, Graduate School of Business Administration, Harvard University, September 25, 1959); this address was also printed in pamphlet form by Arthur Anderson & Co., pp. 5-6.

ILLUSTRATION I--(Continued)

Explanation of Columns 2 to 4, Inclusive		
Column	Company X	Company Y
2	Uses last-in, first-out for pricing inventory.	Uses first-in, first-out for pricing inventory.
3	Uses accelerated depreciation for book and income tax purposes.	Uses straight-line depreciation for book and income tax purposes.
4.	Credits extraneous gains, net of income tax, directly to retained income, or treats them as special credits below net profit.	Includes extraneous gains, net of income tax, in net profit.

The methods of accounting used by both companies conform to "generally accepted accounting principles" as understood by practicing accountants. Should not sets of "principles" be challenged if their application allows such highly diverse results in reported figures ?

There is a great possibility of having the shares of these two comparable companies selling at greatly varying prices on the market, merely because of the differences in the accounting principles employed. In the illustration it will be noticed that Company Y's shares could sell for over three times the amount at which the shares of Company X could be marketed. As a stockholder, obviously one would prefer the accounting followed by Company Y to that followed by Company X, as it means that one's stock would bring three times as much cash upon sale. The price differential was not due to any real difference between the two companies; the price differential was artificially caused by differences in the reported earnings caused by differences in the accounting principles applied.

Managerial or Administrative Accounting

Accounting reports prepared for the use of management in operating a business enterprise can be noticeably different from the accounting reports prepared for outside parties. The internal reporting function is of extreme importance in operating any business enterprise efficiently. Regulatory rules and regulations never need to restrict good internal reporting practices. Internal reports for managerial purposes should produce financial and operating data which are helpful in operating a business currently and in planning its future operations. Often the necessary records kept in order to comply with the regulations are not the same records which management requires in operating the business. They often have no utility as a managerial tool. However,

the management can still receive any data which are required in order to operate the business efficiently.

Managerial accounting must provide past information and, more importantly, information that can be used as a basis for future action. Usefulness of the reports is of the utmost importance; often reports contain much accurate and truthful information, but this information has no managerial value.

Internal accounting reports should relate what has occurred and should point to the causes of such occurrences. Internal reports should not be used merely as historical records; in such case the company is merely wasting time and money. However, the reports should be dynamic and present data which the management can use in improving its operations.

Management can receive and is entitled to receive any information which it deems necessary; the accountant should design an accounting system which will produce the desired information. For managerial purposes accounting should be able to produce any type of information which management desires. Managerial needs govern the accounting system; the reverse is not true. The accounting system must keep pace with the changing requirements of the user. The usefulness of internal accounting reports must be measured against the benefits obtained in improving the operations of the company, and not against traditional accounting practices. Therefore, when accounting principles are considered the purposes and usefulness of the reports must always be kept in mind.

Financial Accounting

Financial reporting, also known as public reporting, refers to accounting reports issued for the use of parties besides the management of the company concerned. Generally, these consist of the published reports of any company. The public, who use the published financial reports, is made up of many different segments whose interests are independent. In fact, the interests of these outside parties differ from the interests of business management. At the present time the accounting principles and practices followed in the published reports present problems which have affected good reporting for managerial purposes. Objectively, there is no reason why financial reporting need have an effect on internal management reporting. However, accountants do allow the principles and practices followed in reporting to outsiders to influence managerial reporting; this procedure limits the usefulness of the managerial reports produced.

The so-called principles adhered to in the preparation of accounting reports for public use consist of numerous practices, many of which are followed for only traditional reasons, and are not applicable under current conditions. Some of these so-called principles have few objective standards, if any, and they have progressed and gained authority mainly by precedent and tradition. Many of the reasons supporting the original adoption of these so-called principles have been made meaningless because the purposes and uses of such reports have changed over a period of time.

As was mentioned earlier in this chapter, many of these precedents in accounting, which are obsolete, are maintained through the use of important sounding phrases like "generally accepted accounting principles." Very few persons, if any, really understand these principles. These principles which are regarded as being generally acceptable are numerous, but their objectives are not clearly defined.

Because accounting objectives have never been clearly defined, so-called accounting principles have been constantly confused with accounting rules, procedures, conventions, etc. Many times these so-called principles have been established on the basis of policy instead of reason. Some of our so-called principles are adequately defined and have sound objectives; some others are recognized as being acceptable but cannot be justified or defined and produce entirely different results.

Accounting principles and practices followed in preparing published reports and principles and procedures followed when preparing reports for regulatory or taxing purposes often produce misleading reports. These principles and practices should, in no way, be allowed to distort the internal management reports. Managerial reports, which form the basis for business decisions, must disclose the most useful data, regardless of tradition or generally accepted accounting principles used for published reports. This difference between published reports and internal reports is important and should be considered.

Stockholders of a corporation judge its management by the financial results which such company produces. These stockholders are naturally interested in profits and high market value for their investments. In many instances the stockholders will judge the success of a company by the relative market performance of its stock in the market. The market price of any stock is dependent, to some degree, on the financial position and earnings of the company. This is further illustrated by the fact that it is common practice to refer to a price-earnings ratio when analyzing the statements of a company; stated in another way, it is common practice to multiply the earnings per share by a current multiplier (rule-of-thumb) that seems reasonable for a particular industry at a particular time. This calculation is supposed to result in an estimate of what the market value of a particular company's stock should be. It is not within the scope of this paper to consider the merits and disadvantages of this computation. However, since it is currently being used it must be recognized that the estimated market price of the stock depends directly on the earnings figure. The accounting principles employed in arriving at the earnings figure, therefore, have a very direct effect on the estimated market price of the stock.

A certified public accountant, states that in his opinion the earnings reported on the published financial statements have been determined in accordance with "generally accepted accounting principles." The stockholders rely on such statement and their decisions relative to

the purchase, sale, or retention of securities are often governed by such reports.

It appears that there would be a temptation among corporate accountants to employ those "generally accepted accounting principles" and practices which would produce the highest earnings figure on the published financial reports; this would lead to the highest possible market value for the stock. It is fairly well understood that management has the responsibility to disclose factual and reliable reports to their stockholders. However, this worthwhile goal may actually be very difficult to achieve. If a competitor is using those accounting principles and practices which produce the highest possible earnings figure, resulting in a high market price for its stock, it may be impossible for the company to prepare its reports strictly on the basis of an equitable presentation. The company's stockholders are not interested in the reasons for the accounting principles which were used; they are interested in the price differential between the stocks of the two companies in the market.⁵

The problem stated above exists only because the structure of accounting theory has never been adequately defined. If all corporations were required to follow the same body of accounting principles, these problems of non-comparability would not exist.

⁵See Illustration I. The situation is clearly shown in this illustration.

Up to this point the stockholders' use of the financial statements has been stressed. Most of what has been written on the previous pages can also be applied to all other users of the published financial statements. All of these parties--bondholders, bankers, creditors, brokerage firms and other firms in the investment field, governmental agencies, employees and their organizations, courts of law, and the general public--use published financial reports for some specific purpose. It is impossible for these parties to analyze and interpret such reports intelligently if each report is based on a different set of accounting principles. How can the banker decide a loan question, or how can a broker give sound investment advice to his clients under these circumstances? Certainly no valid comparisons, even within the same industry, can be made from reports prepared under currently used "principles."

Tax Accounting

Tax accounting is a highly specialized field and therefore, this area will be mentioned only briefly. Reports submitted to the taxing authorities of the federal, state, and local governments are governed by special regulations and rules established by such authorities. The regulations and rules often times are completely different than that which is recognized as being acceptable under our present body of accounting "principles." Consequently, if one should compare the published financial statements of a company with the same company's statements as prepared for the tax return, very little similarity would

be found. Certain items of earned income would not appear on the tax return because of a special provision exempting it; an item of expense on the tax return may have to be capitalized under present accounting principles.

It must also be kept in mind that many of the rules and regulations of the various taxing authorities were established on the basis of expediency rather than principle. It is to be hoped that in due time the accounting principles employed for the preparation of internal reports, published reports, and tax reports will be standardized.

Accounting--Science or Art;
Profession or Craft?

The techniques of accounting and the presentation of the financial statements have, at various times and by various persons and organizations, been referred to as a profession, a skill, a craft, a tool of business, an art, and a science. It has been shown that accounting and the resultant financial statements certainly qualify as very important tools of business, and that they are important to a great many interested persons. Accounting is probably more accurately described as a profession than as a craft or skill. It is recognized as a profession for several reasons. Accountancy does require a certain amount of general education, a substantial amount of technical education, and the successful completion of a program of internship under qualified accountants. The CPA certificate does identify public accountants as professional

accountants; it is granted only upon successfully completing certain educational and experience requirements and passing a written examination. Industrial, commercial, and governmental accountants have no such evidence of professional status at the present time, although their work certainly merits such recognition. No person should have the idea that the public accountant is more important than the industrial, commercial, or governmental accountant. Each of these groups serves a particular and useful function and each is necessary. Each of these groups should also concern itself with the problem of "generally accepted accounting principles" as each group will be directly affected by the establishment or lack of accounting principles.

Accountancy is generally recognized as a profession. However, the question continues to arise from time to time: "is accounting a science or an art?" Much controversy has arisen over this particular question and much has been written on this subject. It is not within the scope of this paper to investigate this question exhaustively, but we will consider it briefly. At the present time accounting may be generally regarded to be both a science and an art. It may be regarded as a science since it does include a body of systematized knowledge. It certainly is not a physical, natural, or exact science like physics, chemistry, and mathematics whose body of knowledge is based upon observation of natural phenomenon and natural law. Accounting, like economics, is not based upon the operation of

natural laws, but on human institutions and social behavior. It does rely upon certain concepts or working rules, which are, in effect called principles. This dissertation is primarily concerned with these concepts, working rules, and "principles." Accounting is considered to be an art in the sense that it requires the skillful adaptation of means for the attainment of some useful and beneficial results. This situation is comparable to that of the artist who is selecting the proper colors and determining how to use them in interpreting the subject of his painting.

The fact that accounting is not a natural science does not eliminate the necessity for a body of principles. All sciences, natural and otherwise, require definite sets of principles which govern all actions that take place. As the artist knows that the blending of certain colors will produce a known effect, the accountant should know that through application of a set of accounting principles certain effects will be produced, and outside parties should also be made aware of these facts.

Confusion of Principles with Other Terms

In studying the problem of accounting principles, it is inevitable that one comes in contact with terms which are often used as synonyms for the term "principle." The most frequently used terms are concepts, conventions, standards, procedures, assumptions, rules, postulates, and theories. It does not matter whether or not these really are synonymous with "principle"--it does matter that these are used as

synonyms, and interpretation among accountants often is peculiarly based on their synonymity. Persons reading current literature in the field of accounting, publications of various professional organizations, government publications, and textbooks will find such terms used in many different ways. Since these basic terms are so essential to the basic understanding of accounting and the resulting financial statements, and are so often used in the certified public accountants' reports, it seems that they should be more uniformly understood than they are at the present time. This presents another problem (the one of communication of meanings) which the profession must meet and solve.

Standardizing the meanings of these basic terms will result in the preparation of financial reports which will be more understandable both to the accountant and to those readers not technically trained in accounting. By standardization it is meant to imply that each term, "principle," "concept," "convention," etc. will convey the same meaning to all persons interested in the financial reports--persons who prepare the reports and those persons who read and use the reports.

Objectives of Dissertation

As can be observed from the foregoing discussion, the entire structure of accounting theory needs to be re-examined and "overhauled." The over-all problem of building a sound structure of accounting theory is a broad one, which will probably take many years to complete. This dissertation considers some of the important aspects

of the structure of accounting theory, and consequently, the objectives of this study are:

1. to establish some basic postulates or assumptions of accounting on a rational basis;
2. to consider some important problems and possible solutions in formulating and adopting accounting principles, in conformity with the established postulates.

It is not within the scope of this study to state or spell-out individual accounting principles. The emphasis and concentration will be on establishing a structure for adopting and testing accounting principles, rather than on developing individual principles.

Plan of Dissertation

Source data for this study includes the large store of literature included in accounting and business periodicals, textbooks, reference books, publications of professional organizations, and government publications and reports. Appropriate literature in the fields of economics, finance, and management has also been considered. Several statistical reports and surveys have been examined.

Following this introductory chapter, there are six additional chapters. Chapters II and III provide material on the development of accounting principles in the United States. These chapters on the historical development of accounting principles indicate deficiencies which existed in the past in accounting theory and which must be remedied in the future.

Chapter IV considers the basic postulates and assumptions which must provide the foundation for the structure of accounting theory. An attempt is made to support these postulates strictly from the viewpoint of logic and economic reality.

An investigation and analysis of some important problems involved in the establishment and testing of accounting principles is the basic subject matter of Chapter V. The establishment of principles, of course, depends on the basic postulates justified in the previous chapter.

Chapter VI presents the author's plan for establishing a structure of accounting theory.

Chapter VII summarizes this entire study, "Some Aspects of the Structure of Accounting Theory." It includes a restatement of the significant factors and presents certain conclusions which appear to be justified by the arguments of the preceding chapters.

It is the sincere hope of the writer that the factual materials and the conclusions developed here will have some constructive implications for public accountants, private accountants, governmental accountants, and accountants in the academic field. It is also the hope of the author that this dissertation will be of value in the formulation of more informative and clearer reports to all interested parties, whoever they may be.

CHAPTER II

THE DEVELOPMENT OF ACCOUNTING PRINCIPLES
IN THE UNITED STATES--TO 1939Introduction

Our present accounting principles¹ evolved to meet definite needs. In many of the changes that have taken place over the years, factors external to the profession have been very influential. Accounting evolution has essentially been the response of the accounting profession to economic, business, and governmental influence.²

Behind the push to establish some types of standards to govern the preparation of accounting reports were several organizations--professional and governmental. The part which each of these important major organizations and important events played in the development of the present structure of accounting principles in the United States will now be considered. This historical background material is primarily presented from a chronological approach rather than from an institutional approach. The author feels that the chronological approach shows relationships and changes in accounting thought to best advantage.

¹In Chapter I, it was concluded that no real body of accounting principles actually exists. Wherever the terms "principles" and "accounting principles" are now used, the writer is referring to those concepts which are now called principles by accountants.

²James Don Edwards, "Public Accounting in the United States from 1928 to 1951," The Business History Review, XXX (December, 1956), 444.

However, within the different time periods, some evidence of the institutional approach can still be seen.

Period to 1929

General

Until the latter part of the nineteenth century, little or no financial information was submitted by management to stockholders in a formal report. Since stock ownership was quite limited at that time, the necessity of accounting for the stewardship function of management to a large body of stockholders did not exist. With the increase in the use of the corporate form of organization, the need for published reports appeared. The first really modern type of annual report was published in 1902 by the United States Steel Corporation. In 1916 General Motors Corporation was the first company to announce formally that it would publish semiannual financial statements in addition to its regular annual report. Many other companies soon started to issue informative financial reports. However, at the same time there were many companies which were issuing misleading reports, either intentionally or unintentionally. Many of these companies, issuing misleading reports, were companies who were listed on a stock exchange and whose stock was widely held by the public.³

³B. Bernard Greidinger, Preparation and Certification of Financial Statements (New York: The Ronald Press Company, 1950), pp. 3-4.

As far back as 1866, the New York Stock Exchange attempted to collect financial statements from leading companies. In 1900 all companies applying for listing on the exchange agreed to publish financial reports. This agreement was subsequently expanded so that in 1926 a listed corporation was required to publish, and submit to stockholders, at least fifteen days prior to their annual meeting, an annual report containing its financial statements. In addition, companies were requested to publish semiannual or quarterly earnings statements.⁴

Effect of Income Tax Law

Except in regulated industries, until about twenty-five years ago there were virtually no effective restrictions on the choices of management as to the principles of accounting and disclosure which they used in setting forth financial representations. The adoption of the corporate income tax by the federal government in 1913 brought about some measure of uniformity as corporations tended to use those practices which tended to minimize taxes.⁵

In the early development of income tax practice, during World War I, certain accounting leaders made great efforts to gain acceptance for the idea that the determination of income for tax purposes

⁴Ibid., p. 6.

⁵Alvin R. Jennings, "Accounting Research," The Accounting Review, XXXIII (October, 1958), 549.

should follow generally accepted accounting principles. Certain of these ideas were adopted. However, since that time the constant addition, deletion, and amendment of the regulations has created a growing divergence between tax procedures and the accounting principles followed for general business purposes. These differences came about because of a desire to promote administrative convenience in the Bureau of Internal Revenue, and in part because of the fact that the Bureau, acting as the interpreter of the taxing power of Congress, has assisted in determining the tax burdens which various classes of the economy shall bear.⁶

At the time the income tax law was adopted, most companies, including the largest, were not examined regularly by independent certified public accountants. If an examination of the records was made, it was usually made at the request of a potential creditor, such as a bank. Opinions of the certified public accountants at this time were short and made no reference to any body of generally accepted accounting principles; there was no authoritative codification of generally accepted accounting principles at this time.⁷

⁶Thomas H. Sanders, "An Analysis of the Forces Which Are Shaping the Future of Accountancy," The Journal of Accountancy, LXXXX (October, 1950), 286.

⁷Jennings, loc. cit.

Cooperation of American Institute of
Accountants, Federal Reserve Board
and Federal Trade Commission

Early in 1917 an effort was made by the American Institute of Accountants,⁸ in cooperation with the Federal Reserve Board and the Federal Trade Commission, to improve the form and content of the financial reports of industrial and commercial corporations. In that year the Federal Trade Commission requested the American Institute of Accountants to prepare a memorandum on balance sheet audits. This memorandum was prepared and approved by the Federal Reserve Board. It was published as a pamphlet entitled Approved Methods for the Preparation of Balance Sheet Statements. This publication prescribed the type of examination and verification which could be made by independent public accountants in cases of companies whose financial statements were to be submitted to banks for credit purposes. Included also were forms of balance sheets and income statements. The intention was that this published bulletin would help to standardize the form of statements submitted to bankers for credit purposes and to provide a program for verification of items and uniform preparation of statements. This publication was widely disseminated and was probably the first material published on the subject. In 1929 a revision of this bulletin

⁸The American Institute of Accountants changed its name officially as of June, 1957. This organization is now known as the American Institute of Certified Public Accountants. In this paper this organization will be referred to as the "Institute."

was prepared by the Institute, under the direction of the Federal Reserve Board. The revision was entitled Verification of Financial Statements (Revised), and the audit procedures and form and content of financial statements stated therein were still intended to apply primarily to those statements which were being prepared for credit purposes. This was one of the early attempts of the organized accounting profession to standardize and upgrade accounting procedures.⁹

Cooperation of American Institute of Accountants and Stock Exchanges

Just prior to the Great Depression, evidence of faulty financial practices and methods of correcting these practices were brought to light. The need for more informative financial statements and cooperation between the stock exchanges and public accountants was realized. In 1927 accountants attempted, through the American Institute of Accountants, to have the New York Stock Exchange and the Institute appoint a joint committee to study the entire problem of financial reporting. However, the Exchange did not feel prepared to undertake such a project at this time.¹⁰

⁹ Edwards, op. cit., p. 445; Greidinger, op. cit., p. 7; J. Harry Williams, "Accounting Methods and Standards," Selected Papers--1957, 406. (This is a paper which was presented at a conference under the auspices of the International Cooperation Administration at New York University in November, 1957.)

¹⁰ J. R. Taylor, "Some Antecedents of the Securities and Exchange Commission," The Accounting Review, XVI (June, 1941), 193.

Period 1929-1935

Stock Market Crash

The stock market crash of 1929 caused many investors to suffer substantial losses; many of these investors blamed their losses on the inadequacy of financial reports submitted to stockholders. The exact influence of this clamor for better stockholder reports is unknown, but Congress did pass two security regulatory bills soon thereafter. In 1933 it passed the Securities Act and in 1934 it passed the Securities Exchange Act. In the following years several other laws were passed. These laws will be considered in more detail later in this chapter. These laws and the Securities and Exchange Commission, established under the 1934 Act, have had a profound influence upon the formation of an acceptable body of accounting principles and standards. The individual laws require full and adequate disclosure of financial data included in reports required to be filed.¹¹

Cooperation of American Institute of Accountants and Stock Exchanges

The New York Stock Exchange was soon convinced, after examining the reports filed with it, that frequent reporting could be confusing and misleading where statements failed to make a full and fair disclosure of the financial and operating data essential for appraising the value of the corporate securities. From 1926 to 1933 it intensified

¹¹Williams, op. cit., p. 407.

its efforts to secure informative reports from listed companies.¹²

In 1930 it was recognized that cooperation between the Institute and the New York Stock Exchange would be desirable. Although the Exchange refused to undertake a joint study in 1927, it was prepared to undertake such a project at this time.¹³ The argument was advanced that proper accounting methods and independent audits might have prevented at least some of the financial losses during the depression. This realization led to conferences between the New York Stock Exchange and the American Institute of Accountants.

In 1930 the Institute appointed a special committee on cooperation with stock exchanges in an effort to improve reporting; this event eventually had a profound influence on narrowing areas of differences in corporate accounting. This committee, under the direction of George O. May,¹⁴ was the first formal group to address itself in the name of the profession to the task of finding better ways and means to make corporate reports more informative and authoritative and to educate the public as to the limitations as well as the value of accountants.¹⁵

¹²Greidinger, op. cit., pp. 6-7.

¹³J. M. B. Hoxsey, "Accounting for Investors," The Journal of Accountancy, L (October, 1930), 251-78.

¹⁴Mr. George O. May had been the accounting advisor to the New York Stock Exchange for several years previously.

¹⁵Jennings, op. cit., pp. 549-50.

This special committee determined that two possibilities existed for narrowing the areas of difference and eliminating inconsistencies in financial reporting. One alternative would be to have a competent authority select, from a body of acceptable methods then in use, detailed sets of rules which would be binding upon all corporations of a given class. This method would place corporate financial reporting in the same class as other regulated industries, such as the railroads, which are under the jurisdiction of the Interstate Commerce Commission. Under this plan corporations would be strictly governed by a relatively inflexible set of procedures. The committee rejected this alternative. Instead, it decided that a more practical alternative would be to leave each corporation free to choose its own methods of accounting within broad limitations regarding disclosure of the methods employed and consistency in their application from one year to the next. This conclusion was influenced by the committee's belief that it was relatively unimportant to the investor which precise rules or conventions are adopted by a corporation in reporting earnings as long as the investors are kept fully informed as to the particular methods used and were assured that such methods had been applied consistently.¹⁶

The committee recommended certain objectives to the New York Stock Exchange. These were:

¹⁶ Ibid., p. 550.

1. To encourage recognition of the fact that the balance sheet is not a representation of present values.
2. To emphasize that balance sheets necessarily are, to a large extent, historical in character and are largely the reflection of individual judgments.
3. To emphasize the relative importance of the income account and the recognition that it must be so presented as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the period to which it relates.
4. To require acceptance by corporations of certain broad principles of accounting which are regarded as having achieved general acceptance but to make no attempt to restrict the right of the corporation to select detailed methods of accounting.

The committee also, at the request of the Stock Exchange, suggested a revised form of independent public accountant's report, which was accepted immediately by the profession. For the first time the opinion paragraph related the fairness of the presentation to the use of accepted accounting principles which were applied on a consistent basis.¹⁷

The special committee on cooperation with stock exchanges, on the basis of its studies, recommended five specific rules to the New York Stock Exchange. These rules were accepted by the Exchange on October 24, 1933.

¹⁷ Ibid., pp. 550-51.

These five rules were:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed costs.¹⁸
2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.
3. Earned surplus of a subsidiary company created prior to acquisition does not form part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.
4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.
5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not

¹⁸The packing-house industry is an example of an industry which must take exception to this general rule.

included under a general heading such as notes receivable or accounts receivable.¹⁹

Cooperation between the Institute and the New York Stock

Exchange produced tangible results:

1. Agreement on five broad accounting principles.
2. A new accountant's certificate in which there was a complete separation of fact and opinion.
3. The issuance by the Stock Exchange of new rules for listing.²⁰

The special committee of the American Institute of Accountants which was appointed in 1930 to work with stock exchanges had a definite effect on the attitude of the Securities and Exchange Commission. The work of this special committee and the steps taken within the entire profession based on its report, are generally credited with the avoidance of an undue extension of governmental regulation of the practice of accounting. The Securities and Exchange Commission, which came into existence during this same critical period, seemed content to limit its functions; the Institute and the Securities and Exchange Commission have worked together in a very cooperative atmosphere from this day to the present.²¹

¹⁹ American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43 (New York: American Institute of Accountants, 1953), pp. 11-12; American Institute of Accountants, General Introduction and Rules Formerly Adopted, Accounting Research Bulletin No. 1 (New York: American Institute of Accountants, September, 1939), pp. 5-6.

²⁰ Taylor, op. cit., p. 195.

²¹ Jennings, op. cit., p. 550.

New Institute Committee on Principles--
"Special Committee on Development of
Accounting Principles"

In the same year (1933) as the five rules were recommended to the Stock Exchange, the Institute formed a special committee known as the "Special committee on development of accounting principles." This particular committee existed until 1936. It was composed of seven members, each of whom was a chairman of a certain Institute committee. The first report of this committee included the six rules subsequently adopted, following its recommendation, by the membership of the Institute in 1934. These six rules included the five which were recommended to the New York Stock Exchange and one additional rule.²² The first five rules were previously stated. The additional sixth rule was:

If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.²³

The principles which were adopted by the New York Stock Exchange and later by the Institute, in its first formal pronouncement,

²²William W. Werntz, "History of the Accounting Procedure Committee--from the Final Report," The Journal of Accountancy, CVIII (November, 1959), 70.

²³See Footnote 19.

are regarded as important first steps in establishing a body of generally accepted accounting principles.²⁴

Securities and Exchange
Commission--Introduction

In 1933 the Securities Act was passed and was administered by the Federal Trade Commission. In the following year, 1934, the Securities Exchange Act was passed which created a new regulatory body known as the Securities and Exchange Commission.²⁵ This Commission was created by an act of Congress as a quasi-judicial agency of the United States government. In September, 1934, the administration of the Securities Act of 1933, which had been under the jurisdiction of the Federal Trade Commission, was turned over to the newly created SEC.²⁶ The Public Utility Holding Company Act was passed a year later, in 1935.

Financial statements and schedules are required to be filed with the SEC under the acts it administers. The investor depends on this information in making investment decisions. Because it was recognized by Congress that accounting was important in achieving full disclosure and in preventing misleading and deceptive information from

²⁴Williams, op. cit., pp. 406-07.

²⁵The Securities and Exchange Commission is often referred to as the "SEC" and the "Commission."

²⁶Louis H. Rappaport, SEC Accounting Practice and Procedure (New York: The Ronald Press Company, 1956), p. 3.

reaching the public, the statutes administered by the SEC deal extensively with accounting. One can appreciate the fact that the SEC does exercise much influence in the field of accounting.²⁷

Since the duties and responsibilities of the Securities and Exchange Commission are governed by the laws it administers, it is considered necessary to review these three major laws.

Securities Act of 1933

The Securities Act of 1933 provides for the registration of certain securities with the Commission before they may be sold to the public. A registration statement and prospectus, which contain specified financial and other information are required. The Commission's task is to examine the documents to see that full and accurate disclosure is made of all important information concerning a company; this is to give a prospective investor a sound basis for making a decision regarding the purchase of securities. The Commission's responsibility is to safeguard the public, and not to protect the issuer or the underwriter of the securities. In carrying out this function of full disclosure, the Commission does not pass on the merits of any securities. If the information presented by a company is deficient in any respect, the Commission can prevent the marketing of any securities until such deficiencies are removed. Civil liability can be imposed for false or inadequate representations of a material nature against the issuer.

²⁷ Ibid., p. 16.

underwriter, and other experts, including accountants. Criminal penalties can be imposed for fraudulent acts in the sale of securities. Most of the financial data required under this Act must be examined by an independent public or certified public accountant, and have an opinion expressed on it.

This Act gives the Commission broad powers to make, amend, and rescind any rules and regulations that may be necessary to carry out the provisions of the law. Under this Act the Commission can define accounting, technical and trade terms used in the law itself and can prescribe the form in which the required information must be shown in the financial statements. The Commission can prescribe the accounting methods to be followed in the accounts, in the appraisal of assets and liabilities, in computing depreciation and depletion, in the differentiation of recurring and nonrecurring costs, in the differentiation of investment and operating income, and in the preparation of consolidated financial statements under certain specified conditions.²⁸

Securities Exchange Act of 1934

The Securities Exchange Act of 1934 provides for the registration of national securities exchanges, national associations of securities dealers, securities listed on exchanges, and brokers and dealers trading in over-the-counter markets. As in the case of the 1933 Act, the Commission's responsibility under this Act is to protect

²⁸Ibid., pp. 3-39.

the public. This law prohibits market manipulations, deceptive devices, or fraudulent practices which give false or misleading appearances of active trading or have the effect of stabilizing the market price. Proxies and changes of security holdings by insiders²⁹ are also controlled by this Act. Registration is necessary by any company which desires to have its securities registered and listed on a national securities exchange. Financial data must be filed and this information is kept current by means of periodic reports. This information is intended to help the investor make decisions. This law also helps to regulate margin requirements and borrowing by brokers and dealers.

Practically all the financial statements and schedules filed must be accompanied by a certificate of an independent public or certified public accountant. Under this Act, the Commission has broad powers to specify the form and content of the financial statements and other reports. It has specific authority to prescribe the methods in preparing reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation of separate and consolidated statements, where necessary.³⁰

²⁹ Insiders refer to directors, officers, and principal stockholders.

³⁰ Rappaport, loc. cit.

Public Utility Holding
Company Act of 1935

The Public Utility Holding Company Act of 1935 provided for the registration of companies in holding company systems in the electric utility or in the retail gas business. As in the 1933 and 1934 Acts, registration is required, with its accompanying financial statements; this is mainly to furnish information about a company's capital structure and the nature of its business. This is the only statute under the jurisdiction of the SEC which is not designed solely for the protection of investors; however, investors have benefited from the improvement in the financial position and stability of these companies caused by SEC regulation.

Under this Act, the required financial information must be certified. This Act also provides for the "Uniform System of Accounts for Public Utility Holding Companies" and the "Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies." These systems, regulated by the SEC, represent the only instances in which the SEC has actually dictated the detailed manner in which the accounts should be kept. These systems are limited to only those companies governed by this Act. Under this Act, the Commission also has authority to make, issue, amend, and rescind any rules and regulations which it deems necessary in order to carry out the provisions of the law. It can prescribe the form and content of financial statements and other information required to be submitted. The Commission can



prescribe the manner in which the cost of all assets shall be shown in required documents and in accounts, and can prescribe the methods to be used in the preparation of reports.³¹

The effect of the regulations of the 1933, 1934, and 1935 Acts were anticipated to strengthen good accounting practices. Company and public accountants would now be able to refer to these requirements in supporting their opinions regarding the accurate and full disclosure of information on the financial statements. While the Commission had tried to make its regulations liberal, practical, and adaptable to the greatly varied conditions of business, yet it was reasonable to believe that accounting principles, as embodied in published corporate reports, would look more like the accounting principles taught in college than ever before. It was also anticipated at this time that published reports of corporations would not differ materially from those filed with the Commission.³²

Mr. George O. May stated, "From the accounting standpoint, the irony of the law was that it gave legal recognition to the function of the independent public accountant, and at the same time, gave to a nonexpert body powers over the profession which went far to destroy its independence."³³

³¹Ibid.

³²T. H. Sanders, "Influence of the Securities and Exchange Commission upon Accounting Principles," The Accounting Review, XI (March, 1936), 73-74.

³³George O. May, Financial Accounting: A Distillation of Experience (New York: The Macmillan Company, 1943), p. 59.

Organization of Securities
and Exchange Commission

The principal office of the SEC is in Washington, D. C. and regional offices are scattered throughout the entire country. The Commission is composed of five members appointed by the President of the United States with the consent of Congress. The President appoints one member to serve as chairman. The Commission is assisted by a staff of professional employees, consisting of attorneys, accountants, engineers, security analysts and examiners. The staff is organized as follows:

- Executive Director--Division of Administrative Management
- Division of Corporation Finance
- Division of Trading and Exchanges
- Division of Corporate Regulation
- Regional Offices
- Office of the General Counsel
- Office of the Chief Accountant
- Office of Opinion Writing
- Office of the Secretary
- Office of the Hearing Examiners
- Executive Assistant to the Chairman

The public accountant who has clients subject to the various acts administered by the SEC is concerned primarily with the Division of Corporation Finance and the Office of the Chief Accountant.

The Division of Corporation Finance has duties in connection with most of the statutes administered by the SEC; its chief responsibility is to prevent fraudulent offerings of securities to the public and the dissemination of false and misleading information in relation to securities. This Division establishes standards of economic and financial information

to be included in the filed documents, and enforces such standards. A director supervises this Division, and he is assisted by several examining sections, the Office of the Chief Counsel, and the Office of the Chief Accountant. The accounting work in the Division is coordinated by the Chief Accountant of the Division, who consults with the Chief Accountant of the Commission regarding new and important accounting and auditing problems. This Division examines all filed documents, conducts field audits, and conducts hearings for the development and verification of facts in submitted documents. This Division also is in charge of drafting rules, regulations, registration reports, and other forms.

The Chief Accountant is the principal adviser to the Commission on all matters regarding accounting and auditing; he supervises the execution of SEC policy in these areas. He brings difficult and debatable problems before the Commission; he is responsible for the execution of Commission policy with respect to accounting principles and practices and for the form and content of financial statements filed with the Commission. He supervises the work of accountants examining financial data filed with the various divisions and regional offices. The Chief Accountant initiates and supervises studies relating to accounting and auditing. In connection with the drafting and interpretation of accounting rules and regulations, he confers with professional accounting organizations, public accountants, and officials of the federal and state governments.

He answers questions from registrants and their accountants on accounting and auditing. Some of his opinions are published by the SEC as Accounting Series Releases, which are discussed later. The Chief Accountant participates in proceedings involving accounting and auditing matters and must conduct investigations. He also is responsible for the consideration of all cases dealing with the independence and qualifications of public accountants who practice before the Commission.

All of the rulings and orders of the SEC are subject to judicial review by the courts. However, experience has shown that the courts usually uphold the decision of the Securities and Exchange Commission.³⁴

The Securities and Exchange Commission now administers all of the following statutes. The first three were already discussed. The latter three will be discussed later in this paper.

- Securities Act of 1933
- Securities Exchange Act of 1934
- Public Utility Holding Company Act of 1935
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisers Act of 1940

The Commission also has certain duties under each of the following:

- National Bankruptcy Act--Chapter X (certain duties in connection with court proceedings)
- Section 851 of the Internal Revenue Code of 1954 (relating to investment companies furnishing capital to development corporations)
- Section 15 (a) of the Bretton Woods Agreement Act (relating to the International Bank for Reconstruction and Development).

³⁴Rappaport, op. cit., pp. 11-15.

