Chapter 4

The Search for Principles

CHAPTER OBJECTIVES

After studying this chapter, you will be able to:

Trace the development of accounting thought over the past 50 years.

Contrast the various meanings of the word *principles*.

Define what is meant by *generally accepted accounting principles*.

Analyze the impact the small investor has had on the development of accounting practice.

Define what is meant by a postulate in accounting.

Define what a standard is and how it differs from a principle.

Explain why the search for principles was so frustrating.

CHAPTER OVERVIEW

The Search Begins

The attempt to define *generally accepted accounting principles* is traced from the invention of the term in the 1930s to the end of World War II.

The Search Quickens

The end of World War II brought increasing prosperity, an emphasis on investing this new wealth in the stock market, and a renewed emphasis on sound financial reporting.

The Search Shifts

By the late 1960s, it was apparent that *principles* were hard to define and the search turned to a consideration of *standards,* which were seen as less pretentious.

The Search in Retrospect

Principles are difficult to define because of the inherent complexity of accounting theory. Their implications are sometimes difficult to sustain because of the economic consequences that flow from accounting information.

Conclusion

Broad concepts, whether called principles, postulates, or standards, are a necessary part of accounting. Nevertheless, it must never be forgotten that as a social science, accounting depends upon the wisdom, judgment, and integrity of accountants.

Every audited financial statement today is accompanied by an auditor's report attesting to its compliance with "generally accepted accounting principles." But what exactly are these principles? Are they the same that one finds in a "Principles of Accounting" text? And who decides what principles are accepted and how widely they must be accepted before they are considered to be generally accepted? What happens if these principles are required by the SEC, say, but not approved by practicing accountants, as has happened? Do they then conflict with generally accepted accounting principles? What happens when the SEC's chief accountant concludes that "procedures so generally followed among accountants as to constitute substantial precedent are not always fundamentally sound?"[1] And, just why do we need these principles in the first place? These questions have never been answered satisfactorily and have set the stage for an ongoing debate on just what precisely constitutes generally accepted accounting principles (GAAP), just what exactly the term *principles* means, and how these principles might be derived, if at all.

This chapter outlines that debate as it has developed over the past 50 or 60 years. The first section relates how the word came to be chosen and the subsequent efforts to give it meaning. The second section develops an approach to theory building which uses the concept of postulates. The third section turns to the more recent approach based on objectives and standards. The rest of the chapter is a critical overview of the theoretical framework developed by the FASB. Later chapters develop at more length the revolutionary developments in theory which have taken place in the past two decades.

THE SEARCH BEGINS*

The precise nature of accounting principles was a matter for debate from the very start as Exhibit 4-1 shows. The word *principle* derives from the Latin *principe*, meaning first in the sense of elementary. Since the first texts accounting students encounter are elementary, the term *Principles of Accounting* is wholly appropriate. What we study in a first accounting course are its principles in the sense of the material being first in time and first in terms of difficulty. However, these topics are not necessarily the principles of the subject in the sense of being first in logic or the subject's foundation stones. One learns, for instance, a great deal of mathematics in school and in college without ever touching the deep philosophical questions which form the foundations of that subject. Many use probability tables in statistics without ever delving into the precise nature of uncertainty. The same is true for accounting. Principles of Accounting might be a first course, but it is hardly a course in the fundamental truths of accounting. For a study of these, as opposed to an introduction to the elements of its practice, one must turn to a course in accounting theory.