Period 1936-1938

Contribution of American
Accounting Association

The American Accounting Association, formerly known as the American Association of University Instructors in Accounting, did some important research concerning accounting principles. In its "Statement of Objectives," two of its official purposes are:

1. To encourage and sponsor research in accounting and to publish or aid in the publication of the results of research.
2. To develop accounting principles and standards, and to seek their endorsement or adoption by business enterprises, public and private accountants, and governmental bodies.³⁵

This organization did some research in its early years of existence, but in 1936 it published its first major contribution in the area of accounting principles. This publication was entitled A Tentative Statement of Accounting Principles Affecting Corporate Reports. The publication stressed the fact that it was very difficult to establish universal principles because of the many differences in business organizations. It did, however, contain twenty propositions which this organization considered necessary for the proper presentation of financial statements. These propositions in accordance with the association's basic assumption that "a corporation's periodic financial statements

³⁵ American Accounting Association, "A Statement of Objectives of the American Accounting Association," The Accounting Review, XI (March, 1936), 1.



should be continuously in accord with a single coordinated body of accounting theory, and that the purpose of the statements is the expression, in financial terms, of the utilization of the economic resources of the enterprise and the resultant changes in and position of the interests of creditors and investors." This pamphlet attempted to standardize accounting practices in three areas where there was much freedom of action. The three areas were: "costs and values," "measurement of income," and "capital and surplus." The Statement also stressed that accounting is not essentially a process of valuation, but rather a process of allocation of historical costs and revenues to the current and future fiscal periods.³⁶

The Statement was criticized by professional accountants on the basis that it failed to make a clear distinction between principles and their application. Even though it had this deficiency, it had the advantageous effect of stimulating research in the field of accounting.³⁷

Activities of American
Institute of Accountants

The second revised edition of the original publication prepared by the Institute in cooperation with the Federal Reserve Board

³⁶American Accounting Association, "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements," The Accounting Review, XI (June, 1936), 187-91.

³⁷Mary E. Murphy, "Development of Principles by Accounting Societies," Selected Readings in Accounting and Auditing (ed. Mary E. Murphy; New York: Prentice-Hall, Inc., 1952), 15-16.

was published in 1936. It was entitled Examination of Financial Statements by Independent Public Accountants and extended the principles and procedures previously advocated in the 1917 and 1929 pamphlets to apply to statements prepared for published corporation reports.

From 1936 to 1938 a committee of the Institute, working in the area of generally accepted accounting principles, was known as the "committee on accounting procedure." The composition of this committee was similar to its predecessor, "special committee on development of accounting principles."³⁸ The 1937-38 committee prepared the statement on profits and losses on treasury stock which was included in the Accounting Research Bulletins.³⁹

The Institute did not engage in research activities on any important scale until 1938. In recognition of the need for a formal and permanent organization for considering accounting principles, a committee was appointed on the development of accounting principles in 1938. This special committee was called the Committee on Accounting Procedure. At the same time a Research Department was established within the Institute's own staff.

³⁸ See pages 36-37.

³⁹ American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., pp. 13-14; American Institute of Accountants, General Introduction and Rules Formerly Adopted, Accounting Research Bulletin No. 1, op. cit., pp. 7-8.

The Committee on Accounting Procedure consisted of twenty-one members from the public accounting profession and from the accounting teaching profession. All of the persons selected were considered to be outstanding men. The initial objectives of this Committee were:

1. To further the development and recognition of generally accepted accounting principles, and
2. To narrow areas of difference and inconsistency in accounting practices.

It can be observed that the Institute did, in a sense, acknowledge responsibility and assumed leadership in the area of accounting principles.⁴⁰

The Institute undertook a research program at that time in response to demands that the great variety of accounting practices allowed in a particular situation be reduced in number and that misleading practices be discontinued. A greater uniformity in practice would make possible a valid comparison of the financial statements of a business from year to year and also the statements of similar businesses could be compared. The greatest demand for uniformity came from the Securities and Exchange Commission.⁴¹

The first Committee on Accounting Procedure was appointed under the chairmanship of George O. May. At that time there were no

⁴⁰Jennings, op. cit., p. 551.

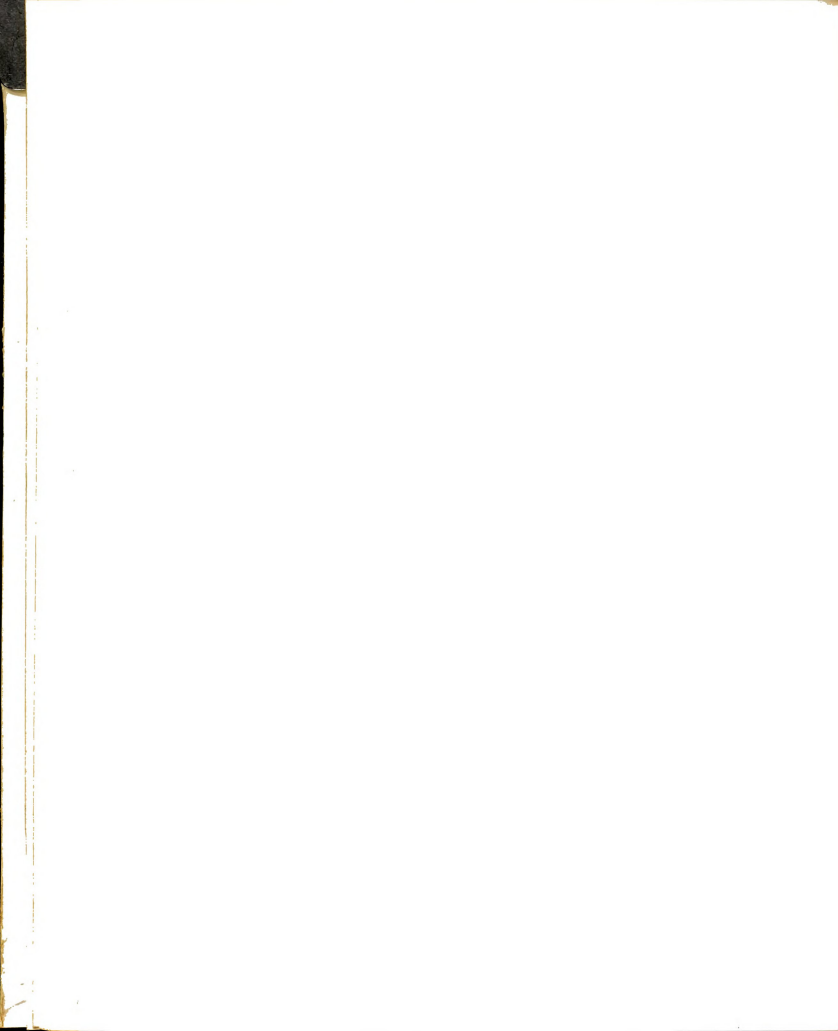
⁴¹Charles T. Zlatkovich, "Accounting Research," Selected Readings in Accounting and Auditing (ed. Mary E. Murphy; New York: Prentice-Hall, Inc., 1952), p. 17.



generally accepted accounting principles with the authority of a professional group behind them. Widespread differences in accounting practices had been the subject of sharp public criticism and were the subject of congressional hearings in the early years of the depression. When the Securities and Exchange Commission was established in 1934, many people expected that this governmental agency would lay down accounting rules. However, a little earlier the American Institute and two committees, which were the predecessors of the present accounting procedure committee, had been considering the growing significance of financial reporting to third parties and to the general public. Statements issued in cooperation with the Federal Reserve Board and the New York Stock Exchange were important steps which resulted in the creation of the accounting procedure committee. With the establishment of this all-important committee, the organized profession of certified public accountants formally undertook to promulgate guides to accounting practice in the public interest.⁴²

After the committee discussed their plans at their early meetings, they concluded that it was not practicable or desirable for it to formulate comprehensive rules to cover the whole field of accounting. Instead the committee said in its first report to the Institute Council:

⁴² Editorial, "The Accounting Procedure Committee," The Journal of Accountancy, CVIII (September, 1959), 29-30.



The present plan of the committee is to consider specific topics, first of all in relation to the existing state of practice, and to recommend, wherever possible, one or more alternative procedures as being definitely superior in its opinion to other procedures which have received a certain measure of recognition and, at the same time, to express itself adversely in regard to procedures which should in its opinion be regarded as unacceptable.⁴³

The Committee did consider two possible approaches to the problem. It could have elected to deal with the problems of a general nature or it could have chosen to deal with problems of a limited nature. The Committee chose the latter course of action. This can be clearly seen by reviewing the topics covered by the research bulletins which are listed later in this chapter. The reason given for the decision at that time was that a broad statement of principles would have taken too long to produce and that there was an urgent need to produce something immediately. The item-by-item plan of attack was adopted and was employed in the forthcoming bulletins.⁴⁴

The Committee then developed a program for research and publication of opinions, resulting in a series of Accounting Research Bulletins. This program commenced in 1938.

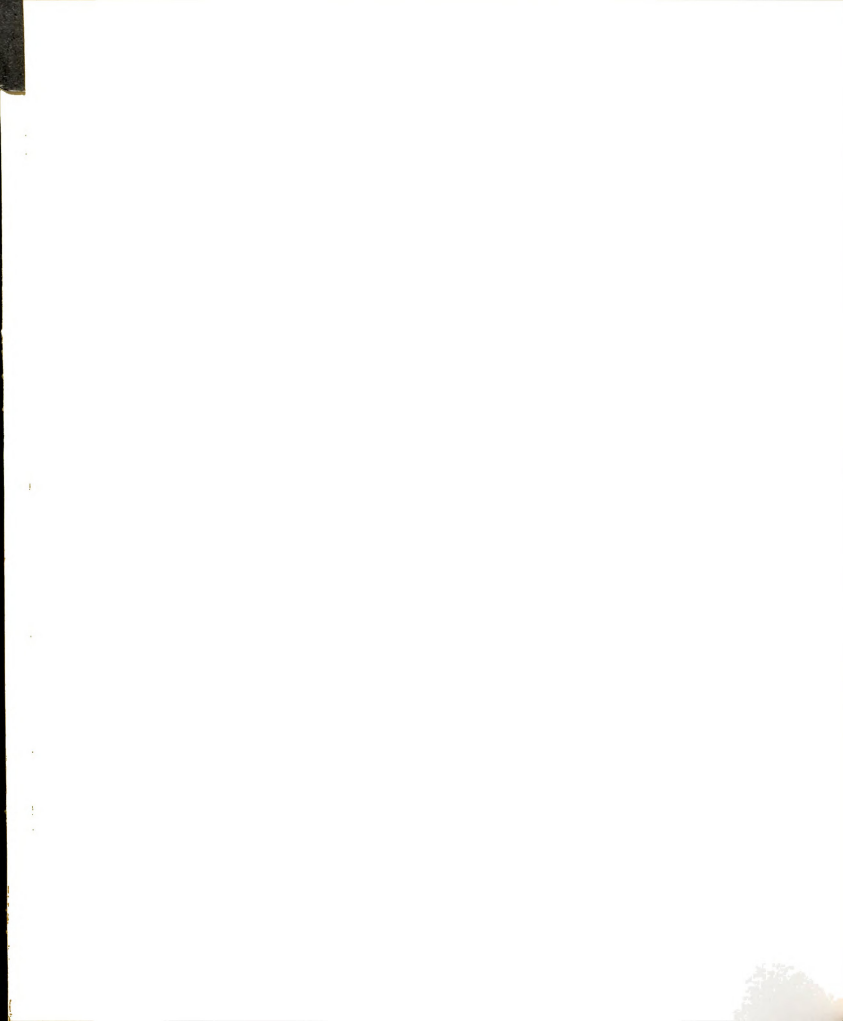
The Accounting Research Bulletins have always been issued by the Committee on Accounting Procedure. In conducting research and in issuing these bulletins the Committee on Accounting

⁴³Ibid.

⁴⁴Zlatkovich, loc. cit.

Procedure had basic ideas and considerations in mind from which to proceed. It would be well to look at their basic ideas:

1. Accounting is essential to the effective functioning of any business organization, particularly the corporate form. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole--not merely from that of any one group of interested persons.
2. The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet changes as they occur. In the past fifty years there has been an increasing use of the corporate system for the purpose of converting into readily transferable form the ownership of large, complex, and more or less permanent business enterprises. This evolution has brought in its train certain uses of the processes of law and accounting which have led to the creation of new controls, revisions of the laws, and reconsideration of accounting procedures.
3. As a result of this development, the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise, with consequent increased recognition of the significance of the income statement and a tendency to restrict narrowly charges and credits to surplus. The fairest possible presentation of periodic net income, with neither material overstatement nor understatement, is important, since the results of operations are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers. With the increasing importance of the income statement there has been a tendency to regard the balance sheet as the connecting link between successive income statements; however this concept should not obscure the fact that the balance sheet has significant uses of its own.
4. This evolution has also led to a demand for a larger degree of uniformity. Uniformity has usually connoted similar treatment of the same item occurring in many cases, in which sense it runs the risk of concealing important differences among cases. Another sense of the word



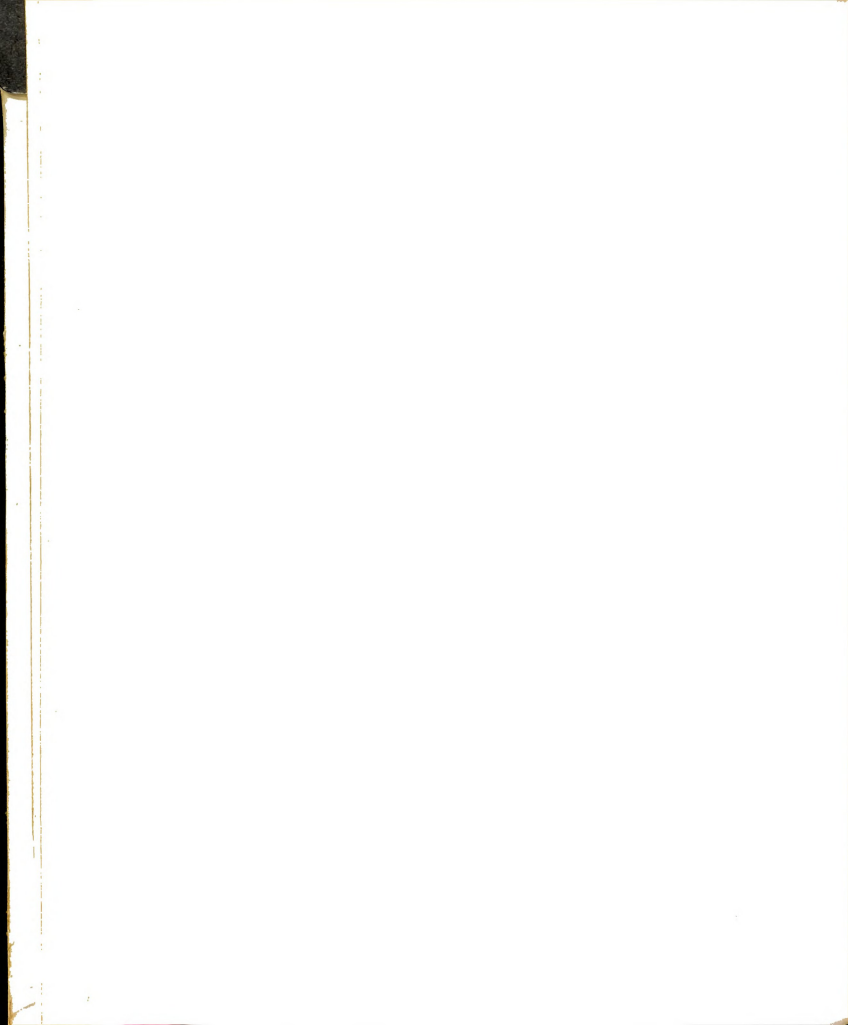
would require that different authorities working independently on the same case should reach the same conclusions. Although uniformity is a worthwhile goal, it should not be pursued to the exclusion of other benefits. Changes of emphasis and objectives as well as changes in conditions under which business operates have led, and doubtless will continue to lead, to the adoption of new accounting procedures. Consequently diversity of practice may continue as new practices are adopted before old ones are completely discarded.⁴⁵

The basic ideas as stated above, from the bulletin issued in 1953, are substantially the same ideas as were stated by the Committee on Accounting Procedures in 1939. Only the wording has been altered slightly.⁴⁶

The main objective of the Committee on Accounting Procedure was to narrow the areas of difference and inconsistency in accounting practices, and to encourage the development and recognition of generally accepted accounting principles through the issuance of opinions and recommendations that would serve as yardsticks in determining whether accounting principles and practices reflected in the financial statements were suitable. The Committee directed its attention to the accounting problems of commercial and industrial enterprises and not to the accounting problems of non-profit institutions, governmental units, and

⁴⁵ American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., pp. 7-8.

⁴⁶ American Institute of Accountants, General Introduction and Rules Formerly Adopted, Accounting Research Bulletin No. 1, op. cit., pp. 1-2.



professional firms. The Committee concentrated on business enterprises organized for profit.⁴⁷

In order for the opinions of the Committee to be meaningful, they must be generally acceptable by those who will follow such opinions.

With this end result in mind the following procedures were adopted:

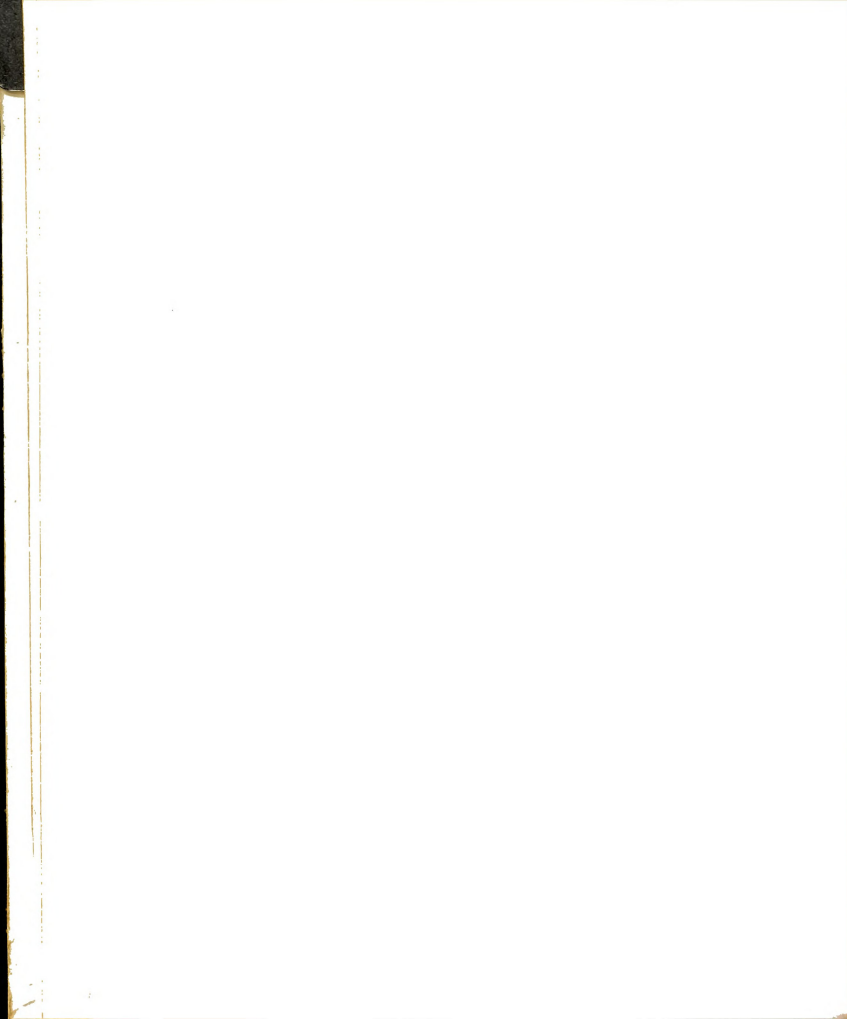
- a. Any opinion or recommendation before issuance is submitted in final form to all members of the committee, in person or by mail.
- b. No opinion or recommendation is issued unless it has received the approval of two-thirds of the entire committee.
- c. Any member of the committee dissenting from an issued opinion or recommendation is entitled to have his dissent and his reasons therefor recorded in the same bulletin.

The Committee also considered prior opinions, prevailing practices, and the viewpoints of professional and other organizations concerned with accounting principles and practices before arriving at its conclusions.⁴⁸

In addition to having passed the scrutiny of the Committee, before an Accounting Research Bulletin was issued it was submitted, in draft form, to the staff of the SEC, the New York Stock Exchange, the state societies of Certified Public Accountants, the Controllers Institute of America, the American Accounting Association, the National Association of Accountants, the Edison Electric Institute, the Robert Morris Associates,

⁴⁷ American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., p. 8.

⁴⁸ Ibid., pp. 8-9.

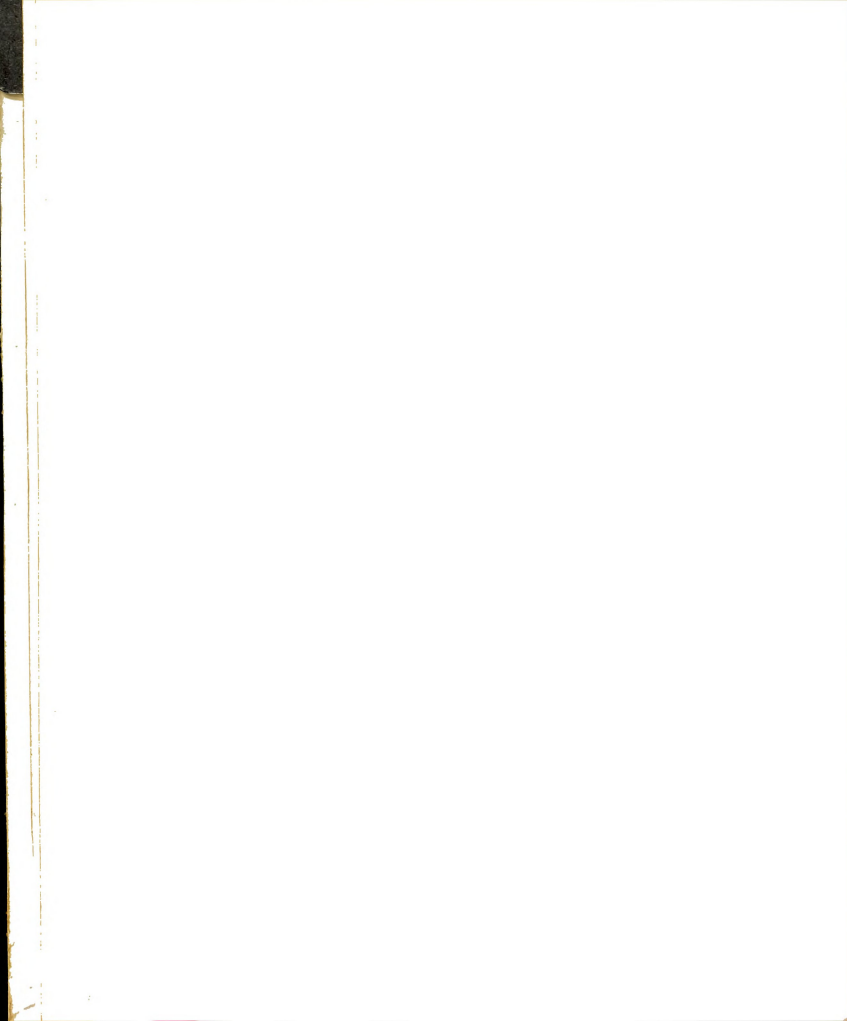


and others. Furthermore, it was usual for the committee members to submit copies of the drafts to the partners of their own firms for suggestions. When a bulletin was finally issued, it carried great weight.⁴⁹

Occasionally the formal adoption of an opinion was asked and secured from the membership of the Institute. Aside from these cases, the authority of the opinions arrived at by the Committee depended on their general acceptability. The Committee did recognize that in special cases fair presentation to all interested parties may require unusual treatment. However, any departure from an accepted procedure, as stated in the opinions of the Committee, was to be adequately justified by anyone who adopted a different treatment. At the same time, the Committee also assumed that its opinions would be applied only to material and significant items; items of little or no materiality or significance were to be dealt with from the viewpoint of expediency. The Committee qualified this by stating, "However, freedom to deal expediently with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant."⁵⁰

⁴⁹Williams, op. cit., p. 409.

⁵⁰American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., pp. 7-8.



The Committee recognized the fact that the adoption and use of accounting principles was the responsibility of others besides the certified public accountants. It stated, "Underlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate. While opinions of the committee are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the committee recommends similar application of the procedures mentioned herein by those who prepare the accounts and financial statements."⁵¹

Activities of Securities
and Exchange Commission

On April 1, 1937, the Securities and Exchange Commission announced a program for the publication of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions. All of these opinions are contained in the Accounting Series Releases and are specifically referred to in Regulation S-X which contains the requirements

⁵¹Ibid., p. 10.

as to the form and content of the financial statements which are required to be filed with the Commission under the various acts.⁵²

On April 25, 1938 the Securities and Exchange Commission stated its administrative policy with respect to financial statements:

In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities and Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.⁵³

This rule was established when some members of the Commission believed that full disclosure could not remedy defects in a financial statement based on unsupportable accounting principles.

On May 16, 1938 the Commission issued an analysis of the deficiencies commonly cited in connection with financial statements

⁵² United States Securities and Exchange Commission, Accounting Series Releases, Releases 1 to 77, Inclusive (Washington: United States Government Printing Office, 1956), preface.

⁵³ United States Securities and Exchange Commission, "Release No. 4; Administrative Policy on Financial Statements," Accounting Series Releases (Washington: United States Government Printing Office, 1956), 5-6.

filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. This analysis was prepared by Mr. Carman G. Blough, at that time Chief Accountant for the Commission. Among the deficiencies cited, three were concerned directly with accounting principles. In summary, these are the deficiencies cited:

Deficiency No. 1: Accountant's opinion in respect of (1) the financial statements of, and (2) the accounting principles and procedures followed by the registrant, not clearly stated.⁵⁴

Deficiency No. 7: Certifying that the accounting principles followed by the registrant are in accordance with the system of accounts prescribed by a State regulatory body, or in a particular industry, but without indicating whether the practice of the registrant is in accordance with generally accepted accounting principles and procedures.⁵⁵

Deficiency No. 9: Effect upon the financial statements of the registrant's failure to follow generally accepted accounting principles and procedures not commented upon and explained by the certifying accountants.⁵⁶

The above releases show that the Securities and Exchange Commission was genuinely interested in the problem of generally accepted accounting principles.

Activities of National Association of Cost Accountants

The National Association of Cost Accountants, now known as the National Association of Accountants as of July, 1957, was founded

⁵⁴ United States Securities and Exchange Commission, "Release No. 7; Commonly Cited Deficiencies in Financial Statements Filed under the Securities Act of 1933 and the Securities Exchange Act of 1934," Accounting Series Releases (Washington: United States Government Printing Office, 1956), p. 8.

⁵⁵ Ibid.

⁵⁶ Ibid.



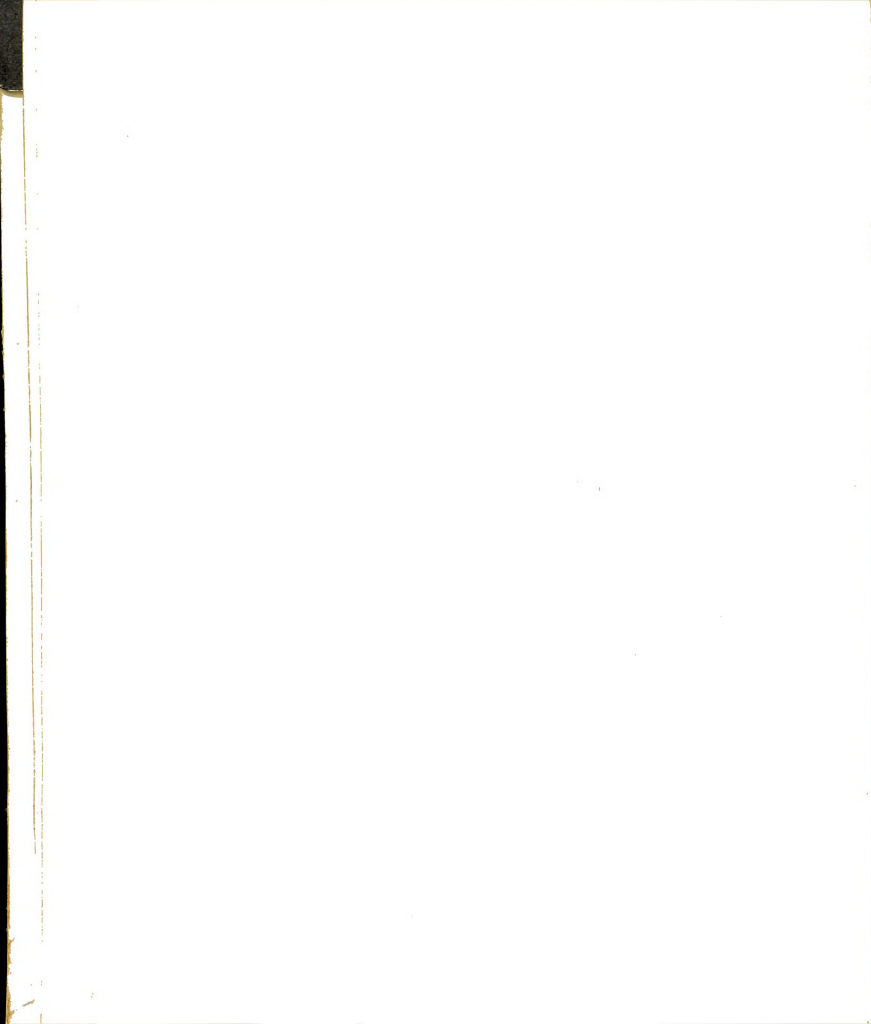
in 1919. This organization had always been interested in research, and had issued research studies. Up to 1936 its research studies were not concerned with general accounting principles; instead, these studies were either surveys of existing practices or were studies of specific problems. Starting in 1936, up to 1942, a series of eleven major reports were prepared; each of these reports were current practice surveys and were based upon findings of questionnaires sent to members of this Association. The questionnaires returned did reveal a great variety of practices followed at that time. However, the reasons for these variations were not investigated or otherwise discovered at this time.⁵⁷

A Statement of Accounting Principles--
Sanders, Hatfield, and Moore

In 1938 the executive committee of the American Institute of Accountants, with permission from the Haskins and Sells Foundation, published the monograph, A Statement of Accounting Principles written by Thomas Henry Sanders, Henry Rand Hatfield, and Underhill Moore. The Institute believed this work to be a valuable contribution in the area of accounting principles.

The three authors commenced their work on this publication in the summer of 1935. Its statement of accounting principles was prepared only after extensive interviews and correspondence with

⁵⁷ Zlatkovich, op. cit., p. 19.



competent persons, complete review of accounting literature, study of statutes, and legal decisions referring to accounting, and an examination of corporation reports and the accompanying certificates of the auditors.⁵⁸

This work goes beyond the area of accounting principles. It also includes coverage of the form of the financial statements. The authors, the Institute, and the Haskins and Sells Foundation all hoped that this report would establish a body of accounting principles which would help to standardize accounting practices. In this respect, the writer believes it failed; this publication never has achieved the importance and authority which had been hoped for. However, it did stimulate thinking in the area of accounting principles.

⁵⁸ Thomas Henry Sanders, Henry Rand Hatfield, and Underhill Moore, A Statement of Accounting Principles (New York: American Institute of Accountants, 1938), pp. 1-138.

CHAPTER III

THE DEVELOPMENT OF ACCOUNTING PRINCIPLES

IN THE UNITED STATES--1939 TO 1959

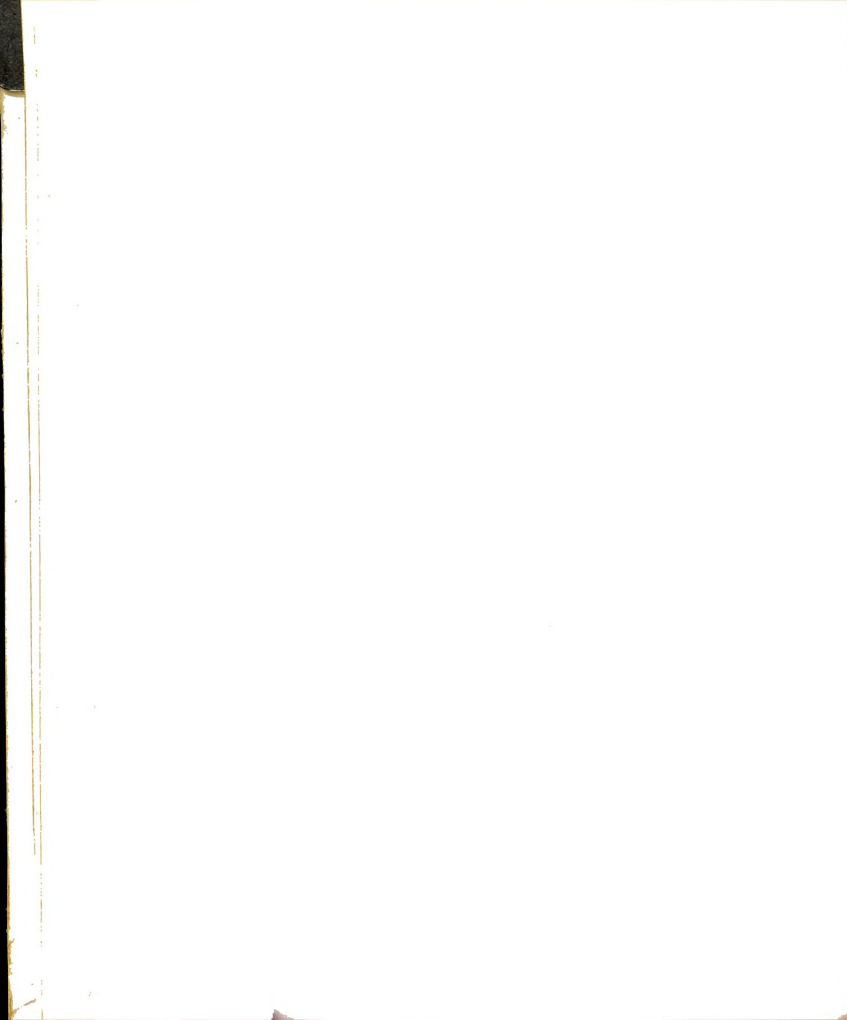
Period 1939-1946Activities of American
Accounting Association

The 1936 Statement of the American Accounting Association was revised in 1941. The new publication was entitled Accounting Principles Underlying Corporate Financial Statements. This revision was brought about by the high degree of interest shown by various groups in the formulation of accounting principles; the 1936 publication stirred up some of this interest.

The Executive Committee realized, at this time, that any statement of principles would not be considered a final word on the subject by all accountants. The Committee did believe, however, that the area of principles should receive continuous attention, keeping in mind that the financial statements have become the basis for many vital decisions by business and government.¹

Many business managements have permitted themselves such freedom of action in selecting the accounting principles and

¹ American Accounting Association, Accounting Principles Underlying Corporate Financial Statements, Issued by the Executive Committee (Columbus, Ohio: American Accounting Association, June, 1941), p. 51.



practices which their company will use that published statements are, in many instances, difficult to interpret without a great deal of supplemental information. In many cases it is impossible to compare the financial statements of different enterprises, and even the comparisons of the financial statements for the same enterprise for successive periods. The Association took the view that to avoid these problems every corporate statement should be based on accounting principles which are uniform, objective, and well understood. The Committee did recognize the fact that the variety of business firms would necessitate some exceptions to the general rules. However, they believed that it was still possible to arrive at standards of adequacy and reasonableness in the presentation of corporate financial statements which would eliminate variations in accounting practice not resulting from the individual characteristics of every firm, but rather from the lack of well-conceived and common standards.²

The 1941 Revision was based on the following basic assumption:

The purpose of periodic financial statements of a corporation is to furnish information that is necessary for the formulation of dependable judgments. A knowledge of the origin and expiration of the economic resources of a company and the resultant changes in the interests of its creditors and investors is essential to this purpose, and these facts should be expressed in such a manner as to make the financial statements both intelligible and, as far as possible, comparable with statements of other periods and of other corporations. The reader of a statement should be able to assume that, in the absence of clear indications to the contrary,

²Ibid., pp. 51-52.

certain basic principles or standards have been followed. To achieve this end a unified and coordinated body of accounting theory is required.³

The 1941 pamphlet set forth fundamental propositions in respect to cost, revenue, income, and capital.

Activities of the American Institute of Accountants

The Committee on Accounting Procedure, which was appointed in 1938 by the American Institute of Accountants, began issuing its accounting research bulletins in 1939. From that year until 1953 forty-two research bulletins were issued; revisions and supplements were also issued. Eight of these bulletins concerned themselves with terminology, and consequently were based on research of the committee on terminology. The other thirty-four bulletins were the result of study by the committee on accounting procedure, and were aimed at those specific areas of accounting practice where the most serious problems appeared. The committee concerned itself with specific problems, rather than with the over-all structure of accounting principles. This is not to say, however, that consideration of many of the specific problems did not or could not lead to general accounting principles. Some of the studies were undertaken to keep abreast with new business and economic developments; others were necessary because problems arose out of the war. As business and economic conditions changed, the usefulness of many of the bulletins also changed;

³Ibid., pp. 52-53.

therefore, some of the bulletins had to be changed, superseded, or withdrawn.⁴ Illustration II on the following three pages shows a chronological list of the first forty-two Accounting Research Bulletins. This complete list is presented now so that it can be used for reference throughout the remainder of this paper.

Activities of Securities and Exchange Commission

Three more laws which fell under the jurisdiction of the Securities and Exchange Commission were passed in 1939 and 1940.

The Trust Indenture Act of 1939 provided for the approval of trust indentures by the SEC, before bonds, debentures, and other forms of indebtedness may be offered to the public. Documents must be filed relative to the indenture provisions. Annual reports by the trustee are required. The public accountant has no part in the preparation of the registration statements or annual reports required to be filed under this Act. However, many companies do have a public accountant review the indenture before it becomes final.⁵

The Investment Company Act of 1940 was passed after a complete four-year investigation by the SEC of the practices of investment trusts in the 1920's. This law represents a compromise measure

⁴American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., p. 5.

⁵Rappaport, op. cit., pp. 8-9.

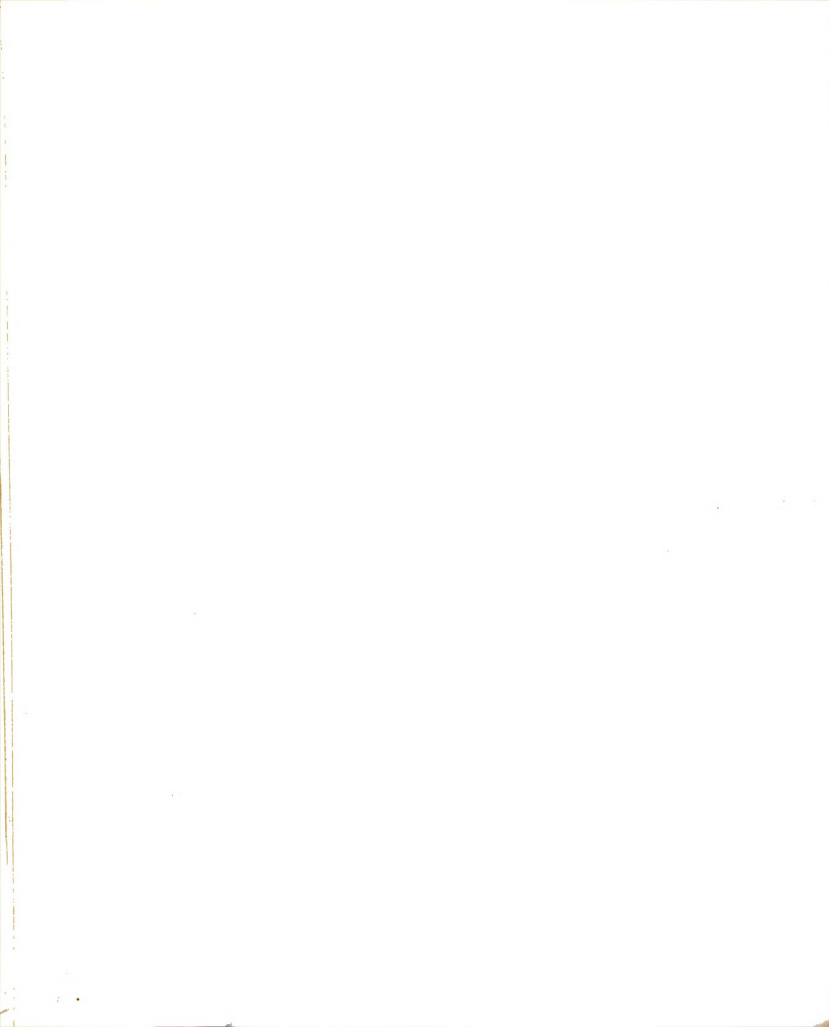


ILLUSTRATION II. --Chronological list of Accounting Research Bulletins
1 through 42

No.	Date issued	Title
1	Sept. , 1939	General Introduction and Rules Formerly Adopted
2	Sept. , 1939	Unamortized Discount and Redemption Premium on Bonds Refunded
3	Sept. , 1939	Quasi-Reorganization or Corporate Readjustment--Amplification of Institute Rule No. 2 of 1934
4	Dec. , 1939	Foreign Operations and Foreign Exchange
5	April, 1940	Depreciation on Appreciation
6	April, 1940	Comparative Statements
7	Nov. , 1940	Reports of Committee on Terminology
8	Feb. , 1941	Combined Statement of Income and Earned Surplus
9	May, 1941	Report of Committee on Terminology
10	June, 1941	Real and Personal Property Taxes
11	Sept. , 1941	Corporate Accounting for Ordinary Stock Dividends
12	Sept. , 1941	Report of Committee on Terminology
13	Jan. , 1942	Accounting for Special Reserves Arising out of the War
14	Jan. , 1942	Accounting for United States Treasury Tax Notes
15	Sept. , 1942	The Renegotiation of War Contracts
16	Oct. , 1942	Report of Committee on Terminology
17	Dec. , 1942	Post-War Refund of Excess-Profits Tax

ILLUSTRATION II--Continued

No.	Date issued	Title
18	Dec. , 1942	Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)
19	Dec. , 1942	Accounting under Cost-Plus-Fixed-Fee Contracts
20	Nov. , 1943	Report of Committee on Terminology
21	Dec. , 1943	Renegotiation of War Contracts (Supplement)
22	May, 1944	Report of Committee on Terminology
23	Dec. , 1944	Accounting for Income Taxes
24	Dec. , 1944	Accounting for Intangible Assets
25	April, 1945	Accounting for Terminated War Contracts
26	Oct. , 1946	Accounting for the Use of Special War Reserves
27	Nov. , 1946	Emergency Facilities
28	July, 1947	Accounting Treatment of General Purpose Contingency Reserves
29	July, 1947	Inventory Pricing
30	Aug. , 1947	Current Assets and Current Liabilities-- Working Capital
31	Oct. , 1947	Inventory Reserves
32	Dec. , 1947	Income and Earned Surplus
33	Dec. , 1947	Depreciation and High Costs
34	Oct. , 1948	Recommendation of Committee on Terminology-- Use of Term "Reserve"
35	Oct. , 1948	Presentation of Income and Earned Surplus

ILLUSTRATION II--Continued

No.	Date issued	Title
36	Nov., 1948	Pension Plans--Accounting for Annuity Costs Based on Past Services
37	Nov., 1948	Accounting for Compensation in the Form of Stock Options
38	Oct., 1949	Disclosure of Long-Term Leases in Financial Statements of Lessees
39	Oct., 1949	Recommendation of Subcommittee on Terminology--Discontinuance of the Use of the Term "Surplus"
40	Sept., 1950	Business Combinations
41	July, 1951	Presentation of Income and Earned Surplus (Supplement to Bulletin No. 35)
13	July, 1951 (Addendum)	Limitation of Scope of Special War Reserves
26	July, 1951 (Addendum)	Limitation of Scope of Special War Reserves
42	Nov., 1952	Emergency Facilities--Depreciation, Amortization, and Income Taxes
11	Nov., 1952 (Revised)	Accounting for Stock Dividends and Stock Split-Ups
37	Jan., 1953 (Revised)	Accounting for Compensation Involved in Stock Option and Stock Purchase Plans

by industry representatives and the SEC, and is intended to remedy a number of abuses which were associated with investment trusts at that time. Investment companies must register and submit about the same information as is required under the 1933 and 1934 Acts. An opinion must be expressed on the financial statements and schedules. The Commission is authorized to issue rules and regulations providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements required by the law. The Commission has authority to make, issue, amend, and rescind any rules and regulations defining accounting, technical, and trade terms used in the law. It may also prescribe the form and content of statements, applications, and reports.⁶

The Investment Advisers Act of 1940 required the registration of certain persons engaged in the business of advising others with respect to security transactions. This is a supplement to the Investment Act of 1940, and also requires registration information. The public accountant has no important function under this act.⁷

On February 21, 1940, a uniform set of accounting requirements which applied to most of the forms required under the Securities Act of 1933 and the Securities Exchange Act of 1934 was issued by the

⁶ Ibid., pp. 9-10, 19.

⁷ Ibid., p. 10.

Commission. Under this new regulation, called Regulation S-X, a new single accounting regulation was substituted for several different sets of accounting instructions which had been issued previously to apply to the various forms. It was the intention that Regulation S-X would simplify interpretations of the rules, as a standard set had now been put into effect. Another main objective of this regulation was to protect the public interest and for the protection of the investors.⁸

Activities of National Association
of Cost Accountants

In 1943 and 1944 the National Association of Cost Accountants reviewed its previous studies and surveys, which were made mainly by questionnaires. The Association decided to supplement the questionnaires with field investigation and interview.⁹

In 1945 the national directors provided for the appointment of a research committee of twenty-eight men. This new committee was formed and it formulated its function. The committee decided that its function would not be to do the actual research work, but rather to suggest, plan, and guide the research program; it would serve as a funnel for ideas, and would assign priorities to suggested topics and would work through the

⁸United States Securities and Exchange Commission, "Release No. 12; Regulation S-X," Accounting Series Releases (Washington: United States Government Printing Office, 1956), pp. 16-19.

⁹Zlatkovich, op. cit., p. 19.

national headquarters research staff and any other facilities available for research activities. This Committee also would review all research prior to publication and would meet periodically. The Committee also announced that out of its investigations of accounting practice and discussions of the adaptations of accounting methods to managerial purposes, it would develop "what may be called statements of good practice."¹⁰

It was expected that these "statements of good practice" would eventually assume an authoritative position in the field of cost accounting.¹¹ Impliedly, they were to be Accounting Research Bulletins in the field of cost accounting. Three years later it was decided by this Committee to abandon this project as it was deemed to be too time consuming; it was also stated that current problem and practices studies were very numerous and would require all of the Committee's attention. However, even though specific surveys and studies were, once again, being undertaken, there was a noticeable difference when compared to the former surveys. Now the emphasis was on how things were being done rather than on mere statistical studies. Most of the studies were undertaken in response to the need of some of the Association's

¹⁰ National Association of Cost Accountants, Committee on Research, "Research in Industrial Accounting," NACA Bulletin, XXVII (November 15, 1945), 253-57; Since July, 1957 this organization is known as the National Association of Accountants (NAA).

¹¹ Ibid., p. 255.

members. Some of the studies were the result of a new law, new economic conditions, or the war situation.¹²

An Introduction to Corporate Accounting Standards--Paton and Littleton

In 1936 "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements" was published in The Accounting Review.¹³ This Statement was thoroughly criticized and evoked much criticism in periodicals, American Accounting Association meetings, etc. Professors W. A. Paton and A. C. Littleton decided that the Statement should be supplemented by an outline of the basic theory of accounting. Their final result was the publishing of a monograph entitled An Introduction to Corporate Accounting Standards, published in 1940.

This new publication, although published by the American Accounting Association as Monograph Number 3, did not express the views of the organization. It was clearly recognized as the views of only the two authors.

The authors attempted to present in one place the basic ideas of accounting. In other words, an attempt was made to build a

¹² Zlatkovich, op. cit., p. 20.

¹³ American Accounting Association, "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements," The Accounting Review, XI (June, 1936), 187-91.

framework for future corporate accounting standards. The authors state in the preface to their monograph, "Accounting theory is here conceived to be a coherent, coordinated, consistent body of doctrine which may be compactly expressed in the form of standards if desired." This publication considered the problems of standards, concepts, cost, revenue, income, and interpretation.¹⁴

Of all the attempts made by various writers to state a coordinated and logical structure of accounting theory, the Paton-Littleton statement appears to be the best. It represents a work which is still being printed, still is in great demand, and still is recognized as an excellent work in the area of accounting principles.

Period 1947-1952

Activities of American Accounting Association

The 1941 pamphlet¹⁵ of the American Accounting Association was reprinted in The Accounting Review in January, 1947. Readers were asked to constructively criticize this Statement with a view towards a revision.¹⁶ In addition, suggestions were solicited and obtained from

¹⁴W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, Monograph No. 3 (Chicago: American Accounting Association, 1940), pp. 1-156.

¹⁵See pages 61-63.

¹⁶American Accounting Association, Committee on Revision of Statement of Accounting Principles, "Research Reports," and "Accounting Principles Underlying Corporate Financial Statements," The Accounting Review, XXII (January, 1947), 101-07.

practicing accountants and others interested in the subject.¹⁷

The next revision was published in 1948 and was entitled Accounting Concepts and Standards Underlying Corporate Financial Statements. This Statement was a concise statement on accounting principles. Accounting principles advocated by this revision were challenged because of their rigidity; however it was also recognized that this publication did make a worth-while contribution to the development of generally accepted accounting principles.¹⁸

The 1948 Statement restated the preliminary considerations expressed in the 1941 publication. These considerations were:

- a. The basic objective has been to stimulate the continued study and discussion of accounting standards and their periodic restatement, thereby assisting in the orderly development of accounting concepts and their wider acceptance both among accountants and among others in any way influence by or interested in the findings of accountants.
- b. So many decisions are dependent on interpretations of corporate reports that uniform, objective, and well-defined standards have become a requisite for the use of the reports by persons having an interest in an individual enterprise or in the broader problems relating to the national economy.
- c. Because basic accounting concepts and standards remain relatively undisturbed even during periods of economic change, restatements will involve primarily changes in emphasis.

¹⁷Zlatkovich, op. cit., p. 21.

¹⁸Murphy, op. cit., p. 16.

- d. Although a comprehensive understanding of the financial position and operating activities of a corporation is derived only in part from financial statements, it should nevertheless be possible for a person moderately experienced in business and finance to obtain from such statements basic information on which he may rely with confidence.
- e. In the application of standards individual differences in industries or in enterprises within an industry may require that allowance be made for well-established practices, but the standards here recommended are believed to be capable of general application. Any deviation therefrom should be carefully weighed and, if made, disclosed both qualitatively and quantitatively in the financial statements.¹⁹

The 1948 publication covered general areas such as assets, income, liabilities, and stockholders' interest, and financial statements. In conclusion the pamphlet stated that if accounting standards are to be accepted, financial statements which are based on such standards must supply dependable information for the formulation of judgments. Such judgments can be relied upon only if the standards are applied consistently and changes in accounting policy should be limited to those that will improve standards.²⁰

Numerous criticisms and comments were made in connection with the 1948 Statement. Mr. George O. May vigorously objected to this publication; he found it very inferior to the 1941 publication.

¹⁹ American Accounting Association, Accounting Concepts and Standards Underlying Corporate Financial Statements, Issued by the Executive Committee (Columbus, Ohio: American Accounting Association, 1948), p. 1.

²⁰ Ibid., pp. 1-6.

He, like others, objected on the grounds that it was impossible to lay out the structure of accounting statements in a few pages, such as this publication contained.²¹ Professor W. A. Paton strongly opposed the Statement on one seriously objectionable feature; Item 5 under "Expense" implied that the accountant was bound by past decisions without regard to their merit or relationship to current facts, and therefore could not revise past incorrect judgments.²² Professor Herbert F. Taggart also strongly criticized the same point as Professor Paton, emphasizing that judgmental errors should be subject to correction.²³ Mr. Daniel Borth criticized the terminology, explanations, and clarity of the Statement, and believed that an abbreviated statement of accounting concepts and standards served only very limited and specialized needs and had many deficiencies.²⁴

²¹ George O. May, "Accounting Concepts and Standards Underlying Corporate Financial Statements," The Journal of Accountancy, LXXXVI (November, 1948), 412-14.

²² W. A. Paton, "The 1948 Revision of the American Accounting Association's Statement of Principles--Comments on Item 5 under 'Expense,'" The Accounting Review, XXIV (January, 1949), 49-53.

²³ Herbert F. Taggart, "The 1948 Revision of the American Accounting Association's Statement of Principles--A Critique and Comparison with the 1941 Statement," The Accounting Review, XXIV (January, 1949), 54-60.

²⁴ Daniel Borth, "Comments on Third Statement of Accounting Concepts and Standards," The Accounting Review, XXIV (July, 1949), 277-80.

Professor Herbert E. Miller's general appraisal of the controversial 1948 Statement indicated that the American Accounting Association's publication did not represent a departure from the previous 1941 Statement, but rather was a continuation of it in the evolutionary process of forming accounting principles.²⁵ Dr. Perry Mason, although making several minor criticisms, believed that this revised Statement certainly helped to codify accounting concepts and standards.²⁶ Dr. Ralph C. Jones, as Chairman of the 1949 Committee on Accounting Concepts and Standards, recognized that there were numerous objections to the 1948 Statement and that these objections were not, for the most part, in regard to the statement as a whole, but applied to certain sections requiring amendment and clarification; he recommended that a revision of this Statement should be started at once.²⁷

²⁵ Herbert E. Miller, "The 1948 Revision of the American Accounting Association's Statement of Principles--A General Appraisal," The Accounting Review, XXIV (January, 1949), 44-49.

²⁶ Perry Mason, "The 1948 Statement of Concepts and Standards," The Accounting Review, XXV (April, 1950), 133-38.

²⁷ Ralph Coughenour Jones, "Accounting Concepts and Standards," The Accounting Review, XXV (April, 1950), 139-41.

The 1948 Statement was issued by the Executive Committee, but the preliminary draft was prepared by a special committee which was appointed in 1946. The previous two Statements, issued in 1936 and 1941, had been issued by the Executive Committee.

In 1949, a Committee on Concepts and Standards Underlying Corporate Financial Statements was appointed to consider special problems relevant to financial reporting. Subsequently eight supplementary statements were issued by this Committee, which are listed below. The supplementary statements represent the reasoned judgment of at least two-thirds of the members of the Committee, and are not recognized as official pronouncements of the American Accounting Association or its Executive Committee. Also, these supplementary statements are not necessarily viewed as stating rules of current professional conduct or procedure; rather, they state objectives in the development of accounting principles. Some of the pronouncements could be applied immediately while others were forward-looking.²⁸

Supplementary statements were issued with the 1948 Revision. Following is a list of such supplements:

²⁸ These views are expressed at the end of each of the eight supplementary statements.

ILLUSTRATION III. --List of Supplementary Statements to Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948
Revision issued by the American Accounting Association

Supplementary statement no.	Year issued	Title
1	1950	Reserves and Retained Income
2	1951	Price Level Changes and Financial Statements
3	1951	Current Assets and Current Liabilities
4	1952	Accounting Principles and Taxable Income
5	1953	Accounting Corrections
6	1953	Inventory Pricing and Changes in Price Levels
7	1954	Consolidated Financial Statements
8	1954	Standards of Disclosure for Published Financial Reports

It can be observed from the foregoing list of supplementary statements that the American Accounting Association has attempted to deal more with the general area of accounting principles, and less with specific problems which have arisen from time to time.

Activities of American Institute of Accountants

The possibility of preparing a comprehensive statement of accounting principles was again given serious consideration in 1949 and 1950. This consideration was finally abandoned in favor of a revision and restatement of previous bulletins.²⁹ The Restatement was published in 1953 and is discussed later in this chapter.

Activities of Securities and Exchange Commission

On December 20, 1950, the Commission announced a general revision of certain sections of Regulation S-X. This was the first comprehensive amendment to this regulation since its original adoption in February, 1940. Rule 2-02 regarding accountants' certificates stated that the certificate should clearly state the opinion of the accountant in respect to accounting principles and practices reflected in the financial statements, and any material changes in accounting principles or practices or methods of applying such principles or practices.³⁰ Rule 3-07 stated that any change in accounting principle or practice, or in the method of applying any accounting principle or practice which affects the comparability of financial statements for different periods would have to be disclosed in a note to the appropriate financial statement

²⁹William W. Wernitz, "History of the Accounting Procedure Committee--from the Final Report," op. cit., p. 71.

³⁰United States Securities and Exchange Commission, "Release No. 70; Revision of Regulation S-X," Accounting Series Releases (Washington: United States Government Printing Office, 1956), 264.

together with a statement as to the effect of such changes upon the net income for each of the periods. Rule 3-08 allows information regarding the accounting principles and practices reflected in the financial statements to be presented in a single statement.³¹

Regulation S-X did concern itself with the problem of accounting principles. However, it referred to such principles continuously without stating exactly what they were. Over the years the Commission has cooperated with and agreed with the viewpoint of the Institute, for the most part, regarding generally accepted accounting principles. Considering the long period over which the Accounting Series Releases have been issued, their number is extremely small. This may be due to the fact that the SEC has, for the most part as a matter of policy, not wished to impose its views on the accounting profession. Wisely, the SEC sought the advice and assistance of the accounting profession--that is, the practicing certified public accountants, the accounting educators, and the accountants in industry. The advice and assistance of all these groups were used in formulating the rules and regulations governing financial statements. The SEC has refrained from laying down inflexible rules with respect to accounting principles, but has left the determination of the system of rules to accountants themselves.³² Occasionally, the SEC did deem it advisable to issue its own opinion on

³¹Ibid., p. 266.

³²Williams, op. cit., pp. 407-08.

an accounting or auditing matter. However, these were merely opinions, and while they had considerable influence on accounting procedures, they have never been issued in the nature of edicts. It is the writer's opinion, however, that the opinions did have the same effect as edicts in many instances. Even in those rare instances when the SEC wished to issue its own opinion on a matter, copies of the proposed opinion were submitted to various professional organizations for constructive criticism; other interested parties were also invited to submit their views on any proposed opinion. Experience has shown that the SEC does consider these comments, and very often modifies its original proposal on the basis of these comments.

The opinions and accounting releases of the SEC represent the views of the Commission, but these views were not necessarily expressions of generally accepted accounting principles.³³ However, these decisions and opinions on accounting and auditing matters have carried a great deal of authority; they created a "common law" of accounting for companies which were governed by the various laws under the jurisdiction of the SEC.³⁴

Although the Securities and Exchange Commission did have the authority to prescribe the accounting principles to be followed

³³ Robert H. Montgomery, Norman J. Lenhart and Alvin R. Jennings, Montgomery's Auditing (Seventh Edition; New York: The Ronald Press Company, 1949), p. 66.

³⁴ Rappaport, op. cit., pp. 20-23.

in the financial statements filed with it, it did not very often make use of its authority to dictate exactly how the financial statements should be prepared. In Regulation S-X it established the requirements as to the form and content of financial statements filed. In its decisions and in the Accounting Series Releases it has expressed its opinion on a few accounting principles and practices. Under the Holding Company Act it has established and enforced two uniform accounting systems. However, in regard to the large body of accounting principles which exist, the SEC has been content, mainly, to rely on generally accepted accounting principles as they exist or develop with the passage of time; the public accounting profession led the way in establishing these principles. However, the Commission has criticized practices which were generally acceptable within the profession but which were faulty in the eyes of the Commission. In several cases the Commission has overruled the opinions of qualified accountants. In one case they stated, "However, as we have previously stated, while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice."³⁵

³⁵United States Securities and Exchange Commission, "Release No. 73; Findings and Opinion of Commission in the Matter of Haskins & Sells and Andrew Stewart, file No. 4-66 (Rules of Practice-- Rule II (e), " Accounting Series Releases (Washington: United States Government Printing Office, 1956), 295.

Period 1953-1959

Activities of American
Accounting Association

In 1955 the Committee on Concepts and Standards Underlying Corporate Financial Statements of the American Accounting Association was delegated the job of revising the controversial 1948 Statement. This Committee prepared the 1957 Statement although it was issued by the Executive Committee, as had been the previous Statements.

The 1957 revision was published under the name of Accounting and Reporting Standards for Corporate Financial Statements. This report was prepared after a complete study of the prior statements and their supplements. The Executive Committee of the Association published the 1957 revision, but it was actually prepared by the Committee on Concepts and Standards Underlying Corporate Financial Statements. The revision considered broad topics such as "Underlying Concepts," "Assets," "Income Determination," "Equities," and "Standards of Disclosure."³⁶

The purposes of this statement were to present fundamental concepts in accounting and to suggest standards for general-purpose reports to stockholders and other interested parties. These standards

³⁶ American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements, Issued by the Executive Committee (Columbus, Ohio: American Accounting Association, 1957), pp. 1-11.

could also be used to judge existing accounting practice.³⁷

Activities of American
Institute of Accountants

In 1953 the Committee on Accounting Procedure of the Institute issued Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins. This Bulletin superseded the previous forty-two bulletins which had been issued from 1939 to 1953, and also established a separate series of Terminology Bulletins. The purpose of the Restatement was four-fold:³⁸

1. To eliminate past bulletins or parts of past bulletins which were no longer applicable.
2. To condense and clarify information of continuing value.
3. To recognize changed views.
4. To rearrange the applicable material by subjects rather than in chronological order.

The Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, involved many changes in wording; sometimes an entire bulletin or section of a bulletin had to be completely rewritten. All changes were made in order to clarify, condense, or eliminate material no longer applicable. Certain changes in substance were made.³⁹ Following Accounting Research Bulletin No.

³⁷Ibid., p. 1.

³⁸American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., pp. 7-8.

³⁹Ibid., p. 137.

43 issued in 1953, were Bulletins 44 to 51, issued from 1953 to August, 1959. Illustration IV which follows shows a chronological list of Accounting Research Bulletins 43 to 51.

ILLUSTRATION IV. --Chronological list of Accounting Research Bulletins 43 through 51

No.	Date issued	Title
43	1953	Restatement and Revision of Accounting Research Bulletins
44	Oct., 1954	Declining-Balance Depreciation
45	Oct., 1955	Long-Term Construction-Type Contracts
46	Feb., 1956	Discontinuance of Dating Earned Surplus
47	Sept., 1956	Accounting for Costs of Pension Plans
48	Jan., 1957	Business Combinations (Supersedes Chapter 7(c) of Accounting Research Bulletin No. 43)
49	April, 1958	Earnings per Share
44	July, 1958 (Revised)	Declining-Balance Depreciation (Supersedes Bulletin No. 44)
50	Oct., 1958	Contingencies
51	Aug., 1959	Consolidated Financial Statements

All of the Accounting Research Bulletins issued up to 1953 had been issued by the Committee on Accounting Procedure. After Accounting Research Bulletin No. 43 was issued in 1953, the bulletins dealing with terminology were issued separately by a separate committee,

the Committee on Terminology. Bulletin No. 1, Review and Résumé, was issued in 1953. This bulletin contained information which had been included in the eight previously issued Accounting Research Bulletins concerning terminology.⁴⁰ The purpose of this first terminology bulletin was to begin, with a résumé of what had been issued previously, a series of separate terminology bulletins.⁴¹ Since 1953 three additional bulletins considering terminology have been issued. Illustration V following shows a chronological list of such terminology bulletins.

ILLUSTRATION V. -- Chronological list of Accounting Terminology
Bulletins 1 through 4

No.	Date issued	Title
1	1953	Review and Résumé
2	Mar., 1955	Proceeds, Revenue, Income, Profit, and Earnings
3	Aug., 1956	Book Value
4	July, 1957	Cost, Expense and Loss

⁴⁰Reference to Illustration II will identify these terminology bulletins as Numbers 7, 9, 12, 16, 20, 22, 34, and 39.

⁴¹American Institute of Accountants, Review and Résumé, Accounting Terminology Bulletin No. 1 Issued by the Committee on Terminology (New York: American Institute of Accountants, 1953), p. 5.

The Committee on Accounting Procedure, after issuing a total of fifty-one Accounting Research Bulletins, and their revisions and supplements, over a period of twenty-one years finally was dissolved in September, 1959. It had been recognized for some time that the piecemeal approach followed by this committee was not entirely satisfactory. An attempt was made for this committee to prepare a comprehensive statement of accounting principles. This intended comprehensive statement never materialized.⁴²

Mr. Alvin R. Jennings, past president of the Institute, proposed in his inaugural address⁴³ the creation of a new research organization whose function would be "to carry on continuous examination and re-examination of basic accounting assumptions and to develop authoritative statements for the guidance of both industry and our profession."⁴⁴

A special committee was appointed in December, 1957 to study the entire subject of accounting research. This committee was composed entirely of Institute members and included representatives of public practice, industry, government, and accounting teachers.

⁴² Editorial, "Accounting Research and Accounting Principles," The Journal of Accountancy, CVI (December, 1958), 27-28.

⁴³ This inaugural address took place at the annual meeting of the American Institute of Certified Public Accountants in New Orleans, October, 1957.

⁴⁴ Editorial, "Accounting Research and Accounting Principles," loc. cit.

In formulating their proposals, this committee had certain basic considerations in mind. In summary, these considerations were:

1. 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 own members and of others. A survey of existing practices is not the solution; continuous effort to determine appropriate practice and to narrow areas of differences and inconsistency in practice is necessary. Although the Institute can assume some leadership in these matters, it should be remembered that reliance should be placed on persuasion rather than on compulsion.
2. The broad problem of financial accounting should require attention at four levels: postulates, principles, rules to apply principles to specific situations, and research.⁴⁵

The special committee further recommended that the organization for carrying out the desired research should consist of an Accounting Principles Board and an accounting research staff. The main products of the program were anticipated to be a series of accounting research studies and a series of statements on generally accepted accounting principles, which would be regarded as authoritative.⁴⁶

The recommended research program of the Institute was accepted and commenced officially on September 1, 1959. Several projects are under consideration, although the program is still too new to show any tangible results to date. The Committee on Accounting Procedure turned over its responsibilities to the new Accounting Principles Board

⁴⁵"Report to Council of the Special Committee on Research Program," The Journal of Accountancy, CVI (December, 1958), 62-68.

⁴⁶Ibid.

and a new director of accounting research. The new board and director will continue the work of narrowing areas of difference in accounting practice. However, they will go far beyond this; they will undertake the formulation of more general statements of accounting principles.

The right of the American Institute of Certified Public Accountants and its Committee on Accounting Procedure to issue accounting opinions has recently been upheld in the courts. In the case of three public utility companies against the Institute and its Committee on Accounting Procedure, a United States District Court, the United States Court of Appeals, and a Justice of the United States Supreme Court all rendered decisions upholding the authority of an Institute committee to express opinions on accounting principles. The courts thereby established a significant precedent. An adverse decision could have meant that the new research program of the Institute, which had been approved by the Institute Council in April, 1959 and which was in the planning stage, would never materialize. Instead, these decisions which were favorable for the Institute provided an additional stimulus for the new Accounting Principles Board to carry out its function of formulating basic accounting postulates and statements on accounting principles. Also, it must be recognized that the authority of the Institute's Accounting Research Bulletins has been recognized; the legal decision confirming these rights and obligations gave added

strength to this new Accounting Principles Board.⁴⁷

The three utility companies⁴⁸ which were plaintiffs in this case had originally obtained on April 15, 1959, without notice and without hearing, an injunction preventing the issuance of a letter to the membership interpreting Accounting Research Bulletin No. 44 (Revised), Declining-Balance Depreciation, which had already been approved by eighteen of the twenty-one member Committee on Accounting Research. This letter had also been read into the public record by Mr. Carman G. Blough, Research Director of the American Institute of Certified Public Accountants, when he appeared as a witness at a Securities and Exchange Commission rule-making hearing.⁴⁹ The injunction prevented the letter from being mailed without first exposing it for comment to those to whom the exposure draft of Accounting Research Bulletin No. 44 (Revised) was submitted and deferring its mailing until at least sixty days after such exposure.⁵⁰

The plaintiffs claimed that because of the prestige of the Institute and its committee, issuance and distribution of this opinion

⁴⁷ Editorial, "Institute's Right To Issue Accounting Opinions Upheld by Courts," The Journal of Accountancy, CVIII (August, 1959), 23-24.

⁴⁸ Appalachian Power Company, Ohio Power Company, and Indiana & Michigan Electric Company.

⁴⁹ At this type of public hearing the transcript is available to the public.

⁵⁰ Letter from L. H. Penney, President of the American Institute of Certified Public Accountants, to its members, June 18, 1959.

would cause "irreparable damage." The hearing was held by the United States District Court (Southern District, New York) on May 7, 1959. On May 20 that Court, under the direction of Judge Levet, upheld the right of the Institute to issue such opinions. Accordingly this Court filed an opinion stating that the injunction should be dissolved and the suit dismissed. On May 25 the order was entered to the effect that the suit should be dismissed; however, at the same time the District Court enjoined the mailing of the letter in dispute pending a hearing by the Court of Appeals on a motion for an injunction. This motion was properly filed in the Court of Appeals.⁵¹

On June 17 the Court of Appeals for the Second Circuit affirmed the ruling of the lower Court that the suit should be dismissed and dissolved the injunction.⁵² The Court of Appeals said:

On the merits we agree with Judge Levet's reasoned opinion below, D. C. S. D. N. Y., May 20, 1959. We think the courts may not dictate or control the procedure by which a private organization expresses its honestly held views. Defendants' action involves no breach of duty owed by them to the plaintiffs. On the contrary, every professional body accepts a public obligation for unfettered expression of views and loses all right to professional consideration, as well as all utility, if its views are controlled by other criteria than the intellectual conclusions of persons acting. Absent a showing of actual malice or its equivalent the courts would be making a great mistake, contrary indeed to their own ideals and professions, if they assumed to restrict and denigrate this widely recognized and assumed professional duty.⁵³

⁵¹ Ibid.

⁵² Ibid.

⁵³ Editorial, "Institute's Right To Issue Accounting Opinions Upheld by Courts," The Journal of Accountancy, CVIII (August, 1959), 24.

The letter in dispute and an additional letter,⁵⁴ explaining the entire situation, were prepared and were ready for distribution. Before these letters could be mailed Judge Lumbard of the Court of Appeals reinstated the injunction, pending a hearing by a Justice of the United States Supreme Court on or before July 9. The application for a further injunction was heard and denied by Justice Brennan of the United States Supreme Court on July 6, 1959.⁵⁵ At this time the original letter and the two supplemental letters from Mr. L. H. Penney, President of the American Institute of Certified Public Accountants, were mailed to the members of this professional organization.

The United States Supreme Court finally closed this case. On November 9, 1959 the Court denied application for a writ of certiorari, thereby making final the decision of the Circuit Court of Appeals which upheld the right of the Institute to issue an interpretation of an Accounting Research Bulletin.

The significance of this case for purposes of this study does not lie in the substance of the original letter being issued. Rather, it lies in the legal support which this professional organization received from the Courts. Actually the plaintiffs did not directly challenge the right of the Institute and its committees to issue opinions in the field of

⁵⁴ See Footnote 50.

⁵⁵ Letter from L. H. Penney, President of the American Institute of Certified Public Accountants, to its members, July 9, 1959.

accounting. Instead, they took objection to the fact that the Institute committee had not submitted an "exposure draft" of its opinion to other interested organizations. Under the new research program, the Institute does plan to consult with other groups before statements on accounting principles are issued. However, the final responsibility for its opinions and procedures still rests with the Institute and its committees; this is the principle upheld by the courts.⁵⁶

Internal Revenue Code--1954

Tax accounting provisions are not the same as generally accepted accounting principles. Because of the great differences between them, the Congress, in 1954, attempted to bring them more nearly in agreement with the Internal Revenue Code by amending the Code. However, this legislation was later withdrawn when it developed that the resulting reduction in federal tax revenues would be much greater than had been estimated.⁵⁷

Structure of Accounting Theory--Littleton

In 1953 Monograph Number 5 was published by the American Accounting Association. Professor A. C. Littleton wrote this monograph, entitled Structures of Accounting Theory. The publication represents the views of the author only; it is not intended to represent

⁵⁶ Editorial, "Institute's Right To Issue Accounting Opinions Upheld by Courts," The Journal of Accountancy, op. cit., p. 23.

⁵⁷ Rappaport, op. cit., p. 39.

the views of the American Accounting Association.

Professor Littleton divided his monograph into two parts.

The first part, "Nature of Accounting," attempts to show that the different methods and techniques used in accounting form an integrated system and each does not exist independently. The second part, "Nature of Theory," attempts to deal with the theory and formulation of accounting principles.⁵⁸

Summary

In summary, the existing body of "generally accepted accounting principles" or standards has been primarily built up over the past thirty years by several factors, namely:

1. The impact of the thinking and pronouncements of the American Institute of Certified Public Accountants and its Committee on Accounting Procedure.
2. The impact of the thinking and pronouncements of the American Accounting Association and its Committee on Concepts and Standards Underlying Corporate Financial Statements.
3. The influence of the Securities and Exchange Commission.
4. The practices and procedures adopted by businesses and in use before any regulatory bodies came into existence.
5. A considerable volume of published literature in the area of accounting principles.

⁵⁸A. C. Littleton, Structure of Accounting Theory, Monograph No. 5 (Urbana, Illinois: American Accounting Association, 1953), pp. 1-234.



Many other contributions were made by many other professional organizations and governmental regulatory bodies, but these are insignificant when compared to the contributions made by the organizations and factors enumerated above.

The American Institute of Certified Public Accountants and the American Accounting Association have always considered problems relating to accounting principles and procedures from their very beginnings. Being aware of the numerous and varying accounting principles and procedures being employed, and also being aware of the increasing interest of the public in the published financial reports of companies, particularly corporations, these professional organizations have attempted to clarify many problems in the area of accounting principles and practices.

The Institute, through its many technical and special committees in cooperation with government, industry, finance, stock exchanges, credit men's associations, and educational institutions, has been conducting continuous studies on various accounting and auditing problems of a controversial nature or of major significance. The results of these studies and conclusions have been published in the official bulletins of the Institute--the Accounting Research Bulletins and the Statements on Auditing Procedure. These bulletins have been almost universally accepted as authoritative, chiefly on the basis of the prestige which the committees themselves have earned through the reasonableness of their pronouncements and the eminence of their

members. The Securities and Exchange Commission has almost without exception approved the Accounting Research Bulletins as a guide to accounting practice. Because the bulletins have seemed to cover all the problem areas, the Securities and Exchange Commission has found it unnecessary to exercise its own authority to promulgate general accounting rules. Recently a Federal District Court, a United States Court of Appeals, and a Justice of the United States Supreme Court have issued opinions supporting the opinions of the Committee on Accounting Procedure of the Institute.⁵⁹

The American Accounting Association has also attempted to undertake research programs in the area of accounting principles. This organization has contributed valuable publications in addition to many other contributions in the form of articles in the Accounting Review, issuance of monographs, etc.

It appears that the research programs of the American Institute of Certified Public Accountants and the American Accounting Association have had the same basic objectives--the formulation of generally accepted accounting principles. However, these two organizations used opposite approaches in achieving their objectives. The Institute has approached their research on an item-by-item basis; in other words, they have used the inductive approach. They would

⁵⁹Editorial, "The Accounting Procedure Committee," The Journal of Accountancy, CVIII (September, 1959), 29-30.

first locate or identify a problem and then provide rules or principles which could be applied to the problem. In fact, the items considered were unrelated in most cases. On the other hand, the American Accounting Association has employed the deductive approach; they would start with formulating the principles before investigating a specific problem. The difference in the approaches of these two organizations was caused by two main factors. First, available financial resources may have influenced the type of approach used. Secondly, the two approaches reflect a fundamental difference between the thinking of a practitioner as contrasted with the thinking of an academician. The Institute did, at first, consider the deductive approach. Since its program commenced due to an immediate need for clarification in certain areas, the inductive approach seemed to be the method which would produce useful results in the fastest way.⁶⁰

The National Association of Accountants also considered the development of a series of statements recommending good practices. The Association visualized such statements as being of an authoritative nature. This idea never materialized.⁶¹

A generally recognized and accepted written code of accounting principles is highly desirable. The differences on many basic issues between the American Institute of Certified Public Accountants

⁶⁰ Zlatkovich, op. cit., p. 21.

⁶¹ Ibid.

and the American Accounting Association can possibly be reconciled and combined in a single pronouncement. The practice of the Institute of issuing bulletins on isolated subjects is important, but not nearly as important as would be a codification of generally accepted accounting principles.⁶²

Mr. George O. May dissents from Mr. Stans' proposal in the foregoing paragraph above for a "codification of the entire dogma of financial accounting." He opposes such a proposal on the grounds that such authoritative codification would rest on the power of the professional organizations rather than on knowledge, experience, and high reputation.⁶³

From its very inception, the Securities and Exchange Commission has had the active cooperation of accounting educators, public practitioners, and private accountants, in the development of its accounting rules and regulations. The SEC and the American Institute of Certified Public Accountants have always cooperated very well with each other. In fact, cooperative research has even been considered. The Commission has had an active interest in the Committees on Accounting and Auditing Procedure of the Institute. Likewise, the Commission has had an active interest in the work of

⁶² Maurice H. Stans, "Weaknesses in Present Accounting Which Inhibit Understanding of Free Enterprise," The Journal of Accountancy, LXXXVIII (December, 1949), 470.

⁶³ George O. May, "The Choice before Us," The Journal of Accountancy, LXXXIX (March, 1950), 206-210.

the American Accounting Association in the preparation of its successive statements on accounting principles.⁶⁴

Although the various professional organizations have attempted to limit the variety of accounting principles and practices, and have recognized the need for a body of generally accepted accounting principles, many corporate organizations have not seen eye to eye with these professional organizations. Many corporate reports have violated these recommended principles, even when faced with a qualified opinion or even a disclaimer of an opinion by their certified public accountants. Unfortunately, there are many management people who do not concede the right of the independent accounting profession to develop principles or narrow the methods of presentation in financial statements. Only the enforcement powers of the Securities and Exchange Commission and the New York Stock Exchange over listed companies have brought about as much compliance as does exist. When corporate officials object to the accounting principles advocated by professional accounting organizations they hamper the job of developing good accounting principles; they also are unknowingly requesting ultimate regulation of their reporting practices by the government.⁶⁵

⁶⁴ Earle C. King, "Current Accounting Problems," The Accounting Review, XXV (January, 1950), 35.

⁶⁵ Stans, op. cit., pp. 469-70.

The SEC has had a very profound effect on both corporate management and the accounting profession. Since the SEC laws were passed there has been a very definite improvement in the reporting practices of corporations in our country. The SEC and the stock exchanges have been responsible for a good part of this. As a result of the SEC pronouncements, which are authoritative, more information of a material nature is now contained in corporate reports than ever before; this includes published reports as well as filed reports. The filed reports contain the most comprehensive, dependable, and informative data on the financial and operating conditions of American corporations anywhere publicly available.⁶⁶

The beneficial influence of the SEC is undisputed. However, this benefit has arisen from the enforcement of rules which were laid down prior to its creation, and from strengthening the position of the accountant in relation to the corporation, rather than from the formulation of new rules.⁶⁷

The SEC has dealt with individual problems as they have arisen, in the same fashion as the Institute. This approach was necessary because of the pressure of the work and consequently has prevented the formulation of a statement of the basic principles involved.

⁶⁶ Greidinger, op. cit., p. 9; Rappaport, op. cit., pp. 25-26.

⁶⁷ May, Financial Accounting: A Distillation of Experience, op. cit., pp. 66-67.



Publications of the Institute and the American Accounting Association have served as useful guides. The SEC is vitally interested in determining and gaining acceptance for those principles of accounting which have definitely proved their worth in clearly stating for the investor the effect of business transactions. Accounting research in the SEC is aimed at insuring that the financial statements supplied to investors will be presented on a consistent basis and in accordance with generally sound accounting principles.⁶⁸

It can be seen that the success of the Commission as a regulatory body will be largely dependent upon the development and general acceptance of a body of accounting principles upon which it can rely in its administration of the legislation under its control.⁶⁹

The Internal Revenue Code has influenced record-keeping to a great extent. However, it must be understood that the tax law must also take into consideration administrative functioning in considering rules and regulations for reporting financial data. The Treasury Department is primarily interested in tax revenues and, therefore, must often ignore the encouragement of sound accounting principles where they might hinder tax revenues.

Many authors have contributed, through their writings, to the development of accounting principles. These authors have

⁶⁸ Andrew Barr, "Accounting Research in the Securities and Exchange Commission," The Accounting Review, XV (March, 1940), 94.

⁶⁹ Sanders, op. cit., p. 66.

stimulated thinking in this crucial area. The outstanding individual contribution, in the writer's opinion, has been Paton and Littleton's An Introduction to Corporate Accounting Standards. Although published back in 1940, it has withstood the test of time, and is still today referred to and considered by many persons as the outstanding work in the area of accounting principles.

Important contributions by the various professional organizations, governmental organizations, and individuals, in an attempt to formulate and organize a body of generally accepted accounting principles, were noted in this chapter. These organizations and individuals have certainly made definite contributions to this objective. However, despite their fine efforts, no authoritative or generally recognized body of accounting principles or structure of accounting principles exists today.

CHAPTER IV

THEORY OF ACCOUNTING--POSTULATES

Introduction

At present accountants do not appear to have any one complete system of thought about accounting. (In fact, many accountants do not feel the need for one.) There exist several incomplete systems of thought about the practice of accounting. These systems, for the most part, merely summarize current practices. The descriptions of current practices have been looked upon as accounting theory by many, and for this reason accounting has not had the foundation and advancement in theory that some other fields have enjoyed. Other technologies are based on systems of ideas which serve as the basis and criteria of performance. Their systems of ideas are not simply descriptions of practice; they transcend applications, as any theory should. Only if a theory encompasses the ideal can it serve as a guide to developments and improvements in the practice of the related technology.¹

It is necessary to distinguish between systems of rules relating to the practice of accounting and a theory of accounting.

¹R. J. Chambers, "Blueprint for a Theory of Accounting," Accounting Research, VI (January, 1955), 17. The article was also reprinted in The Australian Accountant, XXV (September, 1955), 379-86. It was also the subject of comment in A. C. Littleton's "Choice among Alternatives," The Accounting Review, XXXI (July, 1956), 363-70.

It is admitted that a system of rules is necessary for the consistent practice of any art and it is useful to arrange such rules into categories. From the description of such rules it is possible to describe any inconsistencies in the system. However, description alone does not assist in determining which of two inconsistent rules should be adopted. This question must be decided by a more fundamental set of propositions which combine the theory of the subject.²

Up to the present day, most attempts to present a codification of accounting principles have been merely descriptions of practice.³ This approach cannot produce a well-established structure of accounting theory. The approach is misleading as it implies that there is nothing more fundamental in the study of accounting than formulations of practices. The erroneous impression is also created that accounting now has a basis similar to those of other sciences. Students are given the idea that certain practices are dominant, without examining the true nature of the propositions and the assumptions underlying the practices employed.⁴

²Ibid.

³An outstanding example of this type of descriptive study is A Statement of Accounting Principles by Sanders, Hatfield, and Moore, published in 1938 by the American Institute of Accountants and reprinted in 1959 by the American Accounting Association.

⁴Chambers, "Blueprint for a Theory of Accounting," op. cit., p. 18.

Attempts are made to justify propositions on historical grounds. The antiquity of widely used practices is no criterion. The environment and the conduct of organized activity has greatly changed since the establishment of double-entry bookkeeping. One cannot expect the same propositions to be valid now as were valid then, or to expect that no new propositions are required now. Historical justification is unnecessary and restrictive. This is not to say, however, that historical studies of accounting practice cannot be used in order to help build a structure of accounting theory.⁵

Law, medicine, chemistry, physics and engineering are all subjects of study and also fields of practice. Each of these fields embraces a body of knowledge, which is being tested and developed constantly by scholars and research workers who have undertaken this task. In their inquiries these persons are guided by what are commonly known as "scientific methods." These scientific methods are designed to be methods of verifying hypotheses which have been carefully constructed, or of testing sheer guesses; these methods lead to the discovery of new knowledge. One of the scientific methods is pure logical reasoning; the logical reasoning concerns the relationship between observed phenomena. This logical reasoning leads to generalizations, principles, and laws, the general body of which constitutes the science.⁶

⁵Ibid., pp. 18-19.

⁶R. J. Chambers, "Detail for a Blueprint," The Accounting Review, XXXII (April, 1957), 206.

Pure study or research is very different from the field of practice which is based on a science. The practicing attorney, physician or surgeon, chemist, physicist, or engineer is not concerned, as a practitioner, with testing and developing knowledge; the practitioner is primarily concerned with applying existing knowledge to specific problems and cases. In the application of existing knowledge the practitioner is not free to experiment for two reasons. He lacks the time; and organized professions commonly have restraints in the area of experimentation. Restraints may be established by the profession itself, or may be the result of the requirement of the general body of clients of the profession. Such restrictions limit the practitioner's work. The practitioner works on the basis of some underlying body of knowledge, but in a social environment; for his own protection and for the protection of his clients and the public, in general, the practitioner is obligated to conform to the standards, rules and codes imposed upon him.⁷

The scientific study of any subject should not be limited by the standards necessary in its dependent field of practice.⁸

⁷ Ibid.

⁸ As was indicated in Chapter III, the great majority of the Accounting Research Bulletins of the American Institute of Certified Public Accountants came about as a result of specific needs in the field of practice, and were not the results of scientific study undertaken in search for pure knowledge.



The persons engaged in research are completely free to consider many modes of action, numerous possible combinations of facts, and many hypothetical propositions in the search for knowledge. The researcher is not limited by the necessity of making any of his theoretical models work in practice. However, if his observations are realistic and his reasoning is logical, his theoretical models can often be used as the basis for new and more useful practices to the practitioner.⁹

The distinction between scientific propositions and rules of practice is evident from the manner in which each is stated. Scientific propositions, which are the conclusions arrived at through observation and reasoning, are stated in a positive manner. For instance, the third law of motion states that to every action there is an equal and opposite reaction. On the other hand, rules of practice and standards are not stated in a positive manner; they are stated as directives, authoritative commands, or obligations. It can be observed that the two approaches are quite different; one is a scientific approach while the other is a practical approach. Both of these approaches do affect the development of a science or an art. The validity of any scientific proposition can be tested by reference to its premises and its reasoning; the validity of a rule or standard cannot be subjected to the same tests because a rule or standard implies a value judgment,

⁹Ibid.

an opinion, or a belief. None of these are subject to scientific testing.¹⁰

Rules and standards are essential, but they belong to practice and not to science. Practice is the "know how" and science is the "know about." Although there is an important difference between practice and science, the two are related. Most professions require prospective members to demonstrate their skill based on a knowledge of theory, before entry into the profession. This knowledge of theory is expected to enable the practitioner to arrive at better informed judgments. The practitioner needs and depends upon an orderly system of connected generalizations on which to base his daily practices. Knowledge of the theory gives cohesion and consistency to practice. Theory cannot completely eliminate practices which have no justification other than expediency and custom, but as knowledge of the underlying theory increases among practitioners the rules and standards which are inconsistent with sound reasoning will be eliminated.¹¹

Accounting practices are apparent and well known. Accounting theory or principles, investigated and established in a scientific manner, are not so well known. This could possibly be due to three causes:

1. The establishment of practical rules has taken precedence over scientific study.

¹⁰R. J. Chambers, "A Scientific Pattern for Accounting Theory," The Australian Accountant, XXV (October, 1955), 432-33.

¹¹Chambers, "Detail for a Blueprint," op. cit., p. 207.



2. Scientific study and practice have not been recognized as two distinct disciplines.
3. Courses of study for the accounting profession have not included scientific studies which would arouse curiosity or provide the tools for a study of basic theories.¹²

The contents of the structure of accounting theory should consist of a set of statements, preferably in the positive mood, dealing with the relationships which exist between concepts describing common accounting or business phenomena and operations. In establishing this set of relationships it is reasonable to consider other subjects which bear reasonably close relationships with accounting. The most obvious subject would be economics. Some accountants oppose this suggestion on the grounds that economics is concerned with national aggregates and not with individual problems with which accounts are concerned. Of course, this objection is erroneous and stems from the fact that many people misunderstand the content of economics. It is true that economists tend to view economic happenings from the viewpoint of whole communities. However, these broad and major economic changes and developments occur through the combination of contributing acts of individuals, business firms, government, etc. From this viewpoint economists are equally interested in the ways in which persons, firms, and other organizations act, and consequently a

¹²Ibid., pp. 207-08.

considerable part of the theory of economics is devoted to the examination of such acts.

Economics may throw some light on, or provide some basic concepts which will be very useful in the study of accounting. Also, some of the conclusions of psychology, law, political science, etc., may also be necessary and useful. The scientific study of accounting requires the application of scientific methods to observable phenomena. In carrying out such a study, one must be free to observe and to adapt the conclusions of any other scientific study as may be required. The study should proceed from observations, from conclusions of other sciences, or from assumptions, to construct in a logical manner a body of propositions which is consistent with reality and which also displays internal consistency. Whenever any deduced propositions lack internal or external consistency, this inconsistency would indicate flaws in the original observations, assumptions, or flaws in logic. Such flaws, must of course, be eliminated.¹³

Form of a Theory

The theory of accounting is to go beyond practice and the historical development of practice. The theory should emerge by building up a series of relevant propositions from a few fundamental assumptions or axioms. Many structures written about to date are

¹³Ibid., p. 208.

superficial, having no assumptions or axioms upon which to build its structure of propositions or principles.¹⁴

It is possible to build a theory of accounting without reference to the practice of accounting. However, this does not mean that the theory will have no connection with reality. Theory is not synonymous with remoteness from reality. It greatly pleases most theorists to put their hypothesis to the test of reality. If one is confronted with what purports to be a theory of accounting, and finds that it deals only with corporation accounting, the obvious existence of unincorporated enterprises would cast doubt on the validity of the theory advanced. This process of checking back is of the nature of scientific method; it helps to eliminate unreal or unjustifiable assumptions.¹⁵

Postulates

General

The entire structure of accounting is based upon a series of general assumptions. These fundamental assumptions or postulates form the basis for specific conclusions made by accountants. Without these postulates it would not be possible to proceed very far in the practice of accounting. If the accountant understands fully the basic postulates, which form the foundation of accounting, improper

¹⁴R. J. Chambers, "Blueprint for a Theory of Accounting," op. cit., p. 19.

¹⁵Ibid.

applications and erroneous conclusions are less likely to occur.¹⁶

Put another way, ". . . to be well grounded, a standard needs to be recognized as resting upon known and accepted assumptions."¹⁷

At the present time certain of these basic assumptions and generally accepted accounting principles founded on these assumptions are being subjected to considerable criticism. Criticism can be remedied by the establishment of a body of accounting postulates and principles based on good reasoning.

Webster defines a postulate as being "a proposition which is taken for granted or put forth as axiomatic; an underlying hypothesis; an essential prerequisite."¹⁸ An assumption is defined as the "act of taking for granted; a supposition."¹⁹ A supposition is "that which is supposed; a theory or surmise."²⁰ It appears from Webster's definitions that the terms postulate, assumption and supposition can be employed interchangeably.

Mr. Eric L. Kohler defines a postulate as

any of a series of axioms or assumptions constituting the supposed basis of a system of thought or an organized field of endeavor.

¹⁶ William Andrew Paton, Accounting Theory (New York: The Ronald Press Company, 1922), pp. 471-72.

¹⁷ Paton and Littleton, op. cit., p. 7.

¹⁸ Webster's Collegiate Dictionary (Fifth Edition; Springfield, Massachusetts: G. & C. Merriam Company, 1946), p. 776.

¹⁹ Ibid., p. 66.

²⁰ Ibid., p. 1002.

The truth of the postulate, like that of other assumptions, is taken for granted: as something generally admitted as self-evident, or as being common to other fields and thus serving as a point of departure. Postulates are chosen for their convenience and fruitfulness in organizing and promoting inquiry and useful action.²¹

Mr. Kohler goes on to define an assumption as

a premise; a statement accepted without proof, sometimes unconsciously, as a basis for a line of reasoning or course of action, either because its applicability is deemed to be self-evident, or because its implications appear to justify exploration.²²

Once again it can be noted that the terms "postulate" and "assumption" are very similar and therefore will be considered synonyms in this dissertation.

The professional organizations, such as the American Accounting Association, the American Institute of Certified Public Accountants, and the National Association of Accountants, and the governmental organizations, such as the Securities and Exchange Commission and the Bureau of Internal Revenue, have never officially defined "postulate" or "assumption."

A statement or list of the accounting postulates which underlie accounting principles has never been constructed. Once these underlying postulates and the broad principles which are based on them are specifically stated, many of today's accounting problems will be

²¹ Eric L. Kohler, A Dictionary for Accountants (New York: Prentice-Hall, Inc., 1952), p. 323.

²² Ibid., p. 38.

solved more easily.²³ The new research organization of the American Institute of Certified Public Accountants will consider the broad problem of financial accounting from four levels: postulates, principles, rules to apply to specific situations, and research.²⁴ It will be noted that the postulates are the top level to be considered.

The committee appointed to study the new research problem of the American Institute of Certified Public Accountants says of postulates:

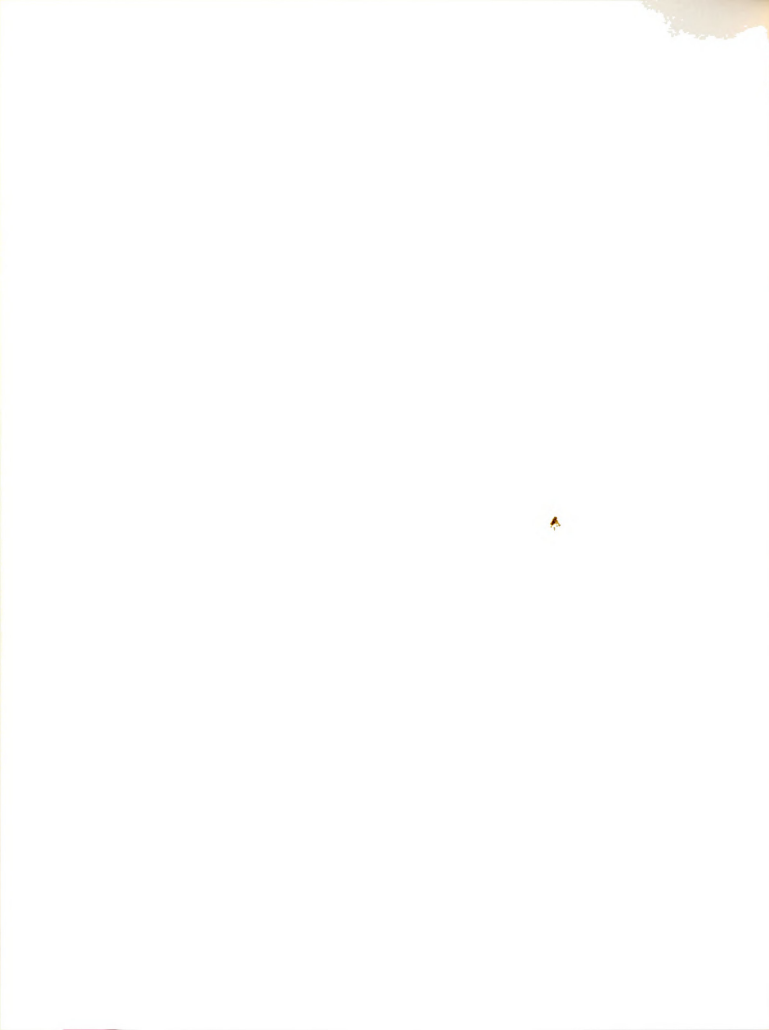
Postulates are few in number and are basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear its understanding and 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 cooperative 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.²⁵

There appear to be two types of postulates. First, there are those postulates that are general or all-inclusive in nature. Such postulates are general enough to cover every circumstance for which accounts may be required. This type of postulate is, by its nature, abstract, idealistic, and very simple. The other type of postulate is

²³Carman G. Blough, "Challenges to the Accounting Profession in the United States," The Journal of Accountancy, CVIII (December, 1959), 37-38.

²⁴"Report to Council of the Special Committee on Research Program," The Journal of Accountancy, CVI (December, 1958), 63.

²⁵Ibid.



the specific kind. These postulates refer to specific ideas or situations and are not as abstract or simplified as the former type described.

Both types of basic accounting postulates will now be considered and discussed. In the following discussion the author considers certain concepts which have been discussed by many writers under the designations of postulates, principles, concepts, theories, procedures, conventions, etc. These ideas are examined in detail and the author attempts to classify them correctly.

General or All-Inclusive Postulates

As has just been indicated, these postulates are intended to generalize. In other words, they are intended to cover every situation for which accounts may be required and therefore tend to be abstract, idealistic, and very simple.

The general type of postulate has been criticized by many as being over-simplified and over-generalized. The main objection to this type of postulate has been that its generalizations have taken it so far beyond the field of accounting that it is no longer useful for the purpose for which such postulates were constructed.²⁶ As Professor Samuelson wrote, "Like eggs, so with theories, there are only two kinds: good ones and bad ones The test of a theory's goodness

²⁶ Ashley Forster, "Blueprint for a Theory . . . A Rejoinder," The Australian Accountant, XXV (October, 1955), 436-37.



is its usefulness in illuminating observational reality" ²⁷

General postulates may appear, at first glance, to be so general as to be entirely useless. A further investigation will reveal that general postulates are very useful in that they provide the foundation for the specific postulates, principles and procedures. Some examples of general postulates follow:

Professor R. J. Chambers believes that the fundamental premises for a theory of accounting lie outside of the field of accounting proper; there is no such thing as accounting in the abstract; accounts are kept for entities which are recognized in other fields, chiefly in economics and government. ²⁸

Professor Chambers considers the following propositions to be necessary:

- a. Certain organized activities are carried out by entities which exist by the will or with the cooperation of contributing parties;
- b. These entities are managed rationally, that is, with a view to meeting the demands of the contributing parties efficiently;
- c. Statements in monetary terms of the transactions and

²⁷ Ibid., p. 437.

²⁸ R. J. Chambers, "Blueprint for a Theory of Accounting," op. cit., p. 19.

relationships of the entity are one means of facilitating rational management;

- d. The derivation of such statements is a service function.²⁹

No claim is made that these propositions are themselves a sufficient basis; however, they appear to be general and all-inclusive.

The general form of the statements listed above was deliberately selected by Professor Chambers in the belief that some widely applicable conclusions could be arrived at. Two substantial uniformities, observable in the real world, provides the basis for the belief that the subject of accounting includes several general propositions. In other words, it can be said to have a "general theory." These two uniformities are:

1. The use of accounting information in organizations having vastly different purposes and legal or social forms;
2. The substantial similarity of method in all these cases.

The general theory to which these observations point would consist of propositions applicable to all situations in which the art of accounting is found to be practiced. These propositions would be equally pertinent to accounting for individuals, unincorporated business firms, corporate business firms, governments, fiduciaries, and non-profit organizations. Of course, these propositions would be concerned only with the broadest features of accounting. The fact that diverse

²⁹Ibid.

entities can be treated without distinction for some purposes points out similarities which would not otherwise be apparent. These general propositions would provide the foundation for the more specific postulates and principles.

Professor Chambers supports his four general propositions as follows: The first one is an observation from the real world and is general enough to embrace every circumstance for which accounts may be required. As it includes all types of organizations--corporations, unincorporated businesses, non-profit organizations, governmental bodies and communities--it serves as the foundation for private, public and social accounting.³⁰

The second proposition also is a real observation. It can be viewed in the sense of maximizing economic returns or in the sense of maximizing all returns to all the contributors. This is basically the same proposition as the one which underlies a great part of economic theory. It can be observed that the exact demands of each of the contributing parties are not specified because the purposes of each will differ materially.³¹

Proposition number three simply recognizes that in a money economy, money is the most convenient common denominator in facilitating rational management, although there may be other means.³²

³⁰ Ibid., pp. 19-20.

³¹ Ibid., p. 20.

³² Ibid.

The last proposition implies that accounting theory should lead to financial statements which serve the needs of all interested parties.³³

A Statement of Accounting Principles by Sanders, Hatfield and Moore also contains some of these general propositions, which they refer to as "general principles."

These are:

- A. "Accounting should make available all material information of a financial nature relating to (a) the financial condition or status of the business, (b) its progress in earning income.
- B. Transactions which add to or subtract from capital must be distinguished from those which add to or subtract from revenue, and, where both kinds of change occur in one transaction, the extent of each must be shown.
- C. A reliable historical record must be made of all transactions of the business; but this record must also be analytical, or susceptible to subsequent analysis, to preserve the necessary distinction between capital and income.
- D. The use of long-term assets involves the apportionment of capital and income over several accounting periods; the accuracy of the accounts depends in large measure upon the exercise of competent judgment in making these apportionments.

³³ Ibid.

- E. The basis of the treatment applied to the several items should be adhered to consistently from period to period; when any change of treatment becomes necessary, due attention should be drawn to the change.
- F. The possible extent of unforeseen contingencies of adverse character calls for a generally conservative treatment of items to which judgment must be applied."³⁴

The foregoing "general principles" are also very general and all-inclusive in nature. However, it can be noticed that these propositions are slightly less idealistic and more concrete than those advocated by Professor Chambers. This is not to imply that these propositions belong to the specific group of postulates; they are still far from being specific.

Specific Postulates

The specific postulates are intended to refer to specific ideas or situations and, therefore, are not as general or abstract as are the general postulates which were previously considered. Each of these postulates are not necessarily universally applicable, but do apply in the vast majority of situations that are encountered. In the minority of situations where "specific postulates" do not apply, exceptions will necessarily have to be allowed. The dynamic and ever-

³⁴Sanders, Hatfield, and Moore, op. cit., pp. 113-14.

changing nature of accounting will always have to provide for exceptions in the case of the specific postulates.

Business Entity Postulate

The existence of a distinct business entity is assumed and is the unit of organization³⁵ with which the accountant is concerned. The records, periodic statements, assets, and obligations are all concerned with the "business," and not with its owners. The business enterprise has a real and distinct existence, apart from its owners and in many instances, such organization exerts a tremendous influence in the industrial community.³⁶ "It has become almost axiomatic that the business accounts and statements are those of the entity rather than those of the proprietor, partners, investors, or other parties or groups concerned."³⁷

In the case of a corporation, the business entity postulate is supported from the legal standpoint. The corporation is a real entity; it has all the rights and privileges of any person engaged in business by reason of a contract with the state, known as the "charter." The corporation may enter into contracts, acquire, own, and dispose of real and personal property, borrow funds, incur liabilities, and otherwise take any action that a person could take. The corporation,

³⁵This includes governmental units, non-profit enterprises, etc.

³⁶Paton, Accounting Theory, op. cit., pp. 472-74.

³⁷Paton and Littleton, op. cit., p. 8.

and not its owners, engages in such actions. From the legal viewpoint, the records and statements clearly show the affairs of the business enterprise, which in this case is the corporation.³⁸

The concept of the entity is important for unincorporated as well as incorporated business enterprises. From the standpoint of administration it is essential that business affairs be kept entirely separate from private and personal affairs. The law does not consider an individual proprietorship or partnership to exist apart from its owners as a separate and distinct business entity. From the legal standpoint, there is no distinction between the business affairs of the proprietor or partners as individuals and the business assets are not segregated from personal assets by law and the business may be restricted from holding legal title to any property. In case of insolvency or bankruptcy, the personal assets of a proprietor or partner may be used to satisfy the creditors, in the same manner as the assets which are definitely employed in the business.³⁹

The law may not consider an individual proprietorship to exist apart from its owners, but a separate business entity can be seen to exist from other standpoints. Accounting in a very significant sense, is institutional; the institution embodies the small unincorporated

³⁸Paton, Accounting Theory, op. cit., p. 474.

³⁹Ibid., Paton and Littleton, loc. cit.

enterprise as well as the giant industrial corporation.⁴⁰ From this institutional viewpoint it cannot be denied that many important and continuing businesses have been established on other than the corporate basis. Numerous banking, investment, and insurance institutions have been built upon proprietorship and partnership forms of organization. The same is true of many organizations offering professional services. The concept of the business entity, as it applies to unincorporated businesses, is used constantly by economists, businessmen, and the layman. The assumption of a business existence is based to an important degree on the actual facts of the business world.⁴¹

"In general an enterprise is any business undertaking with a single management."⁴² In some instances a department or other subdivision of a business enterprise may be important enough to justify treatment, for certain purposes, as a subordinate form of entity. In other cases a number of different corporations may be so closely related as to justify treatment of the group of companies, for certain purposes, as if they were one corporate enterprise.⁴³

The financial statements should be prepared from the business-entity viewpoint in the majority of cases, as the business entity

⁴⁰Paton and Littleton, op. cit., p. 8.

⁴¹Paton, Accounting Theory, op. cit., pp. 475-76.

⁴²Paton and Littleton, op. cit., p. 8.

⁴³Ibid., pp. 8-9.

is viewed as an economic unit for managerial purposes.⁴⁴ In accordance with this view, accounting theory should explain the concepts of revenue and expense in terms of enterprise asset-changes rather than in terms of changes in owners' equities.⁴⁵

The business entity assumption or postulate appears to be in conformity with the legal standpoint in the case of corporations. In all cases this postulate is in conformity with reality. In other words, many important unincorporated business entities can be seen to exist, the concept of the business entity is constantly used in the business world, and even the layman seems to consider a business separate from its owners. The concept of the separate existence of a business entity seems to be a logical postulate on which to base the structure of accounting.

For certain purposes, such as bankruptcy proceedings, lawsuits, etc., a clearer picture of the assets and liabilities involved may be secured by combining the assets and liabilities of the business entity with the individual assets of the owners.⁴⁶ In such instances, for the sake of clarity and realism to all interested parties, the business entity postulate may be ignored.

⁴⁴ Paton, Accounting Theory, op. cit., pp. 477-78.

⁴⁵ Paton and Littleton, op. cit., p. 9.

⁴⁶ This would be particularly true in the case of individual proprietorships and partnerships, where unlimited personal liability exists.

The business entity postulate will apply to the vast majority of situations and therefore should be included as a specific postulate.

Going Concern Postulate

The accountant not only assumes that a business entity exists, but he goes further and assumes the continuity of the entity. In other words, the assumption is made that the business is a "going concern."

The future of any specific business cannot be predicted with absolute certainty. There is a certain amount of risk involved in every business. However, the going-concern postulate appears to be a reasonable assumption. In the absence of facts to the contrary, it is fair to assume that a particular business enterprise is going to continue, at least in the near future. In the case of large and dominant enterprises this continuity of existence is almost absolutely assured. Based on the facts which show that the ratio of business failures to the total number of business enterprises in the United States is very small, it appears that the accountant can rightly make the assumption that the particular enterprise in which he is interested will continue to operate for some time into the future.⁴⁷ Statistics in support of this conclusion are now presented:

⁴⁷Paton, Accounting Theory, op. cit., p. 478.

Following are the figures for business failures as a per cent of concerns in business for 1956, 1957, and 1958.

ILLUSTRATION VI. --Industrial and commercial failures in the United States: 1956 to 1958⁴⁸

	1956	1957	1958
Total concerns in business	2,628,910	2,652,248	2,675,409
Number of business failures	12,686	13,739	14,964
Per cent of business failures	.48%	.52%	.56%

The above statistics indicate the composite results for the United States as a whole. The business failure rates for 1958, broken down by states, show a low of .08% for South Dakota, Wyoming and New Mexico to a high of 1.83% for Oregon.⁴⁹

Current data in Dun's Review show the following:

ILLUSTRATION VII. --The business failure record 1958-1960⁵⁰

	1960				1959		Year	Year
	Mar.	Feb.	Jan.	Dec.	Nov.	Oct.	of 1959	of 1958
Dun's Failure Index*								
Unadjusted	55.2	58.8	52.5	46.1	57.1	48.0	51.8	55.9
Adjusted, Seasonally	51.1	50.7	51.0	49.6	55.4	50.5	----	----

* Apparent annual failures per 10,000 enterprises listed in the Dun and Bradstreet Reference Book.

⁴⁸ U.S. Bureau of Census, Statistical Abstract of the United States--1959, p. 503.

⁴⁹ Ibid.

Current data concerning industrial and commercial

business failures in the State of Michigan show the following:

ILLUSTRATION VIII. --Industrial and commercial business failures in
Michigan: 1939-1958⁵¹

Year	Total concerns in business*	-----Failures-----	
		Number	% of concerns in business
1939	74,321	400	.54
1945	71,476	24	.03
1946	81,566	43	.05
1947	93,933	139	.15
1948	97,949	157	.16
1949	100,243	337	.34
1950	104,231	280	.27
1951	96,967	181	.19
1952	99,217	170	.17
1953	100,366	114	.11
1954	100,330	209	.21
1955	101,074	211	.21
1956	102,130	413	.40
1957	101,330	512	.51
1958	103,842	547	.53

* Represents number of names listed in July issue of the
Dun and Bradstreet Reference Book for each year.

⁵⁰ These statistics were obtained from various volumes of
Dun's Review.

⁵¹ U. S. Bureau of the Census, Statistical Abstract of the
United States, loc. cit.

It can be observed from the foregoing statistics that the business failure rate for the entire United States, on a yearly basis, has varied from .48% to .56% since 1956. Recently, in February, 1960, the unadjusted rate did reach a rate of .588%. For individual states it was shown that the business failure rates in 1958 varied from .08% to 1.83%. For the State of Michigan, the business failure rate since 1939 has never exceeded .54% and usually was much lower. From these low business failure rates it can be seen that the going or continuing concern is the normal case while the insolvent or bankrupt business is the exception.

It can be appreciated that a misleading picture would be obtained if asset values, liabilities, and equity were determined and presented in the financial statements, on the basis of an insolvent and liquidating business. Therefore, the assets and liabilities are shown on the going-concern basis. It is very probable that a highly specialized fixed asset may have a resale or market value which is much below its cost, but because we consider the business from a going-concern viewpoint, resale value is irrelevant. In the case of liabilities, the amount due in the case of insolvency may differ from the accounting liability from the going-concern viewpoint. As an example, the face or par value of bonds may be the legal liability in case of liquidation, but the liability from a going-concern viewpoint would be the effective liability--par value less any unamortized discount or plus any unamortized premium.⁵²

⁵²Paton, Accounting Theory, op. cit., p. 479.

The going-concern postulate emphasizes the fact that usually property has greater value to a going-concern than it would have to a financially embarrassed or insolvent business. "It has been said that if the assets of all businesses were listed at the valuation realizable at forced sale, not only all businesses in the United States, but also the United States itself, would be insolvent."⁵³ Valuation based on the going concern assumption is measured by what will be realized through an orderly disposition; it is not measured by what could be realized by hurriedly placing the property for sale on the market.

The going-concern postulate also stresses the fact that the statements are not ends in themselves. Rather, each statement shows only what exists at a certain time or what took place over a period of time in a firm which is assumed to continue into the future.

Adam Smith, in his Wealth of Nations, made a distinction between "value in use" and "value in exchange" which may have applicability here. He said:

The word value, it is to be observed, has two different meanings, and sometimes expresses the utility of some particular object, and sometimes the power of purchasing other goods which the possession of that object conveys. The one may be called "value in use"; the other "value in exchange." The things which have the greatest value in use have frequently little or no value in exchange; and on the contrary, those which have the greatest

⁵³ C. Aubrey Smith and Jim G. Ashburne, Financial and Administrative Accounting (New York: McGraw-Hill Book Company, Inc., 1955), p. 75.

value in exchange have frequently little or no value in use. Nothing is more useful than water; but it will purchase scarce anything; scarce anything can be had in exchange for it. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it.⁵⁴

As can be seen, Adam Smith concluded that "value in use" or utility is of an entirely independent nature from "value in exchange" and has no part in the determination of the latter.⁵⁵

Adam Smith pointed out that "value in use" of goods is its total contribution to economic welfare while a good's "value in exchange" is the total money or revenue for which it will sell. The price for which an item can be marketed applies to its "value in exchange"; its "value in use" or its value to its owner or possessor may be much different than its value on the market.⁵⁶

The going-concern postulate follows Adam Smith's "value in use" concept. The market value of certain assets which a company owns does not determine its value to a company in business. Its value to the company is usually more or less than its liquidation value, and therefore, such liquidation value should not be considered as it is not relevant to a concern continuing in business.

⁵⁴Adam Smith, The Wealth of Nations, Vol. I (Fourth Edition; Oxford: Clarendon Press, 1869), p. 29.

⁵⁵Paul H. Douglas, "Smith's Theory of Value and Distribution," Adam Smith, 1776-1926, Lectures To Commemorate the Sesquicentennial of the Publication of the "Wealth of Nations" (Chicago: The University of Chicago Press, 1928), p. 78.

⁵⁶Paul A. Samuelson, Economics, (Third Edition; New York: McGraw-Hill Book Company, Inc., 1955), pp. 428-29.

Although it has been shown that the "going-concern" postulate is realistic in over 99% of the situations, it would be foolish to apply such postulate in instances where it is definitely known that an organization is in the process of liquidation. In such cases it is reasonable to take exception to the specific postulate.

Periodicity Postulate

The terms "profit" and "net profit"⁵⁷ appear to transmit the idea of finality or the idea of absolute accuracy and objectivity to the layman. However, accountants and others familiar with the field of accounting understand that reported periodic profit figures cannot be exact figures because of the many estimates involved in the determination of such profit figures. ". . . the word income is used to describe a general concept, not a specific and precise thing, and that the income statement is based on the concept of the going concern. It is at best an interim report. Profits are not fundamentally the result of operations during any short period of time."⁵⁸ It is also generally agreed upon that only after a business has liquidated is it possible to determine its profits with absolute accuracy. Roy B. Kester states, "Profits are accurately and definitely determinable only

⁵⁷ Also the terms "income" and "net income."

⁵⁸ American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., p. 59.

when a business ceases and is liquidated. Profits of a going concern are always estimates."⁵⁹ H. A. Finney and Herbert E. Miller state, "Most businesses can be characterized as being engaged in a continuing 'stream' of activities. Not until a business has ceased to function as a going concern and has disposed of its assets is it possible to compute with absolute accuracy the net income or the loss sustained."⁶⁰ W. A. Paton describes the situation very well, as follows:

The single income report should not be taken too seriously. There is no more difficult problem of quantitative measurement and interpretation than that of determining the earnings of a complex business institution for a given period of time, especially when the period is short. The typical enterprise is a continuing entity, and setting up the report of operations and resulting earnings for a particular month, quarter, or year, coupled with a balance-sheet display at either end, means that many living fibers of activity must be cut, more or less artificially, that estimate and judgment must be relied upon at numerous points. On the other hand, the amount and trend of profits as shown by a series of such reports, carefully and consistently prepared, are reasonably dependable facts, of real service in guiding the actions of interested parties.⁶¹

In the past, it was possible to account for the profits of separate ventures;⁶² it was possible to observe the beginning of a venture and its termination and realization of assets at a later date.

⁵⁹Roy B. Kester, Advanced Accounting (New York: The Ronald Press Company, 1933), p. 494.

⁶⁰H. A. Finney and Herbert C. Miller, Principles of Accounting--Intermediate (Fifth Edition; Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1958), p. 173.

⁶¹W. A. Paton, Advanced Accounting (New York: The Macmillan Company, 1949), p. 19.

⁶²It was a common practice in the distant past to account for profits when a joint venture, such as a ship voyage or caravan trip, had been completed.

This situation lent itself very well to the accurate determination of a net profit or loss for the entire venture, from its very beginning to its final termination. As business enterprises grew in size and industry became characterized by much standardization and uniformity, it became impossible to apply the usual profit tests of termination and realization. The corporation with a permanent life emerged as a popular form of business organization; this effectively prevented any final computation of money profits such as would result if a venture liquidated all of its assets leaving only cash on hand for distribution.⁶³

Today the actual termination of a business can be anticipated, with a view towards an accurate determination of profits, in only a small number of instances. Temporary ventures such as concessionaires at fairs and amusement parks, eating places which are established at places where construction work will take place, etc., are examples of such cases where profits can be determined accurately. "It is somewhat ironic that true accounting profits may be determined for such evanescent ventures while the same simple and accurate determination of profit is utterly impossible for the large, well-managed corporation with an indefinite life tenure."⁶⁴

⁶³Stephen Gilman, Accounting Concepts of Profit (New York: The Ronald Press Company, 1939), pp. 74-75.

⁶⁴Ibid., p. 75.

Since most businesses operate over a long period of time, and most have indefinite lives it would obviously be impractical to eliminate any net income computations until the business has run its life span and terminates. Unless interim computations and reports are made, there would exist no adequate basis for reporting the success of a business. Reports concerning the success of a business must be received regularly by the owners, managers, creditors, trade unions, governmental bodies, etc. These interested parties must make current decisions based on current information. They cannot wait until a business terminates in order to have more accurate data. In other words, fair and reasonable information received currently is much more useful than perfectly accurate data received after an enterprise has discontinued its operations. Therefore, the entire life span of an enterprise must be divided into shorter interim periods for reporting purposes, or as W. A. Paton stated ". . . many living fibers of activity must be cut, more or less artificially."⁶⁵

Under older systems of record-keeping, accounting periods of different enterprises, even among those that were similar, were not necessarily of the same duration. Books were frequently closed and reports tendered at the whim of the proprietor, or when a joint venture had been completed. There are cases on record where books were closed and profits computed only after a span of five years, ten

⁶⁵ Paton, Advanced Accounting, loc. cit.

years, thirteen years, and twenty-six years.⁶⁶ Henry Rand Hatfield reports:

∴ . . . of the old account books which have come down to us, one was not balanced until the end of nine years, another not until twenty-seven years had elapsed. The British East-India Company prepared a general balance sheet in 1665--but not again until 1685. But during the seventeenth century the custom of business-men changed and a marked step was taken by the French Ordinance of 1673 requiring a balance sheet each two years.⁶⁷

Since the earliest business enterprises took the form of independent ventures, the accounting period was automatically the term of the venture. This could be a day, month, year, or several years. As commerce and industry grew, business enterprises undertook continuous operations as opposed to independent ventures. This factor led to the anticipation of a long existence, which prevails today among the majority of business organizations. As was already pointed out, the lives of these perpetual organizations must be divided into time segments if the needs for periodic reporting are to be satisfied. The accounting period is but a chapter in the entire history of any business unit.

One-Year Period

The presently accepted and generally recognized accounting

⁶⁶Smith and Ashburne, op. cit., p. 6.

⁶⁷Henry Rand Hatfield, Accounting (New York: D. Appleton-Century Company, Inc., 1927), p. 3, cited by Stephen Gilman, Accounting Concepts of Profit, op. cit., p. 76.

period is the year.⁶⁸ In the great majority of businesses the changing seasons of the year affect social and economic customs, and in so doing they cause the patterns of production and selling to recur year after year. Following are examples: the Christmas and Easter buying seasons cause a department store's sales during that time to be much higher than at other times during the year; canning factories must process perishable farm products during the harvest season and may be idle in other parts of the year; automobile factories reduce their operations substantially while preparations are being made for the new models. The presence of seasonal patterns throughout industry has been an important factor in making the year the most common accounting period. When a year is used, each accounting period includes the same number of peaks and troughs, and comparison of annual statements is made more meaningful.⁶⁹

The illustrations and charts on the following pages were constructed to show that the changing seasons of the year do actually affect industries and cause certain patterns of production and selling to recur year after year. These seasonal patterns in different industries have been the basis for establishing the year as the recommended formal accounting period; when a year is used, each accounting period will include the same number of highs and lows.

⁶⁸ This could be a calendar year or any other fiscal year.

⁶⁹ Smith and Ashburne, op. cit., p. 53.

The data for these illustrations and charts were obtained from various issues of the Survey of Current Business. Three industries were selected at random as follows:

1. Durable goods manufacturers--transportation equipment manufacturers
2. Non-durable goods manufacturers--textile mill products
3. Retail trade--mail-order firms.

For each of the three industries data were considered for three years, 1956, 1957 and 1958, broken down by months. For the first two categories data are presented for three factors:

1. Industrial production
2. Sales volume
3. Inventories

For the retail trade only data relating to sales volume is presented.

In Illustration IX and X, for the Transportation Equipment Manufacturers, it can be seen that industrial production and sales volume for the three years have a very high degree of correlation; the downward and upward tendencies are the same each year. For inventories, there also is the same pattern from year to year, with the exception of the first four months of 1958.

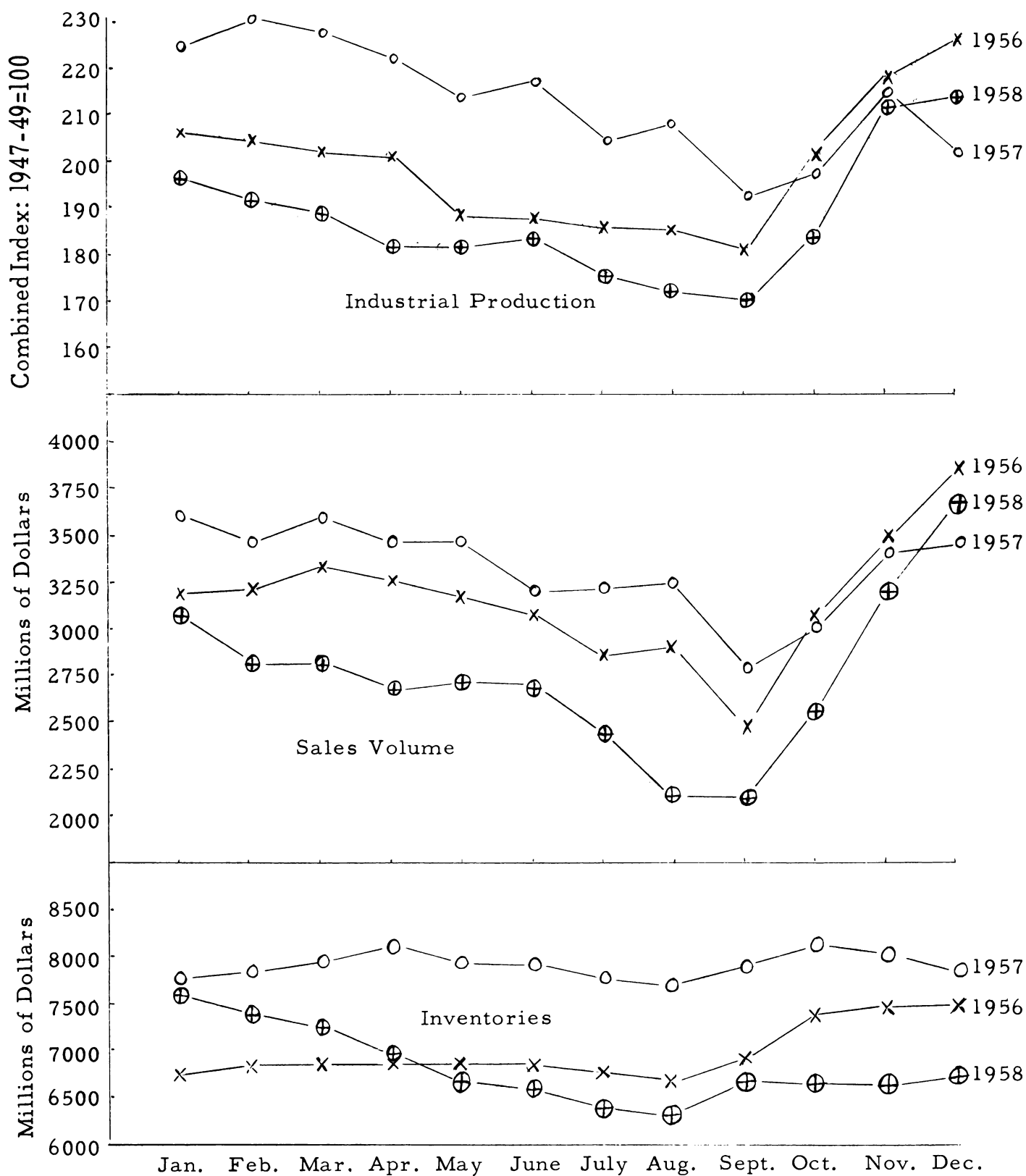
In Illustration XI and XII, for the Textile Mill Products, it once again can be seen that the pattern of industrial production and sales volume for the three years are closely allied. For inventories, the general similarity of pattern is also present, with the exception of the first part of 1956.

ILLUSTRATION IX. --General Business Indicators
Transportation Equipment Manufacturers: 1956-1958⁷⁰

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Industrial Production (Unadjusted, combined index; 1947-1949 = 100)												
1958	196	191	189	181	181	183	175	173	170	184	211	214
1957	225	231	228	223	214	217	205	209	194	198	213	203
1956	206	205	202	201	189	188	186	186	180	202	218	225
Sales Volume (Unadjusted, in millions of dollars)												
1958	3,066	2,807	2,768	2,632	2,675	2,637	2,436	2,103	2,093	2,588	3,208	3,646
1957	3,611	3,467	3,590	3,489	3,496	3,187	3,193	3,256	2,750	3,003	3,463	3,495
1956	3,166	3,169	3,313	3,257	3,181	3,119	2,838	2,875	2,481	3,049	3,647	3,869
Inventories, End of Month (Book value, unadjusted, in millions of dollars)												
1958	7,669	7,414	7,226	6,956	6,716	6,579	6,384	6,302	6,718	6,665	6,593	6,639
1957	7,083	7,878	7,951	8,124	7,969	7,899	7,781	7,713	7,843	8,115	8,006	7,885
1956	6,749	6,860	6,875	6,877	6,889	6,795	6,690	6,600	6,898	7,331	7,415	7,455

⁷⁰These statistics were obtained from the Survey of Current Business, U. S. Department of Commerce, Office of Business Economics, issues 1957-1959.

ILLUSTRATION X. --General business indicators
Transportation Equipment Manufacturers, 1956-1958⁷¹



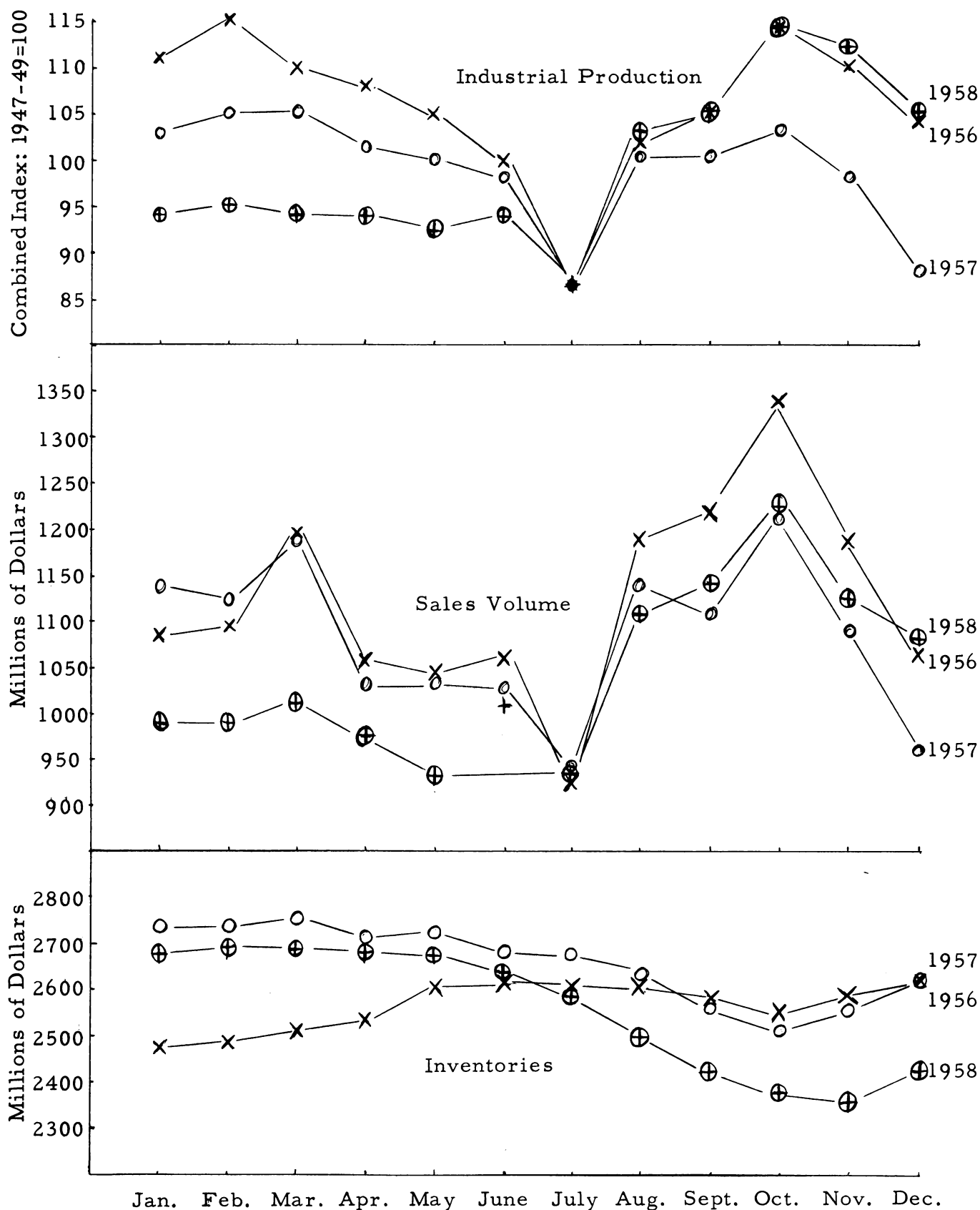
⁷¹ Based on data from the Survey of Current Business as shown on the foregoing page.

ILLUSTRATION XI. --General business indicators
Textile Mill Products: 1956-1958⁷²

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Industrial Production (Unadjusted, combined index; 1947-1949 = 100)												
1958	94	95	94	94	93	94	86	103	103	109	107	100
1957	102	105	105	102	100	99	86	101	101	103	98	89
1956	111	115	110	108	105	100	86	102	103	109	105	99
Sales Volume (Unadjusted, in millions of dollars)												
1958	994	995	1,015	965	930	1,006	936	1,098	1,131	1,219	1,123	1,071
1957	1,143	1,131	1,163	1,030	1,031	1,022	939	1,137	1,104	1,214	1,085	954
1956	1,078	1,090	1,168	1,056	1,046	1,056	920	1,176	1,212	1,345	1,184	1,068
Inventories, End of Month (Book value, unadjusted, in millions of dollars)												
1958	2,667	2,679	2,682	2,675	2,675	2,635	2,584	2,499	2,432	2,385	2,371	2,422
1957	2,739	2,736	2,748	2,698	2,720	2,691	2,678	2,623	2,561	2,515	2,562	2,628
1956	2,460	2,477	2,506	2,542	2,602	2,618	2,612	2,606	2,573	2,559	2,579	2,625

⁷² These statistics were obtained from the Survey of Current Business, U. S. Department of Commerce, Office of Business Economics, issues 1957-1959.

ILLUSTRATION XII. --General business indicators
Textile Mill Products, 1956-1958⁷³



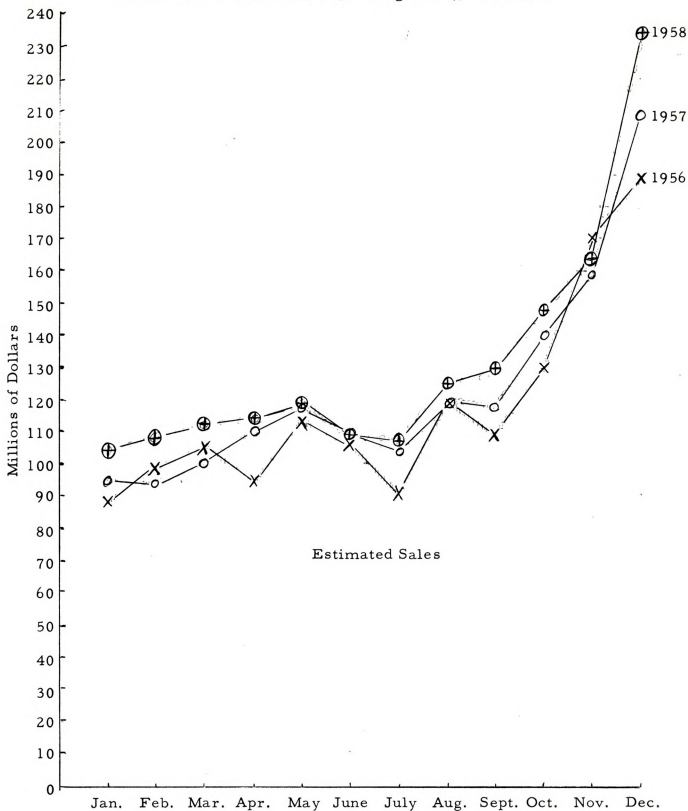
⁷³Based on data from the Survey of Current Business as shown on the foregoing page.

ILLUSTRATION XIII. --Sales Volume
Retail Trade--Mail-Order (Catalog Sales)
1956-1958⁷⁴

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Estimated Sales (Unadjusted, in millions of dollars)												
1958	105	97	111	112	120	108	106	120	129	147	161	234
1957	97	94	100	110	121	105	104	125	117	138	159	209
1956	89	97	106	95	113	105	90	120	108	129	166	189

⁷⁴These statistics were obtained from the Survey of Current Business, U.S. Department of Commerce, Office of Business Economics, issues 1957-1959.

ILLUSTRATION XIV. --Sales Volume
Retail Trade--Mail-Order (Catalog Sales), 1956-1958⁷⁵



⁷⁵ Based on data from the Survey of Current Business, as shown on the foregoing page.

In Illustration XIII and XIV, for the Retail Trade--Mail-Order, the sales trend of three years can be observed to have the same general seasonal pattern.

From the previous illustrations and charts, it can be seen that the tradition of the one-year accounting period actually is supported by conditions of reality. Organizations and persons live and act by the calendar, and the changing seasons actually do affect the operations of particular companies in the same way each year. Therefore, based on reality, it appears reasonable to make the general assumption that an organization's life span can be logically sub-divided into one-year periods for reporting purposes.

The yearly seasonal characteristics which stem from custom and tradition rule out any formal accounting period of less than a one-year duration. Because of the brevity of the period covered the problem of attaining accuracy with respect to income measurement becomes more acute in interim reports of earnings. Such items as income taxes, for example, can only be roughly estimated for periods of less than one year.⁷⁶

As can be seen from Illustrations IX through XIV, seasonal fluctuations are apparent in the different industries. If a period shorter than one year is used as the formal accounting period, such as a month or quarter, all months or quarters would not be comparable as each

⁷⁶W. A. Paton, Accountant's Handbook (Third Edition; New York: The Ronald Press Company, 1949), p. 5.

would be affected by different seasonal influences. However, interim reports for periods shorter than one year may be used for reporting purposes. When such data are used it must be remembered that every month or quarter is not comparable to every other month or quarter. The only valid comparisons which can be made would be between like periods, e. g., January, 1960 to January, 1959 or first quarter, 1960 to the first quarter, 1959.

The question of whether the one-year period should be based on a calendar year or some other fiscal year, such as a natural business year,⁷⁷ would depend upon the individual circumstances surrounding each enterprise. The natural business year has been advocated by many accountants and businessmen because it has many practical advantages such as:

1. professional accountants prefer to spread their efforts over the entire year rather than concentrate their efforts over a short time.
2. businessmen prefer to save the time and money involved in taking an inventory when stocks of goods are high; also operations are less disturbed when business activity is low.

⁷⁷ The natural business year generally does not terminate on December 31, but rather on the last day of some other month when the business activity of the enterprise is at its lowest seasonal point and inventories are at a minimum.

Practical considerations are important, but they are subservient to logical and objective criteria at this point. The natural business year does have some definite logical basis as follows:

1. Since accounts receivable and inventories are low, and these two items require the making of estimates, a more accurate reporting of profits is obtained than would be obtained from the application of any arbitrary fiscal year. This is so because the estimates are applied to the smallest amounts carried at any time during the year.
2. The end of a natural business year coincides with the low point of activity, and therefore provides a very logical basis for a yearly "cut-off." In other words, the yearly reports would include all operations from low point to low point.

In some industries, such as the construction industry, or an industry engaged primarily on research projects, the specific project may provide a better basis for periodic reporting than would a time period, such as a year.⁷⁸ However, even in these industries, the yearly basis may prove sound if a substantial number of long-term projects are being worked on continuously and are in different stages of completion.

⁷⁸ Paton and Littleton, op. cit., p. 22.

Another objection to the one-year period may be advanced in cases where the period of the operating cycle⁷⁹ is more than twelve months. This would be true in the cases where the aging process is involved, e. g., tobacco, lumber, and distillery business. If it is clearly indicated that consecutive one-year period data would not be comparable for such enterprises, such enterprises should be able to use a longer fiscal period, presumably the length of one operating cycle.⁸⁰

Periodicity is an important postulate in accounting. The one-year period appears to have logical support in the vast majority of enterprises, and thus can be considered to be a "postulate" in the general theory of accounting. Certain exceptions, which have been mentioned would have to be considered on an individual basis.

Measurability Postulate

The activities of any particular business enterprise consist largely of exchange transactions with outside parties. In order to place all of the exchange transactions on a similar basis so that they can be combined, on the financial statements, accounting has undertaken

⁷⁹The "operating cycle" refers to the circulation of capital within the current asset group. The average time intervening between the acquisition of materials and services and the final cash realization is called the "operating cycle."

⁸⁰American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, op. cit., pp. 20-21.



to express the exchanges quantitatively. The subject matter of accounting is basically the measured consideration involved in these exchange activities.⁸¹

Transactions are economic facts; accounting attempts to express such economic facts quantitatively in terms of a common denominator, namely the monetary unit.⁸² This is basically what the measurability postulate assumes--that all financial data can be expressed in terms of a monetary unit. This postulate enables an organization to translate all of its non-homogeneous assets and claims to assets into financial equivalents or money values.⁸³

A factory building, a variety of factory equipment, several bank accounts, a variety of factory and office supplies, and an inventory of many dissimilar items cannot be added together until they are first reduced to a common unit of measurement. Money appears to be the most obvious unit to use as the common denominator for goods and services. Accounting certainly can include a variety of records and reports of physical units, but the primary usefulness of financial accounting stems from the fact that it converts all "things" into dollars. "Reported as dollars, assets, liabilities, owners' equity, revenues, and

⁸¹ Paton and Littleton, op. cit., pp. 11-12.

⁸² Littleton, Structure of Accounting Theory, op. cit., p. 10.

⁸³ Gilman, op. cit., p. 26.

expenses can be added, subtracted, compared and interpreted."⁸⁴

The Committee on Terminology of the American Institute of Accountants stated the following:

The term value is used in accounting to signify some attribute of an asset (or other accounting factor); this attribute is expressed in terms of money, which may or may not reflect intrinsic worth, and is normally indicated by a qualifying adjective (e. g., book value, replacement value, etc.). Furthermore in accounting, values as thus broadly viewed, although not homogeneous, may be aggregated or deducted from one another. Thus, it is a universally accepted practice to add the cost value of one asset to the market value of another, and to deduct from the sum the amount of a liability to arrive at a net figure. This procedure, although open to obvious criticism of its mathematical propriety, possesses so many practical advantages and is so well established that it is not likely to be abandoned.⁸⁵

The use of the word "value" as employed in the above context does not involve the concept of current worth, but rather refers to a particular method of quantitative determination.⁸⁶

Mr. B. A. Margo advanced the idea of preparing financial statements on the basis of standard index numbers with no monetary valuations attached. In his article he advances complete details for his system. The difficulties involved in using index numbers, involving the selection of the proper indices and problems of application,

⁸⁴C. Aubrey Smith and Jim G. Ashburne, Financial and Administrative Accounting (Second Edition; New York: McGraw-Hill Book Company, Inc.), p. 51.

⁸⁵American Institute of Accountants, Review and Résumé, Accounting Terminology Bulletin Number 1, op. cit., pp. 7-8.

⁸⁶American Institute of Accountants, Book Value, Accounting Terminology Bulletin Number 3, Prepared by the Committee on Terminology (New York: American Institute of Accountants, August, 1956), p. 2.



have kept this system from becoming popular.⁸⁷

In summary, the measurability postulate simply states that the monetary unit serves to reduce many dissimilar items to a common denominator, the monetary unit, thus enabling these items to be combined in an informative manner on the financial statements. However, it should be realized that many aspects of business affairs are not financial in nature and cannot be reduced into monetary terms (e. g. certain business decisions, good will built up by the business, etc.).

Summary

The structure of accounting theory should not be based on current accounting practices. Instead, such structure of theory should rest upon the foundation of a system of ideas which serves as a basis and criteria of performance. Such theory can be advanced without reference to the practice of accounting, while at the same time it must be in conformity with economic reality.

The entire structure of accounting theory should be based on a series of postulates or assumptions, which are founded on the basis of economic reality and sound reasoning. These postulates are of two types. The general or all-inclusive postulates are very general in nature and are broad enough to cover all possible situations. Such postulates are not directly applicable in specific accounting situations

⁸⁷ B. A. Margo, "Managers Look for New Standard as Inflation Cuts Money Values," Canadian Business, XXX (March, 1957), 52 - 58.

but do provide the basis for the establishment of specific postulates and principles. The second type of postulates, the specific postulates, apply in the vast majority of situations, but do not have universal applicability because of some exceptions which must be made from time to time. These postulates are directly applicable in a given situation and therefore are of extreme importance in building the structure of accounting theory.

The writer has determined that four specific accounting postulates exist. These postulates have been shown to exist on the basis of logic and economic reality. They are:

1. Business Entity Postulate
2. Going Concern Postulate
3. Periodicity Postulate
4. Measurability Postulate

The business entity postulate refers to the existence of an organization apart from its owners; the going concern postulate refers to an organization's status as a continuing venture; the periodicity postulate refers to the division of the life span of an organization into logical periods for reporting purposes; the measurability postulate refers to combining heterogeneous items into meaningful data through the use of a common denominator.

The foregoing postulates are recommended without any reference to income determination, balance sheet valuation, etc. They are intended to form the basis upon which to build the structure of accounting theory and, therefore, are based primarily on economic reality.

CHAPTER V

ACCOUNTING PRINCIPLES

General

The creation of an outline of the structure of accounting is dependent upon the articulation of what constitutes generally accepted accounting principles. The new research committee of the American Institute of Certified Public Accountants proposes to consider principles based on the foundation of established postulates. The special committee on the research program stated:

A fairly broad set of coordinated 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.¹

Webster defines a principle in several ways:²

1. A source or origin; primordial substance; ultimate basis or cause.
2. An original faculty or endowment.
3. A fundamental truth; a primary or basic law, doctrine, or the like.

¹"Report to Council of the Special Committee on Research Program," op. cit., p. 63.

²Webster's Collegiate Dictionary, op. cit., p. 788.

4. A settled rule of action; a governing law of conduct.

A Dictionary for Accountants defines principle as follows:

A proposition asserted to be controlling in a given system or domain of inquiry and having acceptance among members of a professional group deemed to be competent in a society; growing out of observation, reason, or experiment, it purports to be the best possible guide in the choice of alternatives leading to the qualities desired in an end product. Some principles are descriptive or classificational and have either the form "All, some, or no A's or B's (a general proposition) or the form "Y is a function of X" (a propositional function). Other principles are normative and are not concerned with the existence of anything, but rather state what is preferred or prescribed. Among normative principles are definitions Principles are not equally self-evident to all people. The assertion of a descriptive principle establishes neither the truth or wisdom of normative principle. If a principle is accepted without evidence or proof, it may be called an axiom, assumption, or postulate.³

Mr. Kohler presents a separate definition in his dictionary for "accounting principles" as follows:

The body of doctrine commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions and procedures where alternatives exist. Rules governing the formation of accounting axioms and the principles deriving from them have arisen from common experience, historical precedent, statements by individuals and professional bodies, and regulations of governmental agencies. The validity of accounting principles rests on their simplicity, clarity, and generality in mirroring current practices and in furnishing guidance for further growth and development.⁴

Dictionary definitions of "principle" usually take three approaches. The first considers a principle to be a "source, origin, or

³Kohler, A Dictionary for Accountants, op. cit., p. 335.

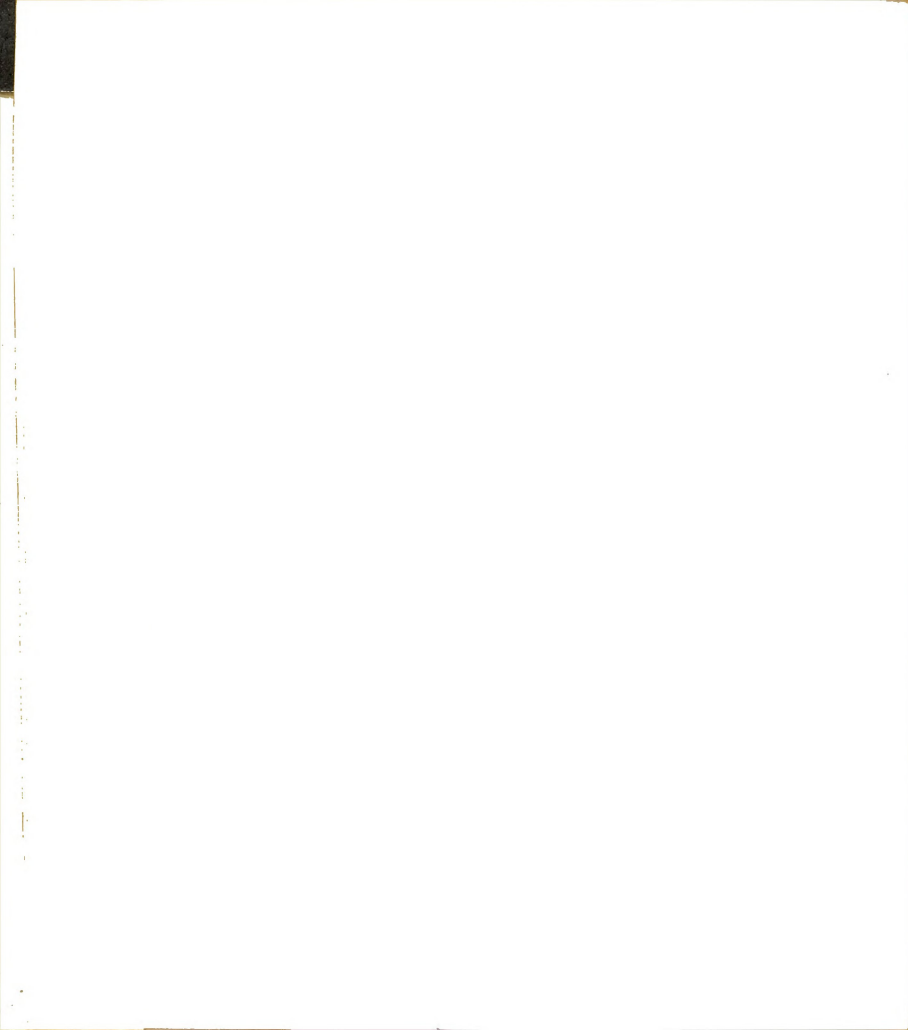
⁴Ibid., pp. 10-11.

cause." This appears to be of little help to the accountant except as it emphasizes the primary character of some principles. Another approach considers a principle to be "a fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths." The third type of definition considers a principle to be "a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice."⁵

The third definition comes the closest to the meaning given to the term "principle" by most accountants, especially those who are practicing. Initially, accounting principles are derived from experience and reason. If they prove useful they become accepted as principles of accounting; a widespread acceptance gives these principles the right to be called "generally accepted accounting principles." The term "principle," as it has been used in the accounting field, does indicate a general law which governs future actions. The reader should not receive the impression that an accounting principle is inflexible. As used in the past, accounting principles have been flexible; in fact, in certain situations it is possible to have a conflict between different principles.⁶

⁵ American Institute of Accountants, Review and Résumé, Accounting Terminology Bulletin No. 1, op. cit., pp. 10-11.

⁶ Ibid., p. 11.

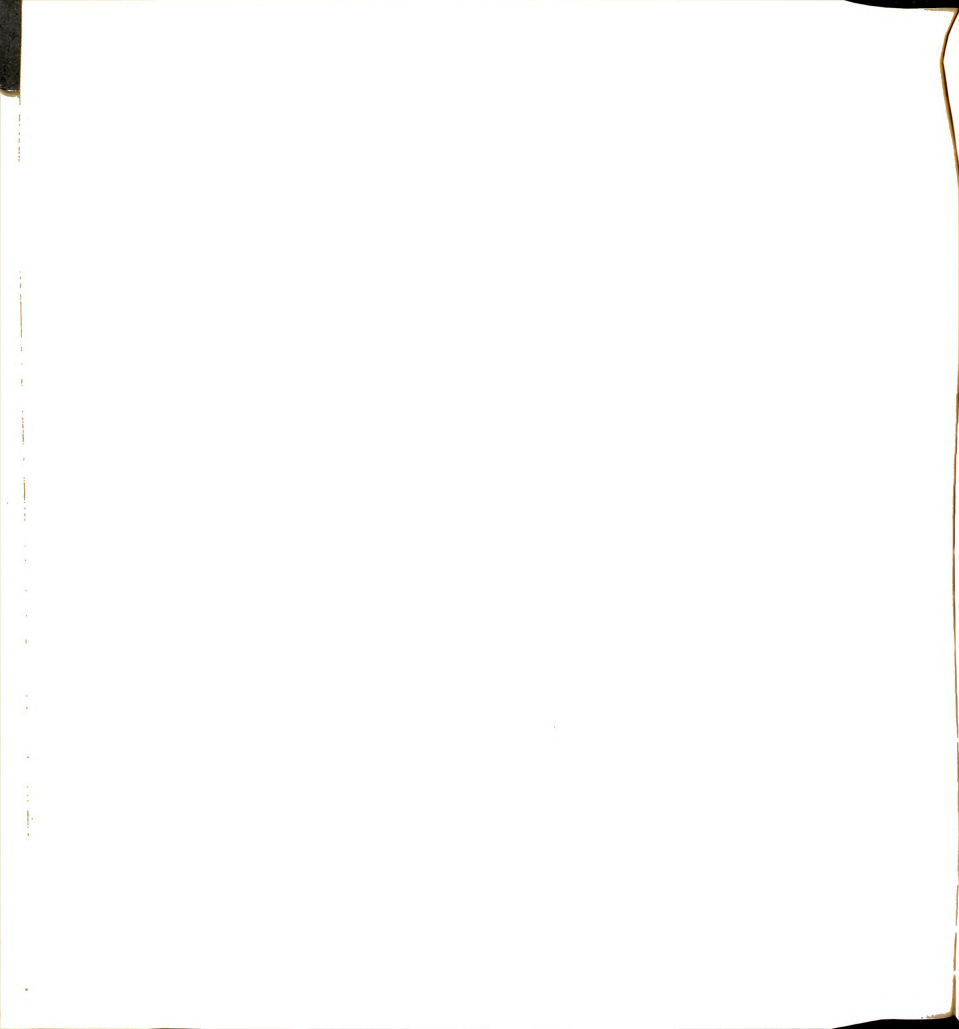


As can be observed from the foregoing discussion, principles of accounting" are not principles in the sense that these principles have been reduced to scientific fact. The laws of science based upon repeated observations of physical phenomena; accounting, on the other hand, does not rest upon physical actions. Accounting depends upon expert opinion relating to what is logical right in a particular accounting matter.⁷

The American Accounting Association prepared a publication in 1936, and subsequently revised such publication three times, each time changing the title and contents. The term "principle" was omitted from the title of the two most recent revisions of this publication. The reader believes that the inability to "pin-point" exactly what a "principle" means led to the omission of the term "principle." Following are the titles of the four publications:

- 1936 "Tentative Statement of Accounting Principles Affecting Corporate Reports."
- 1941 (Revised) "Accounting Principles Underlying Corporate Financial Statements."
- 1948 (Revised) "Accounting Concepts and Standards Underlying Corporate Financial Statements."
- 1957 (Revised) "Accounting and Reporting Standards for Corporate Financial Statements."

⁷ Arnold W. Johnson, Intermediate Accounting (Revised edition; New York: Rinehart & Company, Inc., 1958), p. 718.



When formulating accounting principles the governing idea is that these principles should never be an aim in themselves, but solely a means to arrive at a fair presentation of the financial position at a given date and of the results of operations for the year then ended.⁸

The term "accounting principles" as used by accountants, past and present, has not only indicated basic concepts and standards. This term also has encompassed practices and procedures. The preceptions and comments included in the auditors' opinions with respect to the suitability of the accounting principles applied in the preparation of financial statements, and their consistent application, has referred to practices and procedures as well as to basic concepts.⁹ This application of the term "principle," in the opinion of the writer, is correct. Practices and procedures should not be referred to as principles.

Some of the important problems concerning accounting principles will now be considered and discussed.

General Acceptance of Principles

"General acceptance" has, for a long span of time, been considered to be the authoritative support and the basis on which

⁸ Jacob Kraayenhof, "International Challenges for Accounting," Journal of Accountancy, CIX (January, 1960), p. 34.

⁹George R. Catlett, "Relation of Acceptance to Accounting Principles," The Journal of Accountancy, CIX (March, 1960), 33.

counting principles rest. Until about 1933 auditors' opinions were concerned primarily with the fair presentation of financial statements. At that time it was realized that some standard against which to judge financial statements was needed.¹⁰ Public accountants adopted the practice, in expressing their opinions on financial statements, of referring to "accepted principles of accounting." Some years later this term was changed to "generally accepted accounting principles." The intention in adopting such terminology was to achieve some degree of uniformity in the determination and application of accounting principles. It was predicted that this terminology would also obtain wider support of many of the accounting practices advocated by the American Institute of Accountants, the Securities and Exchange Commission and the New York Stock Exchange.¹¹

If general acceptance is the foundation upon which rests the body of accounting principles, the source of such acceptance should be sought out and defined. A wide variety of viewpoints exist in attempting to make an exact determination of what constitutes general acceptance. These viewpoints are:¹²

¹⁰ In 1933 the Securities Act was passed. The following year, 1934, brought into existence the Securities and Exchange Commission; the Securities Exchange Act was passed in 1934. These events created pressure on public accountants to establish some standard(s) against which to judge financial statements.

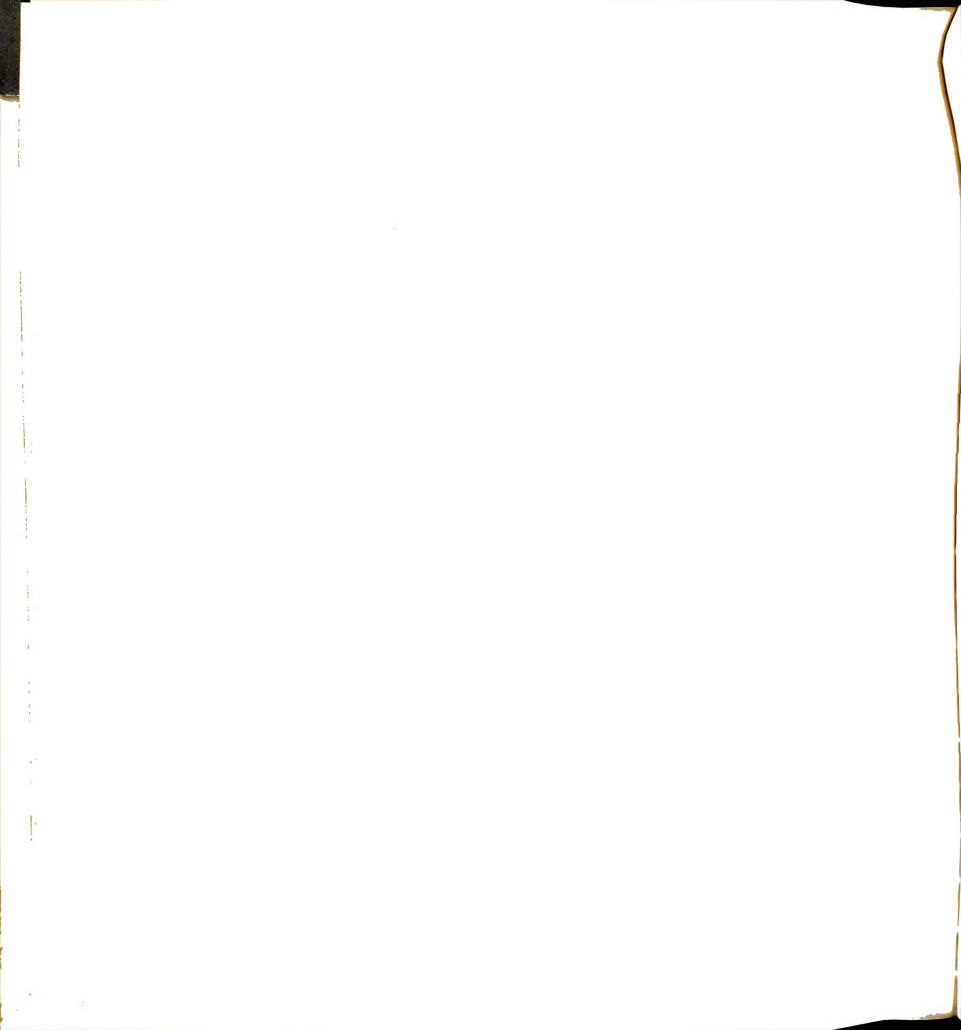
¹¹ Catlett, op. cit., pp. 33-34.

¹² Ibid., p. 34.

1. Actual usage in the commercial world is necessary because accounting principles must be adopted by business managements and not be imposed on them.
2. Public accountants have an absolute responsibility in the area of accounting principles, and acceptance by them is undoubtedly necessary.
3. Pronouncements of the American Institute of Certified Public Accountants are considered by some to be the most authoritative statements and, therefore, are the best and most tangible evidence of acceptance. Others hold the same view with respect to the pronouncements of the American Accounting Association.
4. The entire accounting profession must be involved in any general acceptance. This includes accountants in all fields-- public accounting, industry, government and education.
5. General acceptance sometimes stems from laws and governmental regulations applicable to business organizations.
6. General acceptance can only come from authoritative support by those best qualified to render accounting judgments.

It would be well to consider each of these views separately.

Actual usage of accounting principles in business and industry as a necessary indication of general acceptance seems logical, at first glance. However, past events prove otherwise. History shows that the managements of business enterprises have very often failed to follow sound accounting principles and practices. Sometimes business managements have been under pressure to employ those alternative accounting principles and practices available to them, no matter how unsound they may have been, in order to show the most favorable financial position and operating results. Also, there is a strong possibility that if inadequate principles and practices are followed for



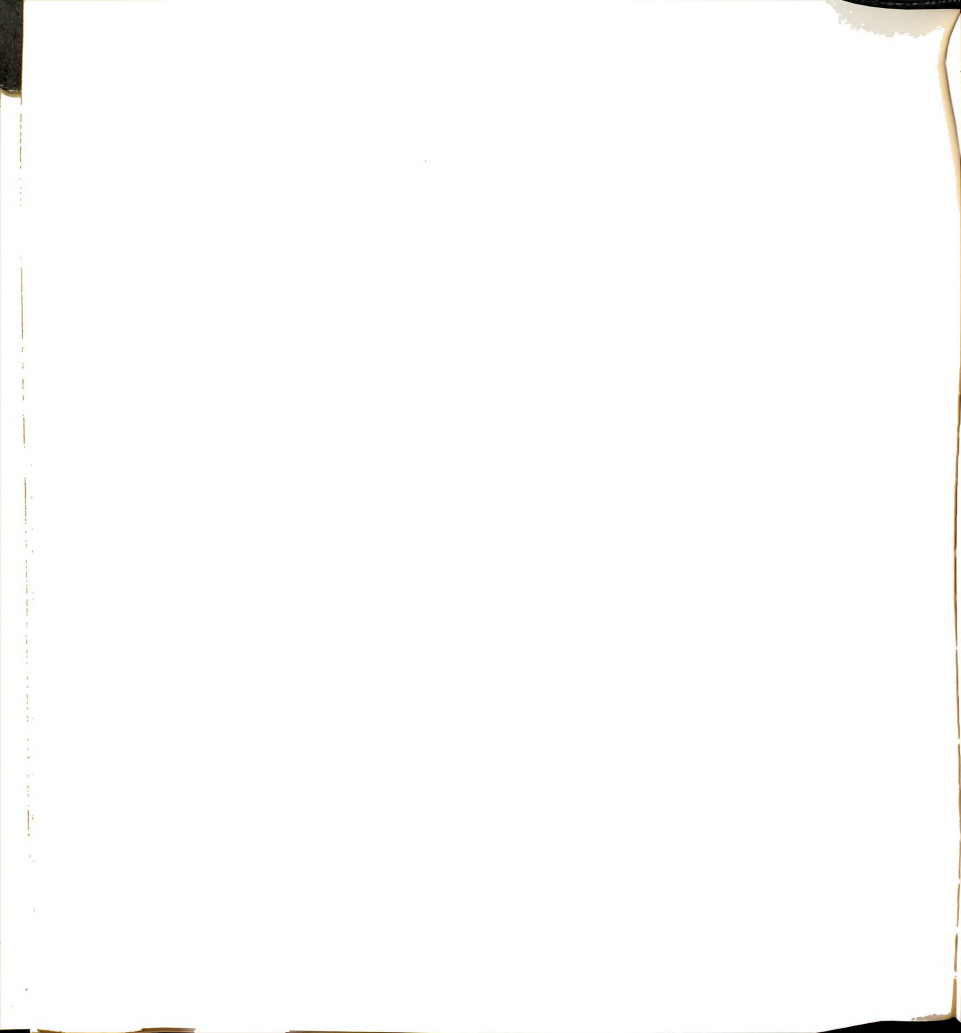
substantial length of time, they would become accepted on the basis of custom alone. The foregoing possibilities illustrate the important fact that actual usage in the business world may indicate general acceptance, but such usage, in itself, does not necessarily insure soundness.¹³

The acceptance of accounting principles by public accountants appears to be essential, since public accountants are responsible for their opinions on financial statements which they render. However, acceptance by public accountants alone does not and should not imply general acceptance."¹⁴

It has often been contended that the pronouncements of the American Institute of Certified Public Accountants, and to a lesser extent the pronouncements of the American Accounting Association, have become generally accepted on the grounds that these organizations hold eminent positions in the accounting profession. It is entirely possible that these pronouncements may eventually lead to general acceptance by the profession, but the opinion of any organization or committee cannot, at the present time, be assumed to be conclusive from the standpoint of the entire profession. In fact, supplemental to the number one to each of the Accounting Research Bulletins issued by the Committee on Accounting Procedure of the American Institute

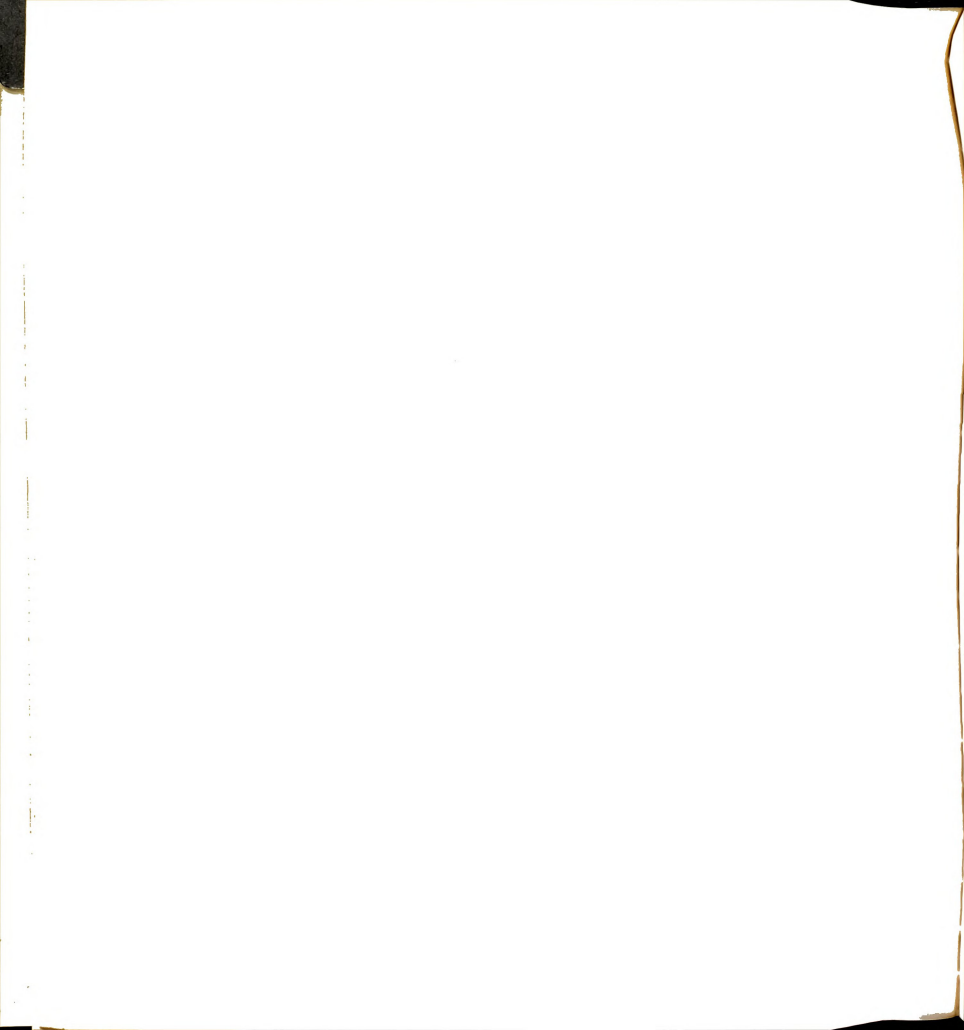
¹³ Ibid.

¹⁴ Ibid.



Certified Public Accountants contains the following: "Except in cases in which formal adoption by the Institute membership has been effected and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached." The fact that the American Institute of Certified Public Accountants and the American Accounting Association have had differing opinions in their respective pronouncements, in regards to accounting principles, also acts as a barrier to the acceptance of the pronouncements of one organization as being considered generally accepted.

In 1957 a study was completed in an attempt to determine whether or not the standards of Accounting Research Bulletin Number 43 of the American Institute of Certified Public Accountants had been efficiently accepted by the accounting profession to constitute generally accepted accounting principles. In this study the data in a random sample of 261 annual reports were evaluated against selected criteria established in Accounting Research Bulletin Number 43; the selected areas considered were inventories, depreciation and high costs, depreciation and amortization of emergency facilities, contingency reserves, and comparative statements. In cases where financial statements contained apparent divergencies, requests were sent to the auditors whose opinions accompanied the financial statements, asking for justification of the presentation. Replies were returned from 63 of the 140 auditors questioned, dealing with questions

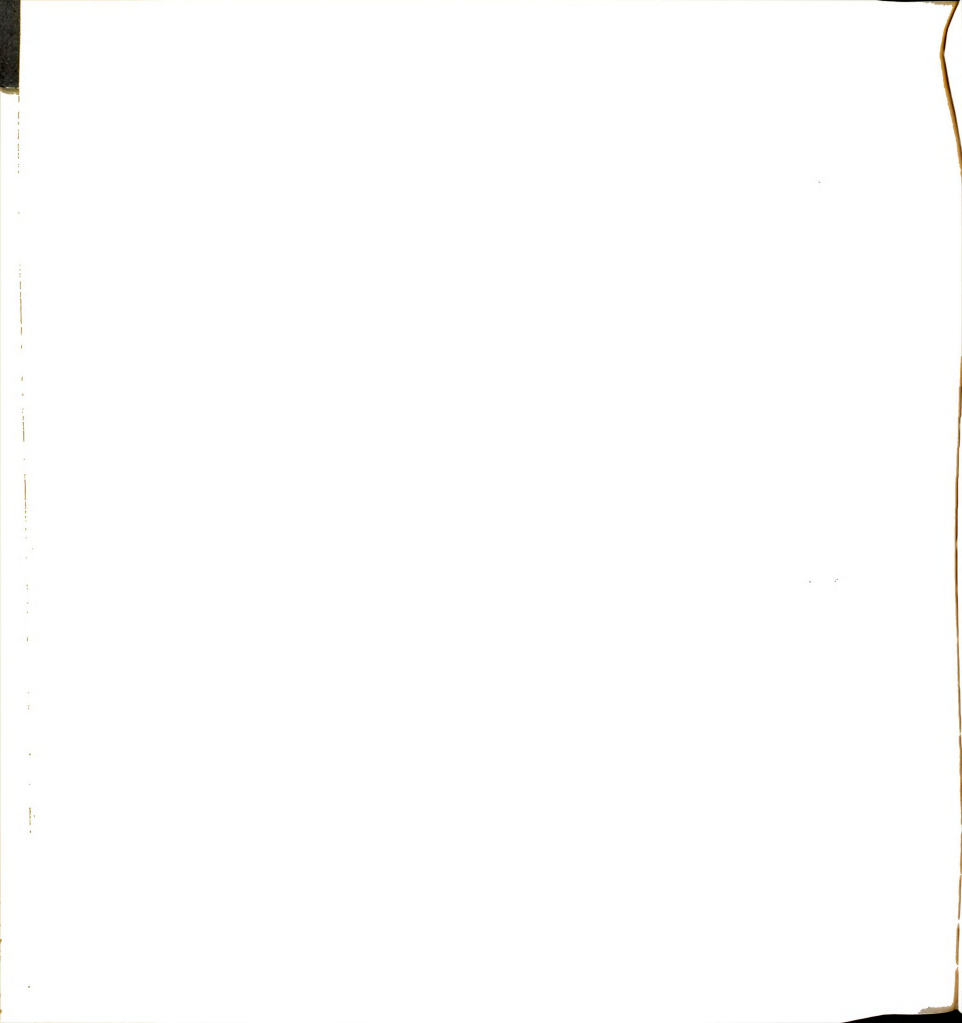


raised in 120 of the 215 annual reports in which apparent divergencies were found. The divergencies most frequently found in the annual financial statements were the omission of full information on the valuation of inventories and the omission of comparative statements. Many of the replies received from the auditors questioned the meaning or authority of Accounting Research Bulletin Number 43, and 18 of the auditors referred to the tabulations in Accounting Trends and Techniques.¹⁵ These indicators of accepted practice.¹⁶

The combined final evaluation ratings in the study just mentioned showed that 64.22% of the financial statements examined conformed to the principles established in Accounting Research Bulletin Number 43, while 35.78% did not conform. Two areas showing the nearest basis for evaluation were Inventories and Comparative Statements. These two areas combined showed that 45.6% of the financial statements examined complied with Accounting Research Bulletin Number 43 and 54.4% did not comply. The above data and other data from this study led to the very definite conclusion that Accounting Research

¹⁵ Accounting Trends and Techniques is an annual publication of the American Institute of Certified Public Accountants. This publication contains the tabulated results of the manner in which various items are presented, classified, and valued on the financial statements of over 100 companies.

¹⁶ Edgar Ben Yager, "An Evaluation of Annual Reports of Selected Industrial Corporations for Compliance with Certain Standards of Accounting Research Bulletin Number 43," Doctoral dissertation, Indiana University, 1957, Abstracts of Dissertations in Accounting, The Accounting Review, XXXIV (October, 1959), 636-37.



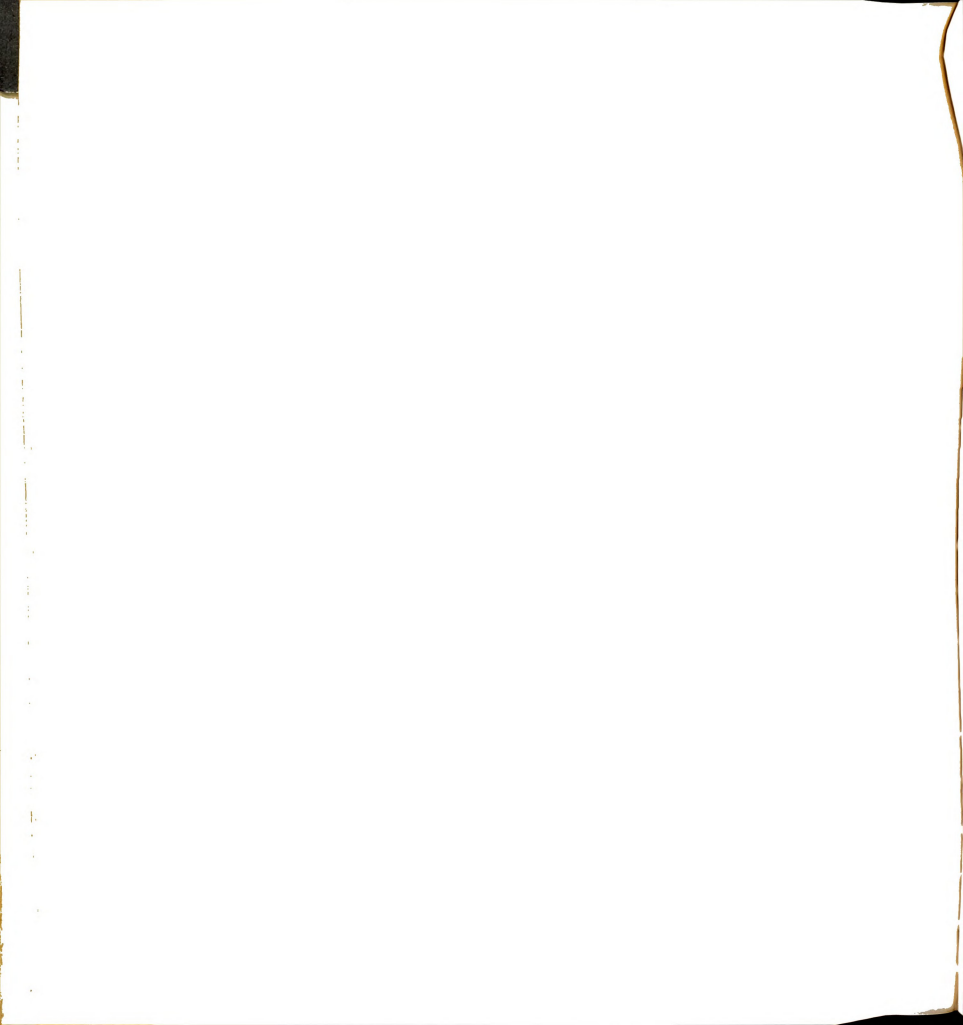
tin Number 43 does not contain generally accepted accounting principles.¹⁷

The above study is mentioned in order to stress the point of the pronouncements of the American Institute of Certified Public Accountants, American Accounting Association, or any other professional organization do not represent, in reality, generally accepted accounting standards as they do not achieve a sufficient degree of compliance.

It is commonly recognized that the entire accounting profession must be involved in any formulation of a body of generally accepted accounting principles. The entire accounting profession consists of members in many fields of activity--public practice, industry, government and education. However, all accountants are members of the same professional organizations; in fact, some do not belong to any organization. It can be seen that there is no one person in a position to be the spokesman for the entire accounting profession.

General acceptance which stems from laws and governmental action is not deemed to be advisable. First, it would tend to make accounting principles rigid and flexibility is needed to meet changing economic conditions. Secondly, it would adversely affect the professional character of accounting, as it would replace individual reasoned judgments by static and rigid laws, which cannot be changed rapidly under legal

¹⁷ Ibid.



cedures. This would impose from the outside illogical conditions, to some tax case decisions.

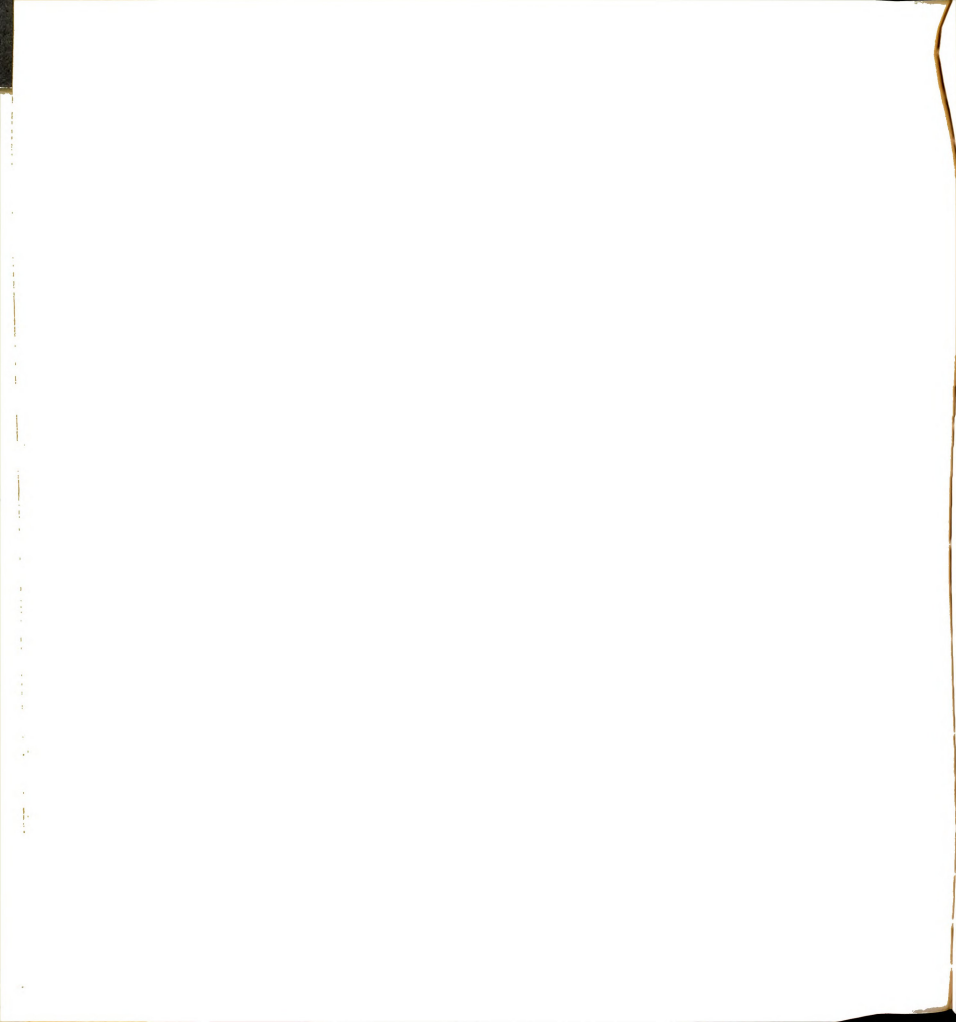
It has been proposed that general acceptance can be obtained if authoritative support comes from those persons best qualified to render accounting judgments. This approach is very logical. However, it contains very practical problems, namely, the determination of those persons best qualified to render judgments on accounting matters and the manner in which accounting judgments should evolve. These problems can be solved by some type of organization whose structure would be similar to that of a court.

An Accounting Court

A "court of accounting principles" has been proposed by Leonard Spacek. This would be in answer to a present urgent problem, namely, the lack of a forum where agreement on basic premises for accounting purposes can be debated. Agreement on accounting procedures and rules would not be the important goal; the objectives of such rules and procedures and the criteria on which to base them would be the important goals.¹⁸

The "accounting court" as proposed by Mr. Spacek recognizes the need for the case method in arriving at decisions

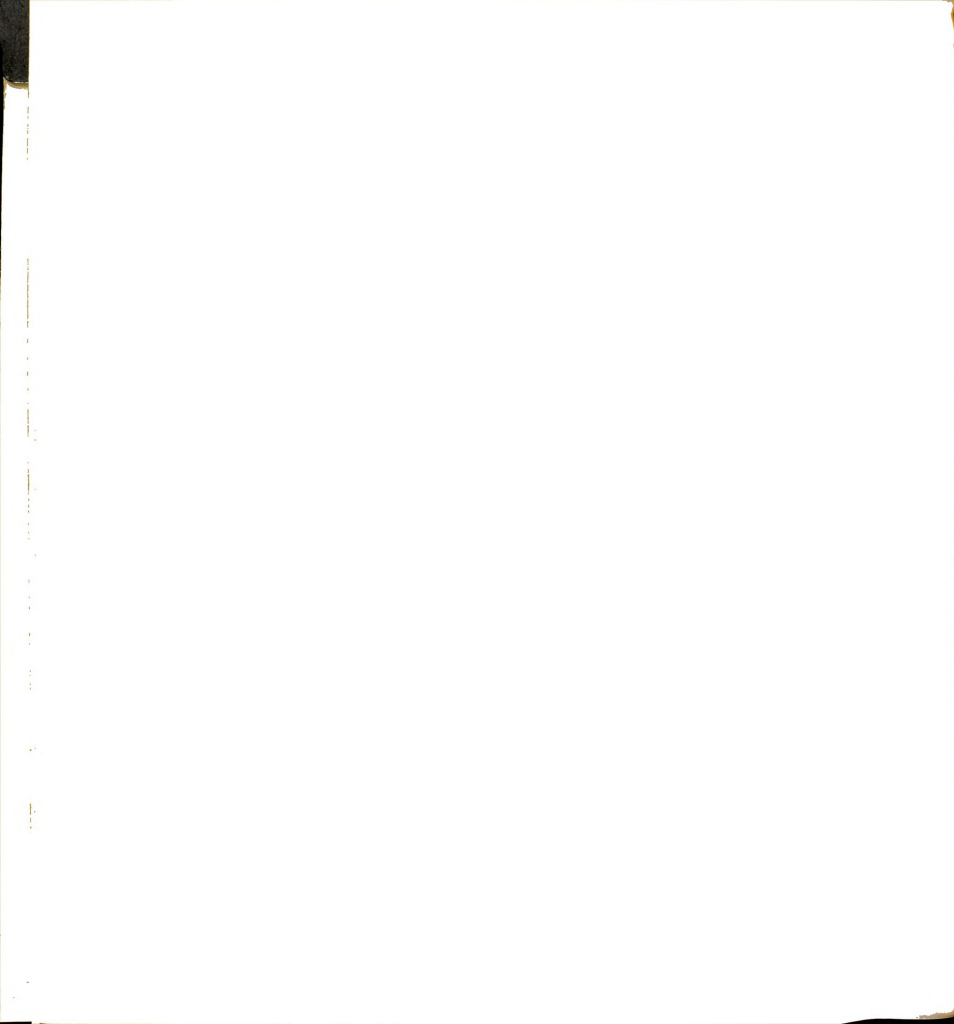
¹⁸Leonard Spacek, "The Need for an Accounting Court," Accounting Review, XXXIII (July, 1958), 369. (This paper was presented at the Annual Meeting of the American Accounting Association at the University of Wisconsin, August 27, 1957).



ing accounting principles; all professions, especially the medical and legal professions, rely heavily on past case histories in arriving at current decisions. The case method is intended to provide the accounting profession, industry, government, educators, and students with evidence of the current thinking used in arriving at accepted accounting principles. This would certainly enhance research and learning. Research would enable the detection of obsolete or faulty reasoning and would also indicate when basic premises have changed. The changing factors would affect accounting principles which also have to undergo change from time to time.¹⁹

Presently, there exists no satisfactory procedure for changing any principles which are presently considered to be generally accepted. It appears that the only means available for making changes is to create outside pressures for such changes. Also at present, the educational process suffers due to the manner in which our currently generally accepted accounting principles" are established and followed. Written summaries or briefs on various viewpoints seem absolutely necessary for educational purposes and for the advancement of the accounting profession. These written briefs would serve the same purpose as do briefs in the legal profession. It can be readily appreciated that the criteria for rejecting an opinion may be just as important as the criteria for adopting it. These materials have been lacking and consequently,

¹⁹ Ibid., pp. 374-75.



re hindered the educational institutions in the teaching of accounting.²⁰

present bulletins of the American Institute of Certified Public Accountants are seriously lacking as to the reasoning and the criteria which the opinions are based.²¹

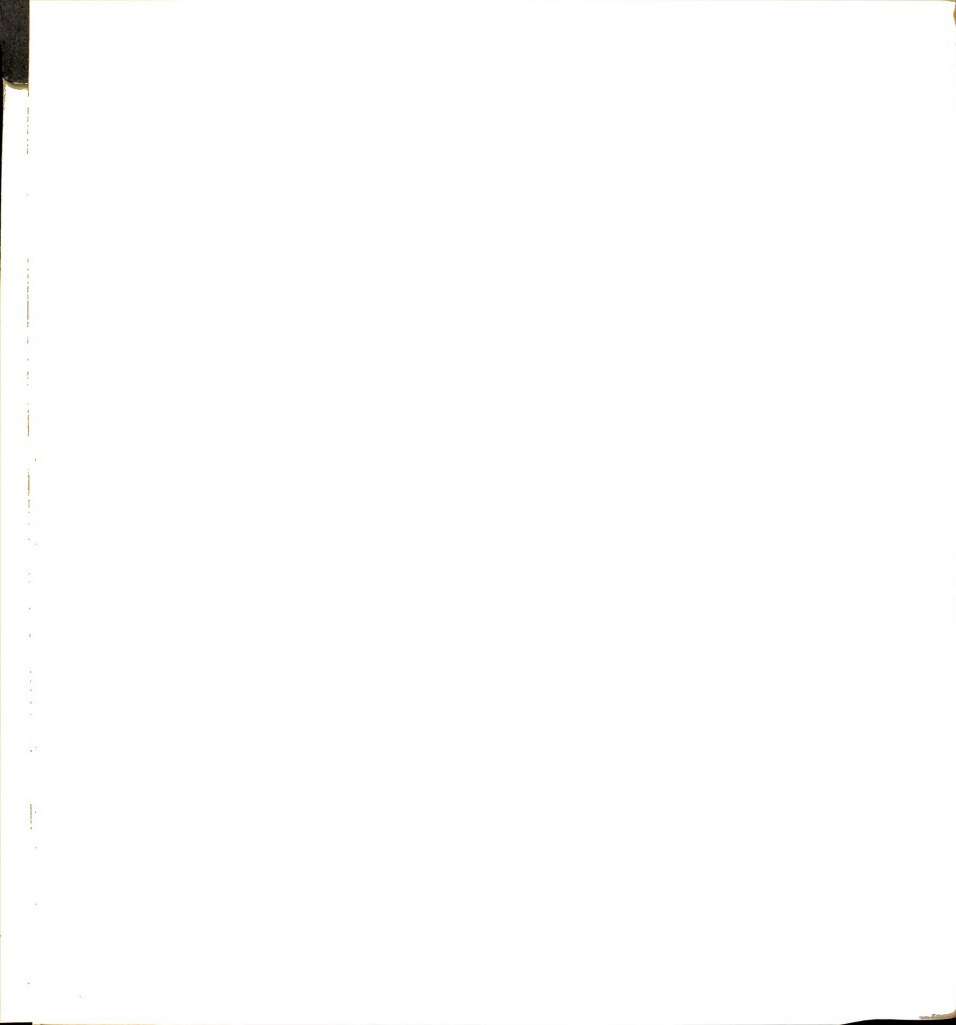
The accounting court would assume a "utilitarian" outlook. In other words, it would establish accounting principles which would be applied to accounting reports which would, in turn, meet the needs of many different groups--stockholders, management, creditors, labor organizations, governmental bodies, general public, etc. The reports would show a "net income" figure that meets the needs of all these segments of society. Each pronouncement of an accounting principle would require support showing why the adopted principle produces the desired results in reports from the standpoint of all the segments of society. This means that each principle would be based on clearly stated economic facts and figures. Certainly, the principles and reasoning behind such principles would always be challenged and changed by the court if it could be seen, with evidence, that our society and certain economic concepts have changed.²²

Mr. Spacek recommends that the American Institute of Certified Public Accountants assume the responsibility for leadership

²⁰ Ibid.

²¹ The results of the new Accounting Principles Board may justify this particular situation; no new bulletins have been issued by the new organization as of mid-1960.

²² Spacek, "The Need for an Accounting Court," op. cit., 375-77.



e development of generally accepted accounting principles.

Therefore, he assigns the following functions to the Institute:²³

1. to change its charter to establish a court of accounting principles; such charter amendment would state the number of members to sit on the tribunal, their salaries, the period of service, their election, the decisions required, the procedure for establishing and/or testing principles, etc. The tribunal would set its own rules of procedure in reference to written briefs, presentation, etc.
2. to adopt a charter amendment defining the criteria of accounting principles. Based on the fact that it is not possible to predict with absolute certainty where or how conflicts of interest arise with respect to the use of accounting reports, it is recommended that an accounting principle be defined as one which can be specifically but separately demonstrated as resulting in a fair report of income from a business transaction for:
 - a. Management, as a statement of accountability to stockholders.
 - b. Stockholders or equity owners, as a fair determination of income.
 - c. Labor, as a fair determination of the stockholders' income and capital devoted to a corporation's activities.
 - d. Consumers, as a fair determination of corporate income from the prices they paid.

If the reasoning behind every principle is supported from the viewpoint of each segment of society, such reasoning will always be subject to attack and defense on its merit. The right to income by each segment of society is not a problem of accounting, but the reporting for economics of business to each segment is the responsibility of accounting. Economic results can be changed by law, but economic facts cannot. Economic results are not the business of accounting, but the reporting of economic facts is.

3. to consider questions to come before the court, to publish the issues, and to arrange the dates for the hearings.

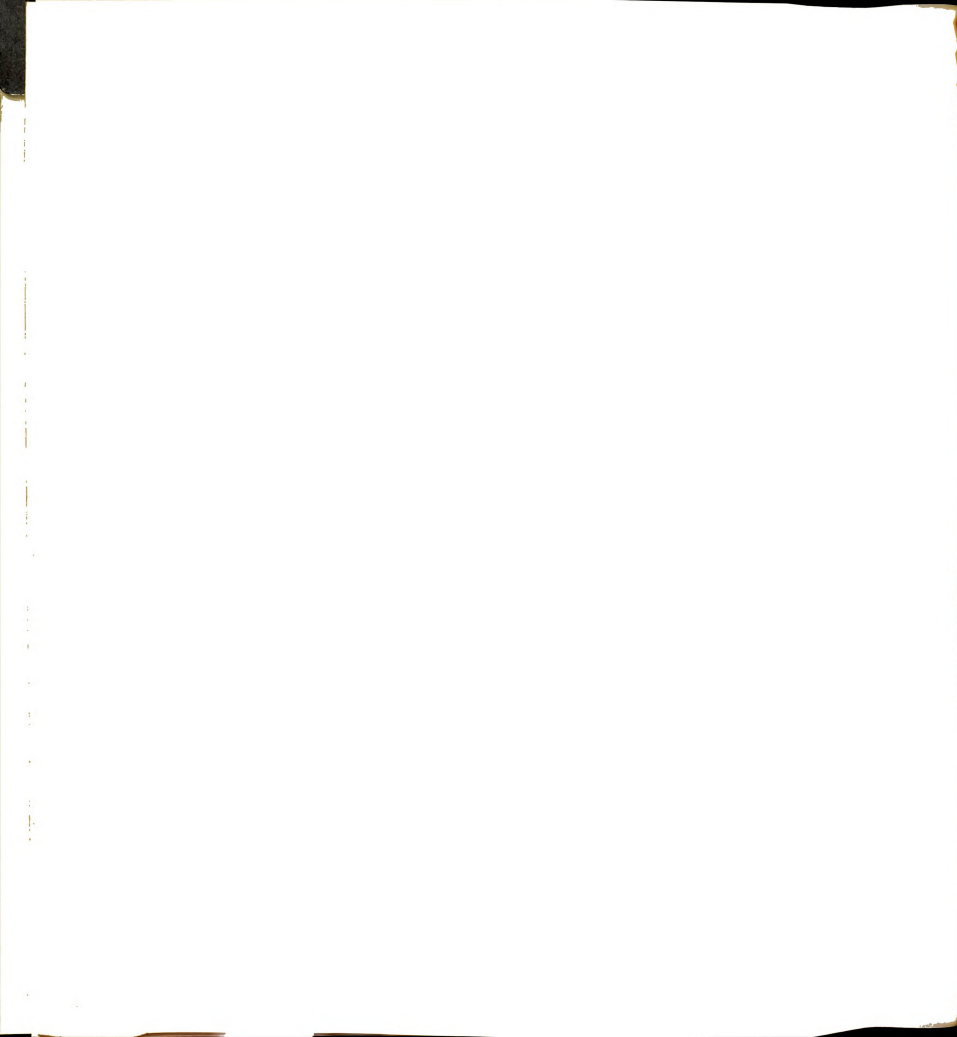
²³Ibid., pp. 377-79.



Decisions arrived at by the court would be printed and bound, including all briefs and arguments, and would be made available to all interested parties.

4. to be responsible for financing the court; a membership assessment on all practicing accountants would be invoked.

The writer believes in the basic philosophy and intentions of a high tribunal of accounting principles. However, disagreement exists in regard to Mr. Spacek's intention of placing the primary responsibility and control with the American Institute of Certified Public Accountants. The writer believes that such tribunal should be established through the joint efforts and association of all the accounting organizations, whether they consist primarily of public, industrial, governmental, or academic accountants. Such combination of organizations should adopt a charter for a completely independent court of accounting, stating the number of judges, terms of service, salaries, qualifications, etc. Positions as members of this court should be on a full-time basis, and salaries comparable to those of judges in the legal field should be established. On this latter point Mr. Spacek and the writer agree. The judges should have no interest, financial or otherwise, in any accounting firm, industrial enterprise, or governmental agency at the time he is serving as a member of the court. The financial support of the court would have to come from many sources, and probably through the various accounting organizations through dues or special assessments. This court would not be a court



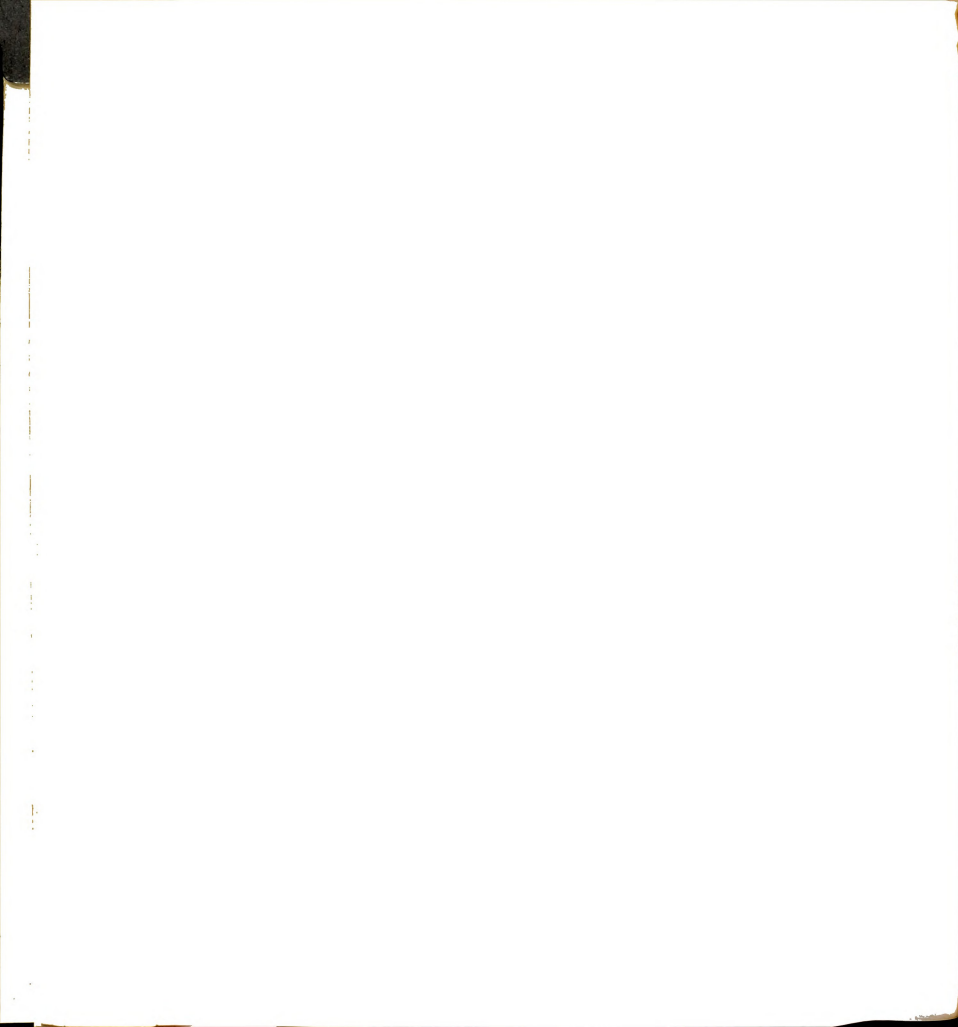
law and therefore, its decisions would not directly affect the laws
administration of the laws by regulatory bodies. Of course,
directly the court's decisions may have an effect on changing, adding,
deleting laws. This tribunal would be a professional court.

The principal advantages to emerge from such a court of
accounting principles would be:

1. Sound accounting principles based on sound reasoning
by an independent body.
2. A place and method to discover and test accounting
principles.
3. Printed briefs and arguments, which would be available
to interested parties. These would serve as a basis for
subsequent study, practice, and possible challenge. More
important, it could serve as a basis for teaching.

An accounting court could have a very pronounced influence
on the profession of accounting, and would lead to more uniform
meanings attaching to the financial statements. "General acceptance"
would be replaced by "general acceptability."²⁴ "General acceptance"
does not imply soundness or logical reasoning; it implies only actual
agreement. In accounting reports and statements, discussion in accounting
books and periodical literature, support by accounting organizations
and companies, and conformity with governmental requirements. On
the other hand, "general acceptability" implies soundness, conformity
with economic reality, and logic. The accounting court as the author

²⁴ Arthur M. Cannon, "We Need a Science of Accounting,"
Journal of Accountancy, CIX (February, 1960), 33.



sees it, would provide the foundation for establishing principles on the basis of general acceptability.

The wording of the usual accounting certificate or opinion should possibly be changed. The opinion paragraph now reads:

. . . present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles²⁵

The word "accepted" should be changed to the word "acceptable."

This would emphasize the logic or soundness of such principles to the reader, rather than emphasize that it means the "majority rules," whether or not it leads to a fair presentation of financial data.

General Principles

Introduction

The four accounting postulates proposed, the business entity postulate, the going concern postulate, the periodicity postulate, and the measurability postulate, will form the foundation for any principles advocated. It will be noted that the above postulates are ends in and of themselves. They are based on economic reality and sound reasoning.

The present concern is with accounting principles. Accounting principles are considered to be "a general law or rule

²⁵ American Institute of Accountants, Codification of State-
ments on Auditing Procedure, op. cit., p. 16.

adopted or professed as a guide to action; a settled ground or basis of conduct or practice."²⁶ As with accounting postulates, the author wishes to separate accounting principles into two groups: general principles and specific principles. The general principles will be applicable to all situations without exception; the specific principles will be applicable to specific situations. The general acceptability of such principles would, of course, be obtained through an independent body, such as the court of accounting principles which was discussed.

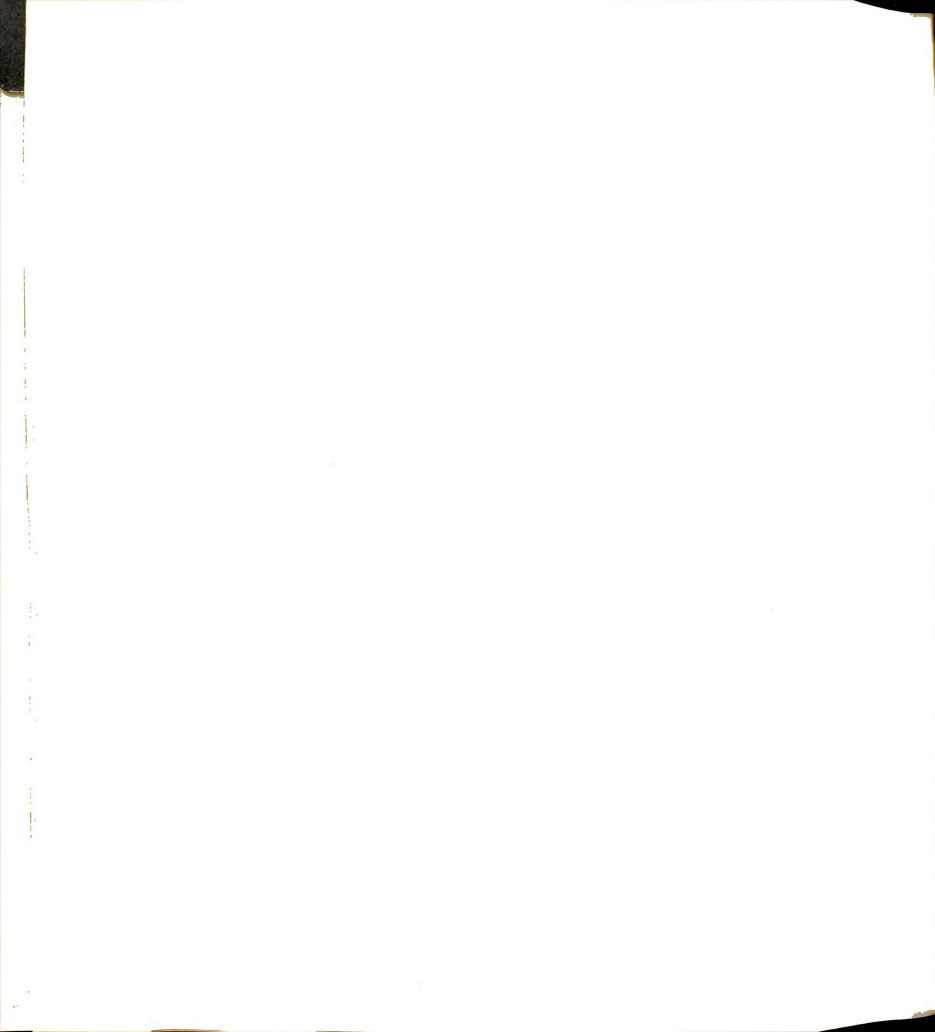
Two accounting principles which appear to fall under the "general" category are: (1) consistency and (2) full disclosure. It should be noted that such principles have universal applicability.

Principle of Consistency

Financial statements are most meaningful as sources of information about any particular business unit when such statements, prepared at several different times, can be compared with each other. Only in this way can trends be determined. In order to obtain this necessary continuity and comparability in the financial statements the accounting methods adopted and employed for purposes of analyzing and recording transactions and for their presentation in the financial statements should be employed continuously from period to period.²⁷

²⁶See Footnote 5.

²⁷Smith and Ashburne, Second Edition, op. cit., p. 52.



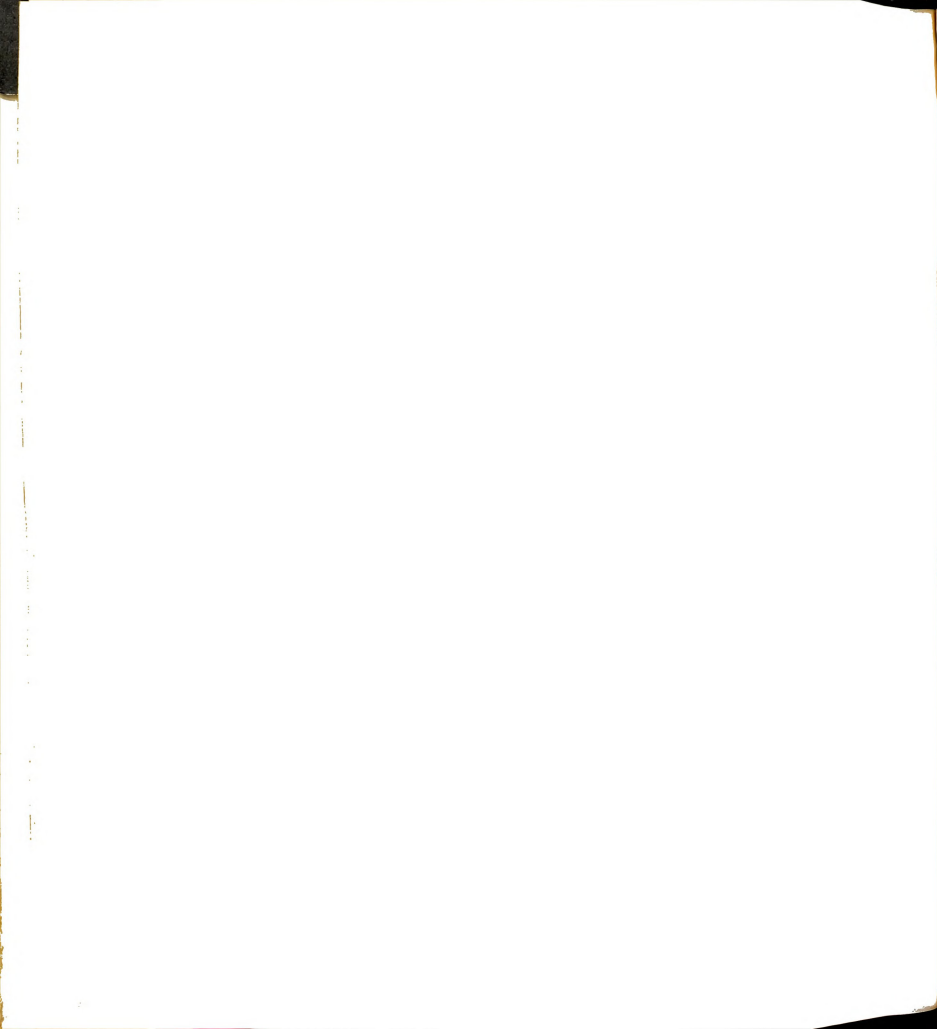
Consistency has been defined as having agreement with self or something else, as being compatible and not contradictory. In accounting the term consistency is used in connection with the application of generally accepted accounting principles and practices. Consistency means that similar items should be handled in a uniform manner within a given period and from one period to another.²⁸ "The virtue of consistency is so great that even incorrect procedures consistently applied may produce useful results."²⁹

As has been pointed out, it is useful to compare several financial statements for the same business enterprise. It is equally beneficial to compare the financial statements of one business with those of another business within the same industry. Therefore, consistency of accounting treatment not only within an individual enterprise, but within an entire industry or other group, would enhance the value of financial reports. Uniformity of accounting principles and procedures enhances the proper interpretation of financial statements and therefore should be an objective of every organization. The AICPA considers this principle of consistency to fall under the "general principle" category on the basis of its universal application.

Consistency is so important that the independent certified public accountant ends the opinion paragraph of his certificate or opinion

²⁸ R. G. Berryman, "Auditing Standards and the Law," Accounting Review, XXXV (January, 1960), 78.

²⁹ Smith and Ashburne, Second Edition, loc. cit.



the following:

"... on a basis consistent with that of the preceding year."³⁰

The principle of consistency in no way implies that flexibility would be sacrificed for consistency. Changes may be made under certain circumstances. A desirable and justifiable change in methods of presentation is permissible, but if such change in method or presentation is made such fact should be clearly stated and the dollar effect thereof, if determinable, should be indicated in the financial statements.³¹

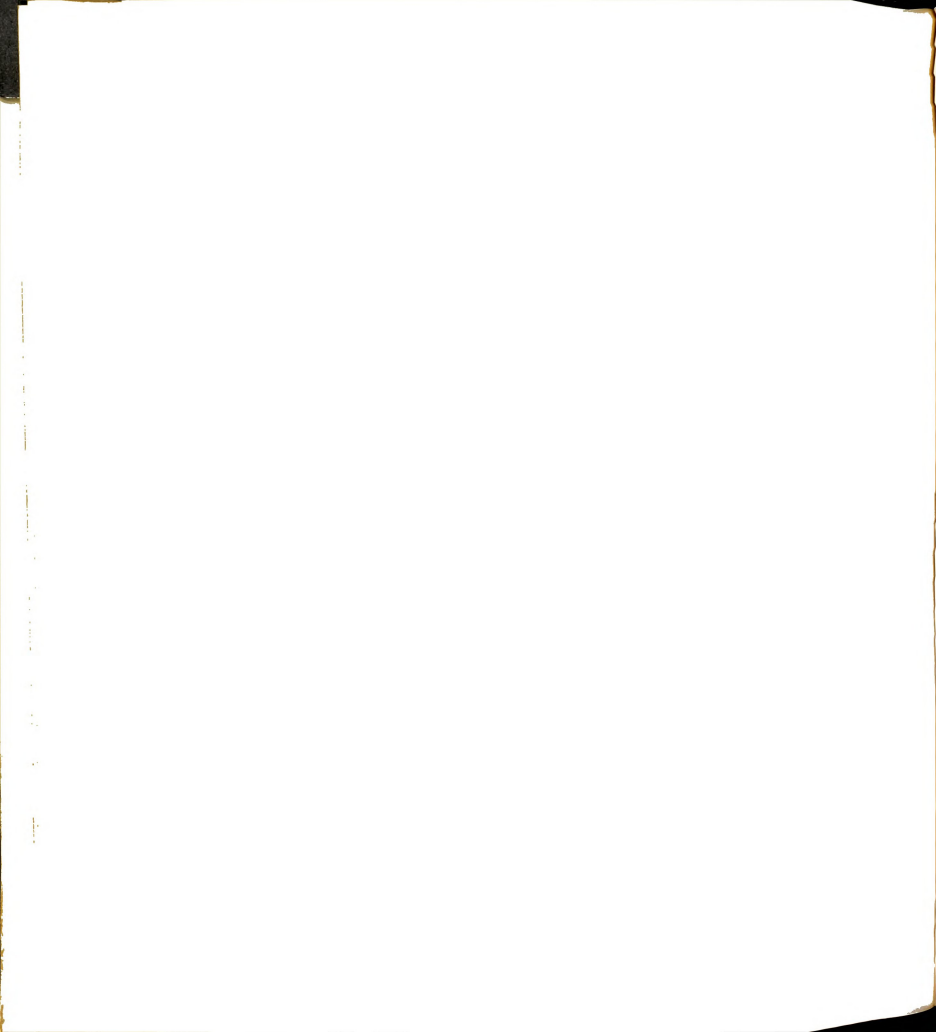
Consideration by any auditor as to whether or not accounting principles have received consistent application requires the determination of the purpose for which any change is made. A change in principle or procedure can be due to three reasons:³²

1. The changes are the proper result of altered conditions.
2. The change is to a procedure of definite preference in general practice from one not enjoying such preference, even though both procedures may be acceptable.
3. The change is merely the choice, when two or more alternative procedures are available, of a method where there is no change of circumstances and where such change could have taken place with possible ulterior motives. Changes are sometimes made merely because they bring about more favorable showings of financial position and/or operating results.

³⁰ American Institute of Accountants, Codification of Statements on Auditing Procedure, *op. cit.*, p. 16. The complete wording of the certificate is included in Chapter I.

³¹ Berryman, loc. cit.

³² American Institute of Accountants, Generally Accepted Auditing Standards, Their Significance and Scope (New York: American Institute of Accountants, 1954), p. 51.



Consistency of application of accounting principles should be considered violated where changes are made necessary by changes in operating conditions or other important circumstances.³³

The principle of consistency is also considered important by the Securities and Exchange Commission. The Commission recently amended Rule 3-07 of Regulation S-X to read as follows:

If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation.³⁴

A change from one depreciation rate to another because of changes in the operating hours of the fixed assets, or a change in the provision for uncollectible accounts made because of altered conditions, are both examples of situations which involve changes which do not involve any element of inconsistency.³⁵

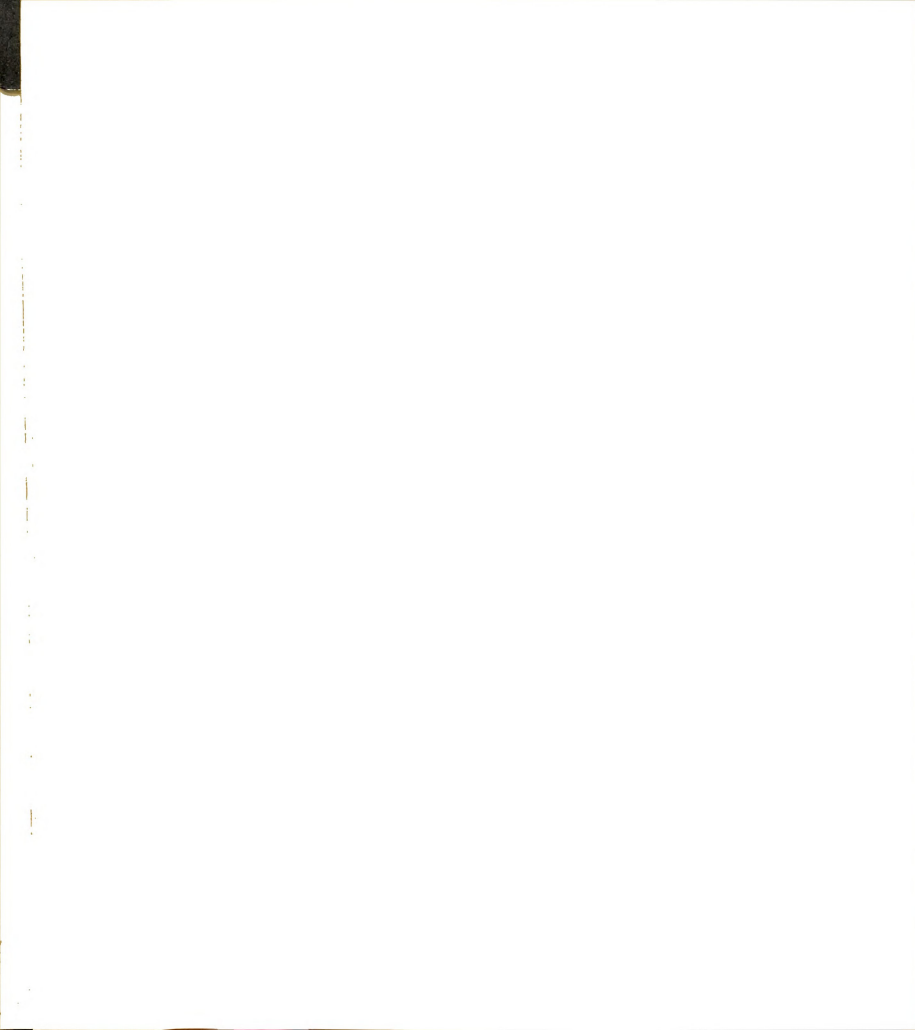
An important fact to be recognized is that in the application of the principle of consistency, the validity of the conclusion that such consistency will produce readily comparable financial statements rests on the implication that the dollar is the common denominator.³⁶

³³Ibid.

³⁴United States Securities and Exchange Commission, Case No. 21; Amendment of Rules 2-02 and 3-07 of Regulation S-X," Accounting Series Releases (Washington: United States Government Printing Office, 1956), 40.

³⁵American Institute of Accountants, Generally Accepted Accounting Standards, Their Significance and Scope, op. cit., p. 52.

³⁶Arthur W. Holmes, Gilbert P. Maynard, James Don Edwards, Robert A. Meier, Intermediate Accounting (Third Edition; Homewood: Irwin, Inc., 1958), p. 644.



ther words, the principle of consistency rests upon the measurability
 postulate³⁷ which establishes the monetary unit as a basis for preparation
 of the financial statements.

Principle of Full Disclosure

The principle of full disclosure simply indicates that all
 relevant facts which may, in some way, serve as a basis for action
 of the user of the accountant's report should be revealed in understandable
 terms. This means that all possible interpretations which any possible
 prospective readers, whether they are lay persons, accountants,
 investment analysts, stockholders, etc., might possibly place on the
 financial statements must definitely be considered before each report
 is prepared and issued. This procedure would help in avoiding mis-
 understandings on the part of the users of the financial statements.
 The law agrees with the accounting profession as to the necessity for
 disclosure of all significant data in the financial statements or
 in the certified public accountant's report.³⁸

It is in accordance with this principle that fairness of
 presentation requires consideration of adequate disclosure of significant
 facts, whether relating to form, arrangement, and content of the financial
 statements (includes supplementary footnotes), the terminology used,

³⁷ For a description of this postulate see Chapter IV.

³⁸ Berryman, op. cit., p. 78.



amount of detail given, the adequacy of descriptive matter, state-
classification, bases of amounts set forth, liens on assets, pre-
d dividends in arrears, contingent liabilities, certain types of
ictions, etc. This principle is usually considered to be applicable
fically to reporting rather than to the record-keeping aspect of
unting.³⁹

The facts necessitating disclosure should be those of a
erial nature, not simply more detail. Excessive detail, descriptions,
qualifications may only tend to obscure certain significant facts and
tionships and thus act as a hinderance rather than as a help in
ing a proper interpretation.⁴⁰

This principle not only requires the accountant to report
ificant financial facts relating to past happenings, but it also
udes an obligation to disclose matters which occur after the balance
et date but before the formal year-end statements are completed
released, if such matters are of material significance. This might
ude an item such as a settlement of a large claim for damages
inst the company.⁴¹

It should be mentioned that the principle of full disclosure
s not require a company to publicize certain kinds of information

³⁹American Institute of Accountants, Generally Accepted
iting Standards, Their Significance and Scope, op. cit., p. 52;
man, Accounting Concepts of Profit, op. cit., pp. 206-07.

⁴⁰Richard J. Bannon, "Basic Accounting Concepts Underlying
ancial Statements" (Chicago: DePaul University, 1960), p. 7 (mimeo).

⁴¹Ibid.



would be detrimental to the company or its owners. Such information can be withheld from the published financial statements.⁴²

James M. Owens sums up this problem of full disclosure, as he calls it "meaningful statement presentation," very nicely, as follows:

Financial statements and reports constitute the culmination of the accounting process. They are the means by which information is transmitted to the various groups interested in the business enterprise. Therefore, the degree of success with which the accounting process fulfills its purpose depends to a large extent on the effectiveness of the financial statements in transmitting useful information to those groups.⁴³

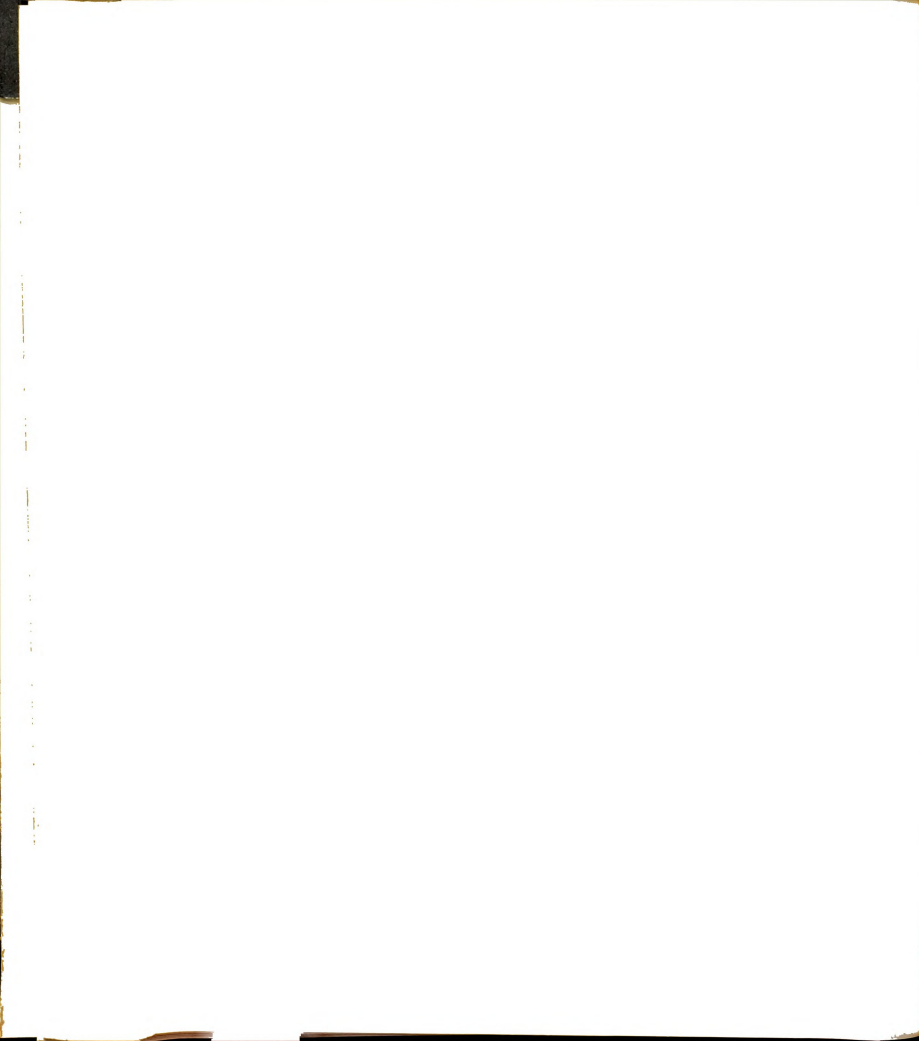
Accountants have not reached complete agreement on many points of terminology, classification, and arrangement on the financial statements. However, there is general agreement on one basic idea relating to statement presentation, namely "accounting statements should present useful data in a form which will facilitate its use by interested parties; there should be full disclosure of all significant data, arranged in such a way as to facilitate its use and analysis."⁴⁴

As financial statements are intended to provide much useful data to a wide variety of interested parties it can be appreciated that the principle of full disclosure is an important one; regardless of

⁴²American Institute of Accountants, Generally Accepted Auditing Standards, Their Significance and Scope, op. cit., p. 53.

⁴³James M. Owen, "A Review of the Basic Concepts of Financial Accounting," N. A. A. Bulletin, XXXIX (June, 1958), 66.

⁴⁴Ibid., pp. 66-67.



ture use of any financial statement this principle is applicable, therefore it is classified in the "general principle category."

Summary

A coordinated set of accounting principles should be formulated on the foundation of the accounting postulates which have been established. These principles should be general laws or rules adopted and professed as a guide to action and should be the basis of conduct or practice.⁴⁵

The general acceptance of principles should be replaced by general acceptability of principles, as determined by an independent fully qualified organization. Such an independent organization could take the form of a court or tribunal of accounting principles, similar to the one advocated by Mr. Spacek. The author agrees with Mr. Spacek on the basic purposes and philosophy of such an organization, and agrees on several of the details. Such an independent body would provide the means for establishing new principles, deleting old ones, and making changes as would be required by our changing economic environment.

The author divides accounting principles into two groups. The general principles are universally applicable; the specific principles are applicable to individual circumstances rather than on a completely universal basis.

⁴⁵ See Footnote 5.



The "general principle" category includes two principles

can be seen to exist universally, because of necessity in financial

erting. They are:

1. Principle of Consistency
2. Principle of Full Disclosure

The principle of consistency refers to the application of

ar accounting principles and methods from one period to another

der to receive the full benefits which emerge from continuity and

arability in the financial statements. The principle of full dis-

re refers to the proper presentation of all significant facts on the

cial statements in order that the reader can make the proper

pretations.

The "specific principles" will be considered in the following

er.



CHAPTER VI

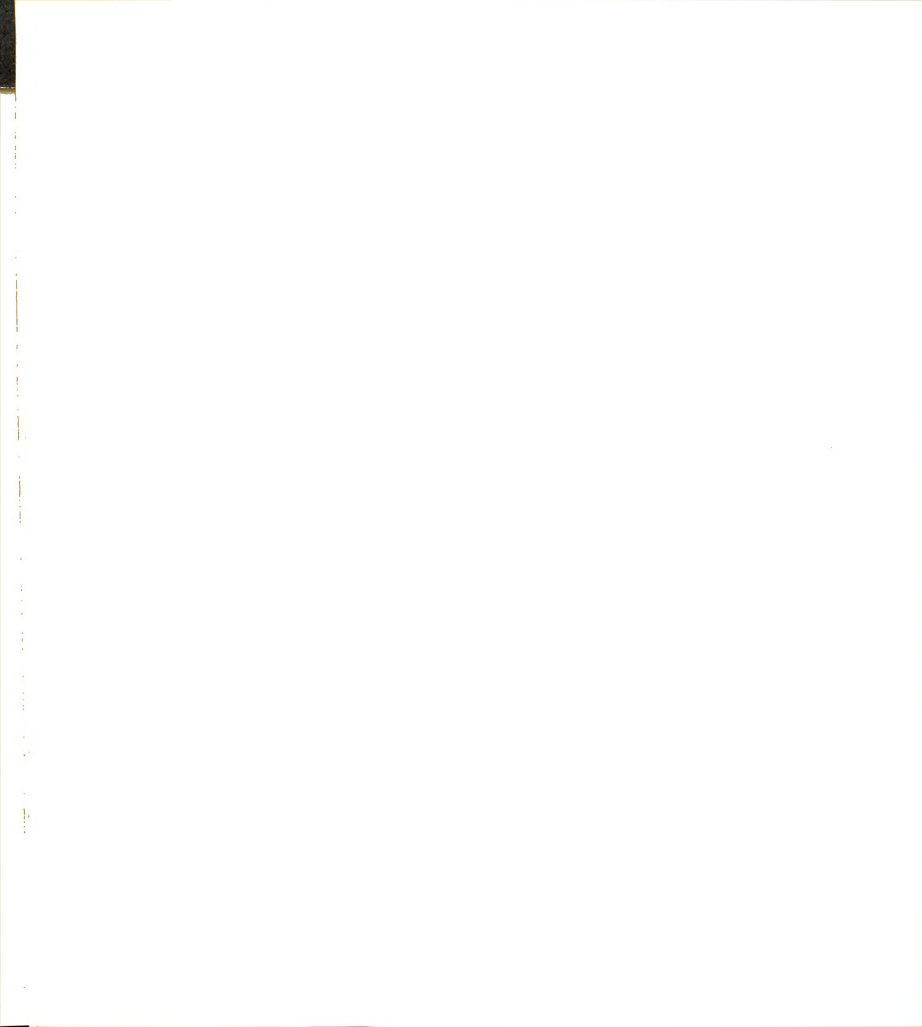
PLAN FOR A STRUCTURE OF ACCOUNTING THEORY

Introduction

The present so-called "theories" of accounting are primarily descriptions of current accounting practices. Even as merely descriptions of accounting practices such theoretical structure is far from being complete.

There can be no dispute over the fact that the vast majority of what has been written and advocated in the area of accounting theory is exclusively to double-entry accounting. This implies that there is no theory of single-entry accounting. The writer believes that this may not be the case at all; it is very possible that there can exist a theory underlying single-entry accounting.

There also appears to be an almost exclusive coverage, in the study of accounting theory, of the accrual basis of accounting with complete disregard for the cash-basis of accounting. This is so, in spite of the fact that it is widely believed that the cash-basis of accounting was extensively used and very useful for centuries before the idea of matching costs and revenues was formulated. Even today many businesses, especially small personal-service type establishments, find the cash-basis of accounting to be very adequate for their purposes. However, the cash-basis of accounting continues to be



ered in almost every accounting textbook on the intermediate level, the "theorists" continue to ignore its existence completely. This implies that there can be no theory applicable to the cash-basis of accounting; this implication has no sound logical foundation as some business enterprises can very well employ the cash-basis of accounting to arrive at fair and informative financial data.¹

Almost every book and article on accounting theory today applies almost exclusively to business enterprises organized for profit-making activities. However, since there are numerous organizations which exist for purposes other than profit-making,² it would seem that accounting for these organizations would also have to be covered in any complete structure of accounting theory which evolves.

On the basis of historical grounds and experiences, the double-entry and accrual basis of accounting, as applicable to an enterprise organized for profit, are almost exclusively considered in any attempt to formulate a "theory." This approach to accounting "theory" can be observed in most books, monographs, and articles

¹ Chambers, "Blueprint for a Theory of Accounting," *ibid.*, pp. 18-19.

² Governmental units, charitable organizations, educational organizations, etc.



cover this area.³ However, it should be realized that antiquity cannot serve as the basis for a well-founded structure of accounting theory.⁴

In the formulation of a structure of accounting theory the need for abstract thinking is present. Of course, when abstractions are to be employed, care must be exercised to eliminate the possibility of their misuse.⁵

³ For examples see:

American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements (American Accounting Association, 1957).

American Accounting Association, Accounting Concepts and Standards Underlying Corporate Financial Statements (American Accounting Association, 1948).

American Accounting Association, Accounting Principles Underlying Corporate Financial Statements (American Accounting Association, 1941).

American Accounting Association, "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements," Accounting Review (June, 1936).

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Thomas Henry Sanders, Henry Rand Hatfield and Underhill Moore, A Statement of Accounting Principles (American Institute of Accountants, 1938; Reprinted by the American Accounting Association, 1939).

⁴ Chambers, "Blueprint for a Theory of Accounting," loc. cit.

⁵ Chambers, "A Scientific Pattern for Accounting Theory," loc. cit., p. 430.



"Accounting" itself is an abstraction. When this term is used without any qualifications, it appears reasonable to assume that it refers to accounting in general--single-entry accounting, double-entry accounting, business accounting, governmental accounting, accounting for non-profit organizations, etc. Numerous statements or so-called "theories" or "principles" of accounting are really invalid because they apply this universal term, "accounting," to only one particular segment of the entire field.⁶

Organizations which require accounting data and reports differ in material particulars. These individual characteristics should determine the type of specific accounting principles which are appropriate for the particular organization being considered. In other words, all organizations are not exactly the same in every respect. Their natural differences should require differences in the accounting in order to present fair and accurate information. The particular characteristics of any organization can be derived by observation. The differences between organizations ". . . do not arise within accounting, and no proposition in accounting can dispose of them."⁷

In building a structure of accounting theory it is necessary to recognize all possible differences that exist between organizations. Some of these differences will have a very definite effect on the

⁶Ibid.

⁷Ibid.

counting principles eventually advocated; some of these differences are only artificial in nature and will have no material effect on accounting theory. In any case, differences between organizations exist in reality and they must be recognized for whatever they are worth.

The objectives and general structure of the author's plan will now be considered.

Objectives and General Structure

We shall proceed on the assumption that there exist only our primary differences in organizations. It is realized, of course, that there are many more differences between organizations, and that the assumed list is by no means final or complete. It is presented merely for purposes of illustration, in order to show the over-all workings of this plan.

The assumed possible differences between organizations are outlined and keyed as follows:

A. Type of entity

- A₁ Corporation
- A₂ Partnership
- A₃ Individual proprietorship
- A₄ Individual
- A₅ Fiduciary

B. Expectation of income

- B₁ Profit
- B₂ Non-profit



C. Continuity of activity

- C₁ Perpetual continuity
- C₂ Limited continuity
- C₃ Liquidation

D. Normal operating cycle

- D₁ Less than one year
- D₂ About one year
- D₃ Longer than one year

Each of the above categories, A₁, A₂, A₃, A₄, A₅; B₁, B₂; C₁, C₂, C₃; and D₁, D₂, D₃, would have certain principles that would apply only to that particular category. For example, consider the general category C, continuity of existence. It is known that entities differ in expectation of existence. Therefore, this general category has been broken down into three possibilities, C₁ - perpetual continuity, C₂ - limited continuity, and C₃ - liquidation. Let us consider the case of the disposition of intangible assets which have no determinable life of their own. The principle determining the proper write-off may be different for each of the three categories of continuity of existence mentioned. The principle for each case might be stated somewhat as follows:

1. In the case of category C₁-perpetual continuity: "An intangible asset with no definite physical or legal life of its own should be carried on the books indefinitely."
2. In the case of category C₂-limited continuity: "An intangible asset with no definite physical or legal life of its own, and with no determinable value at the termination of the organization's life, should be written off equitably over the remaining determinable life of the organization."



3. In the case of category C_3 -liquidation: "An intangible asset with no definite physical or legal life of its own should be valued on the financial statements at its current realizable value, if one exists; otherwise it should be shown at no value."

Each of the sub-divisions of category C might very well have many other principles. The same procedure would apply to all of the other categories being considered. It is, of course, entirely possible that some of the different categories may contain some of the same principles. For example, it may be found that the mere fact that a business is a corporation rather than a partnership in no way affects its valuation of intangible assets on the financial statements. In other words, the particular form of organization alone may cause no differences in certain principles.

It can be observed from the foregoing discussion that separate principles will apply to each individual category. The next step would be to observe a particular organization and afterward to classify it. For example, assume that we are observing a business corporation which has a perpetual life; this corporation manufactures food products and has an operating cycle of about one year. In terms of the assumed outline, this organization would be defined as

$A_1 B_1 C_1 D_2$. If the organization being observed was a partnership of unlimited life, engaged in the retail clothing business, with an operating cycle of less than one year, such organization would be defined as

$A_2 B_1 C_1 D_1$. This defining process is of the utmost importance and it

is imperative that all significant differences in the different organizations be included in the outline. It is also necessary that the individual categories be definite; the ideal structure would be one which would leave no room for confusion and ambiguity, thereby eliminating value judgments, to a large degree, in the defining of individual organizations.

Each of the separate categories (e. g. , $A_1, A_2 \dots A_5$; B_1, B_2 ; $C_1 \dots C_3$; $D_1 \dots D_3$) would have certain specific principles assigned to it. Such principles would have to be established as scientifically and as logically as possible.

After principles have been derived and assigned to each category, a rather complete outline of organizational differences and the principles applicable to each situation will evolve. This outline will actually comprise the so-called "structure of accounting theory." One should not assume that such "structure" or outline would be inflexible or absolutely rigid. As outside economic conditions change, as new theories or principles are developed, and as parts of the existing structure are found to be obsolete and no longer applicable, the structure should be changed accordingly. In this way, at any one specific time the structure would be rigid and definite, but it would also be flexible enough to meet changing conditions and could be altered if the need arose.

It appears that the central problem is to determine the specific principles which apply to a particular organization at a specific

time or for a specific period of time. Once the structure has been established this would be a relatively simple process. First the organization under consideration would be classified as was already illustrated. Referring back to the first example given, a business corporation with a perpetual life, which manufactures food products, and has an operating cycle of about one year, would be classified as $A_1 B_1 C_1 D_2$. In order to determine the specific accounting principles applicable to this particular organization all that needs to be done is to combine all of the specific principles which apply to each of the individual categories contained in the above definition of this organization (A_1, B_1, C_1, D_2). In other words, after any organization is defined in terms of its basic characteristics the specific principles applicable to each of these characteristics should be combined. The result should be a complete and consistent set of accounting principles which is applicable to the particular organization under observation.

After an organization is defined according to its component parts and a complete theoretical structure of principles applicable to each organizational unit is arrived at, the next step would be to devise such rules and procedures as are necessary in order to carry out the principles.

The importance of theory and abstract reasoning was shown to be predominant in the formulation of accounting postulates and principles. In the case of rules and procedures practical considerations will be of the utmost importance. Put another way, theory is not

involved in the selection of one rule or procedure from a group of alternatives, as long as all rules and procedures being considered are in conformity with the postulates (e. g. , entity, going concern, periodicity, and measurability) and principles (e. g. , consistency and full disclosure) previously determined. In selecting rules and procedures where alternatives are available practicality is one of the most important considerations. This implies a consideration of many factors such as cost, time, internal control, simplicity, consistency with other rules and procedures, etc. Such rules and procedures would be in a constant state of evolution and success or failure would be measured by their advantages and disadvantages as shown in actual practice.

Summary of System

Each feature of the accounting process would require a proposition, and such propositions would necessarily recognize the differences inherent in different organizations. In some cases, it may occur that a particular proposition or principle may be too general, in which case it would need to be supplemented by subsidiary propositions. The principles of accounting for each category (A, B, C, D) would be consistent with one another and would also be consistent with the observable or assumed characteristics of the entity.

The method of defining organizations by their component parts, as proposed, is a definite way of insuring that distinctive

characteristics of organizations are not overlooked in the process of formulating postulates, principles, procedures, rules, etc. It is also an important safeguard against making general statements which are assumed to be universally true but which are not valid in all instances.

This system would eliminate the necessity for establishing the "one best set of propositions" which would be universally applicable to all types of organizations. It also would consider the individual characteristics of each organization, and those organizations possessing similar characteristics would be subject to the same accounting principles. This would lead to greater uniformity in the financial statements of similar organizations, with the result of useful comparability to many interested parties.

This system would also eliminate the need to assume "anything." For example, it would no longer be necessary to assume that a concern is a "going-concern," and to establish principles on that basis. If an organization is found to be a going-concern it would be subject to certain principles; however, if an organization is found to be in the process of liquidation, it would be subject to some entirely different principles. It would be ridiculous to assume that a concern in the process of liquidation is a going-concern on the basis of an assumption when facts show otherwise.

The breakdown of organizations by their component parts and the research and assignment of definite principles to each of the

established categories can be controlled by a central body. This group can be similar to the "accounting court" advocated by Mr. Leonard Spacek.⁸ It may take the form of the recently established "Accounting Principles Board" of the American Institute of Certified Public Accountants.⁹ Regardless of the final form that this central controlling body takes, it is necessary that it be independent. It is also necessary that such body have sufficient funds to conduct all necessary research, which would be of a continuous nature.

⁸Spacek, "The Need for an Accounting Court," op. cit., pp. 368-79. The "accounting court" is discussed in Chapter V.

⁹See Chapter III for discussion.

CHAPTER VII

SUMMARY AND CONCLUSIONS

The most basic problem confronting the accounting profession today is one dealing with the nature of accounting theory and its structure. The phrase "generally accepted accounting principles" is used frequently in written and oral communication, both within and outside the accounting profession. It is disturbing to find that the employers of such phrase are not certain of the existence of such a body of principles. If such principles are assumed to exist, there is no uniformity as to the assumptions of their nature.

The independent public accountant's report or certificate states, that in his opinion, the statements have been prepared in conformity with "generally accepted accounting principles" when, in fact, he is not sure of the existence and nature of such principles. Industrial accountants, governmental accountants, and accountants in the educational field are all confronted with the same problem--what is the nature of accounting principles if they do, in fact, exist?

The phrases "accounting principles" and "generally accepted accounting principles" are so often seen in print and are so often referred to in oral communication, that these terms are being used and referred to by persons and organizations outside of the accounting profession. The wide distribution of published corporate

financial reports is one of the major reasons that many persons have been exposed to these "principles," on which the financial statements are supposed to have been prepared. If the accounting profession is itself confused, how can the layman be expected to understand accounting principles?

"Generally accepted accounting principles" have been a subject of controversy for a long period of time, but this subject has just recently started to receive the attention it deserves. The future direction of the accounting profession depends to a large extent upon building a structure that can be used as a guide in the formulation and testing of accounting principles.

The basic purpose of accounting is to provide useful information to many interested parties--management, stockholders (also partners and individual proprietors), creditors, investment and brokerage firms, governmental units, labor, courts of law, customers, general public, etc. The preparation of the financial statements falls primarily to the accountant; the analysis and interpretation of such statements is the concern of many parties. The accountant must bear in mind the necessities of each of these groups in presenting financial data on the statements, in order to give all interested parties all needed information in a clear and fair manner. In other words, the accountant's report should be presented in such a manner as to be of maximum usefulness to any party analyzing and interpreting the statements, whoever such party may be.

The intended uses of the financial statements should be seriously considered when developing the structure of accounting theory. The usefulness of the statements is greatly dependent upon the underlying principles. There should be developed some definite accounting principles which the users of the financial statements could rely upon in making their analysis and interpretations. Without such structure the users of the financial reports cannot rely on them with a full degree of confidence.

Since the primary purpose of accounting is to provide useful information to many interested parties, a definitive structure of accounting theory is of the utmost importance. In arriving at a sound structure, our present "structure" must be re-examined and "overhauled."

The existing body of "generally accepted accounting principles" and standards has been built up over the past thirty years by several factors, the most important being:

1. The impact of the thinking and pronouncements of the American Institute of Certified Public Accountants and its Committee on Accounting Procedure.
2. The impact of the thinking and pronouncements of the American Accounting Association and its Committee on Concepts and Standards Underlying Corporate Financial Statements.
3. The influence of the Securities and Exchange Commission.
4. The practices and procedures adopted by businesses and in use before any regulatory bodies came into existence.

5. A considerable volume of published literature in the area of accounting theory.

The American Institute of Certified Public Accountants, through its various committees, has conducted continuous studies on various accounting and auditing problems of a controversial nature or of major significance. The result of such studies has been the publication of the Accounting Research Bulletins and the Statements on Auditing Procedure. These publications have been regarded as authoritative by many because of two factors: (1) the reasonableness of the pronouncements and the eminence of the committee members formulating them, and (2) the acceptance of these publications by the Securities and Exchange Commission, almost without exception, as a guide to accounting practice. Recently the opinions of the Institute's Committee on Accounting Procedure have been upheld by the federal courts.

The American Accounting Association has also undertaken research programs in the area of accounting theory, and has contributed valuable publications in the form of monographs and articles.

The research programs of the American Institute of Certified Public Accountants and the American Accounting Association have had the same basic objective--the formulation of a structure of accounting theory. However, both organizations have employed opposite approaches. The Institute has approached their research on an item-by-item basis; they used the inductive approach and reasoned

from a specific problem to the principle governing such problem's solution. The Institute's approach led to the consideration of many unrelated problems. The American Accounting Association, on the other hand, has used the deductive approach; principles were considered prior to the investigation of specific problems. The differences in approaches can possibly be reconciled with the result of a codification of "generally accepted accounting principles."

Active cooperation has always prevailed between the Securities and Exchange Commission and the various professional organizations and individuals. Many business corporations violated the accounting principles recommended by the professional organizations until the Securities and Exchange Commission came into existence. Only the enforcement powers of the Commission and the stock exchanges have brought about the degree of compliance which exists today. The SEC has had a very profound effect on both corporations and the accounting profession; since its establishment there has been a definite improvement in the reporting practices of corporations in this country. More information of a material nature is now included in corporate reports than ever before. The SEC has dealt with individual problems as they have arisen, in much the same way as the American Institute of Certified Public Accountants. Publications of the Institute and the American Accounting Association have served as useful guides. The development of a generally accepted body of accounting principles

appears to be a prerequisite for the successful functioning of the Securities and Exchange Commission as a regulatory body.

Many other organizations and events have had their influence on accounting principles, as they now exist. One of these influences was the Internal Revenue Code. However, most often administrative feasibility has overshadowed the consideration of sound accounting principles under the Code.

Many authors, through books, monographs, articles, etc., have contributed to the development of accounting principles and have stimulated thinking in this area.

Despite the fine efforts and contributions made by the various organizations and individuals, no authoritative or generally recognized body of accounting principles or structure of accounting theory exists today. The formulation of such a structure of accounting theory is the most important accounting problem presently existing.

In order to make accounting meaningful, postulates and principles have to be established; however, of necessity the postulates and principles of accounting must differ from those of a physical science. The physical sciences are concerned with the study, observation, and classification of phenomena; the primary consideration is in learning about the natural characteristic of things and reasons for their existence. The physical sciences are extremely interested in the establishment of verifiable general laws or principles. These sciences first establish

a result or observation of a phenomena; they then look backward to the principles which caused such phenomena. Such principles are defined and only the discovery of an error in the original analysis can make such principles invalid. As can be observed, the scientist uses inductive reasoning in arriving at principles.¹

Accounting, like the physical sciences, works with facts. However, the similarity ends here. Science looks within the fact to discover the principle; accounting cannot use this approach as there are no natural phenomena to observe. Accounting must look to the desired end result and create and define principles which will achieve this end result. The objective should be the most adequate presentation of financial data in the reports to meet the needs of all segments of society. The principles adopted should be directly influenced by the needs of accounting.²

The structure of accounting should not rest on current accounting practices. Instead, the structure of theory should be based upon a network of ideas which will serve as a basis and criteria of performance.

The foundation for a structure of accounting theory should be a series of postulates which are formulated on the basis of economic

¹ Jennings, "Accounting Research," op. cit., p. 548.

² Ibid.

reality and sound reasoning, and not on the basis of the requirements of income determination and balance sheet valuation. Postulates are basic assumptions on which principles rest and are derived from the political and economic environment and from the thought and custom of all segments of the business community. Postulates are of two types. The general or all-inclusive postulates are very general in nature and are broad enough to cover all possible situations; such postulates are not directly applicable to a definite accounting situation, but do provide the basis for the specific postulates and principles. The specific postulates are applicable in the vast majority of situations, but because of some exceptions are not universally applicable.

On the basis of economic reality and logical reasoning the author has determined the existence of four specific accounting postulates:

1. Business entity postulate--shows the existence of an organization apart from its owners.
2. Going concern postulate--shows that it is logical to assume that an organization is a continuing venture.
3. Periodicity postulate--shows that it is necessary to divide the life span of an organization into shorter periods of time for reporting purposes; the most logical period is one year.
4. Measurability postulate--shows that in order to combine heterogeneous items into meaningful data it is necessary to convert these items into a common denominator.

A coordinated set of accounting principles should be formulated upon the foundation of the accounting postulates. These principles should be general laws or rules to be used as a guide to

action and should be the basis for the practice of accounting; they are simply rules of human behavior adopted by man with a view to their usefulness for the particular needs of society at a given time and place. Such principles are subject to evolution and change; they are not discovered, but are developed.

The "general acceptance" of accounting principles should be replaced by the "general acceptability" or soundness of such principles, as determined by an independent and highly qualified organization. This independent body could take the form of a tribunal or "court of accounting principles." Such an independent body would provide a means for establishing, deleting, and changing accounting principles in order to produce accounting reports which would meet the needs of all segments of society.

The general principles which appear to be universally applicable to all situations are:

1. Principle of consistency--the application of similar accounting principles and methods from one period to another in order to receive the full benefits which will emerge from continuity and comparability in the financial statements.
2. Principle of full disclosure--the proper presentation of all significant facts on the financial statements in order that the reader can make proper interpretations.

Organizations which require accounting reports differ in material respects. Individual characteristics should be taken into consideration in determining the specific accounting principles applicable to a particular organization. Specific principles should apply to individual

characteristics rather than to organizations as a whole. After an organization is defined according to its significant and basic characteristics, the specific principles applicable to each of its characteristics are combined. The result is a complete and consistent set of accounting principles for the particular organization. This set of principles will produce fair and accurate reports.

Some of the more important aspects of the structure of accounting theory have been considered in this dissertation. Much more research in this area remains to be accomplished by the professional and governmental organizations, universities, and individuals. It is the sincere hope of the author that research in the area of accounting theory will eventually lead to financial reports which can be relied upon by all segments of society.

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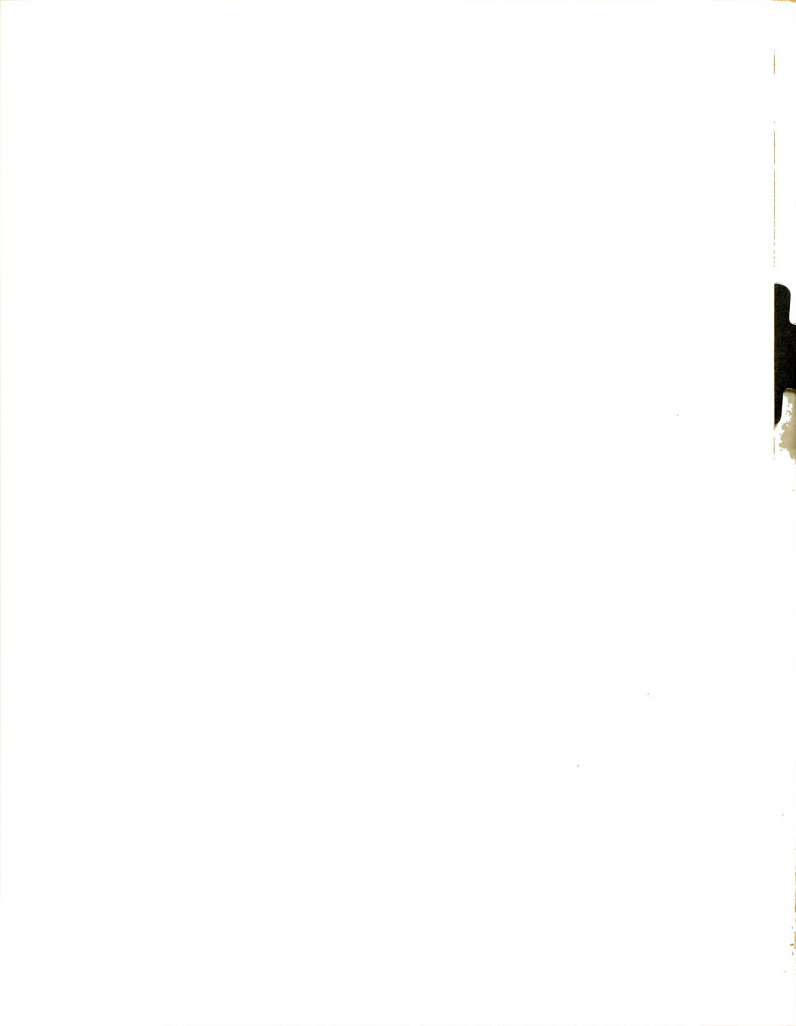
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