First Efforts

Many individuals and groups began work in the 1930s on elucidating what they thought should be meant by accounting principles. First out of the block, somewhat to the chagrin of the AIA, was the American Accounting Association (AAA). Under the leadership of Michigan professor William Paton, who was appointed the first research director of the AAA at the start of 1936, the AAA published in June 1936 the first of what would be a series of brief monographs on the principles of accounting. The 1936 edition was entitled *A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements*.[5] Its expressed hope was that it would be possible "to agree upon a foundation of underlying considerations which will tend to eliminate random variations in accounting procedure resulting not from the peculiarities of individual enterprises, but rather from the varying ideas of financiers and corporate executives as to what will be expedient, plausible, or persuasive to investors at a given point of time." In particular, the Association sought to eliminate the confusion arising from the revaluation of assets up and down according to changes in price levels and expected business conditions by emphasizing the cost basis of accounting. Some saw in this action an attempt to impose a uniform system on accounting; it really just reflected the distrust of

* The title of this chapter derives from one in Stephen Gilman's *Accounting Concepts of Profit* (1939). It was also used as the title of Reed Storey's monograph (1964).

academics for the subjective judgments of financial managers. A review of the accounting practices of the time certainly provides a good basis for their distrust; unfortunately, distrust does not necessarily lead to good accounting theory.

Four years after the appearance of the Tentative Statement, Paton and Illinois professor A. C. Littleton, both members of the 1936 Executive Committee of the American Accounting Association, published *An Introduction to Corporate Accounting Standards*.[6] The intention of the authors

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EXHIBIT 4-1 The Nature of Principles

Gilbert Byrne, in his prize-winning and influential paper presented at the Fiftieth Anniversary Celebration of the American Institute of Accountants (AIA) in 1937, insisted that principles were fundamental truths.[2] Or, as Webster's *New International Dictionary* puts it: "A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which others are founded; a general truth; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate."

George May was to respond swiftly to Byrne's suggestion that principles should be fundamental truths, arguing that the more appropriate definition was one from the Oxford dictionary, reading: "A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice." He claimed that this was the meaning that the AIA committee intended when it used the term.[3] One has to give credence to May's interpretation both because he essentially wrote the report and because this connotation corresponds most closely with the examples of principles that were attached to May's letter of September 22, 1932.* Freely transcribed, these read:

1. Profit shall not be recognized before a sale occurs.
2. All expenses should be charged to the income statement and not to retained earnings.
3. The retained earnings of a new acquisition, earned prior to acquisition, may not be added to the retained earnings of the acquirer, that is, the purchase method rather than the pooling method should be used.
4. Dividends on treasury stock are not income to the company although treasury stock may be treated as an asset.
5. Loans to related parties should be segregated from other loans.[4]

These so-called principles are not Byrne's broad underlying truths. They are much more in the nature of May's rules. In fact, these principles presuppose the existence of the whole set of fundamentals that form the body of accounting: They assume debits and credits, balance sheets and income statements, and so on. Nevertheless, they do give some rather fascinating insight into the way the known body of accounting was being manipulated at the time.

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* The background to this letter is described in the last chapter and in Chapter 8.

was to present a framework of accounting theory conceived to be a "coherent, coordinated, and consistent body of doctrine" which would support the principles enunciated in the 1936 statement. Significantly, they avoided the word *principles*, replacing it with the word *standards* because they felt the former suggested "a universality which obviously cannot exist in a service institution such as accounting." The monograph is considered by many to be a classic and has sold tens of thousands of copies. It is particularly noteworthy for its development of the concept of matching costs to revenues, the process taught to every accounting student for over 50 years now. See Exhibit 4-2 for Littleton's description of the meaning of matching.

Subsequent editions of the AAA's 1936 statement did not make substantive changes in the content but, rather fascinatingly, the title kept changing, indicating each time the current state of academic theory. The 1941 edition, for instance, dropped the adjective *tentative* in the title, while the 1948 edition substituted the term *concepts and standards* for the term *principles*. The series ran its course in 1957 in a document summarizing all the previous work. Here, for the first time, the Association allowed that value was an appropriate measure for assets and equal to the "sum of the future market prices of all streams of service to be derived, discounted by probability and interest factors to their present worths."[8]

The precise impact of these statements is hard to determine because, due to limited resources and the theoretical orientation of the members, the general approach was that of establishing broad basic principles rather

EXHIBIT 4-2 Matching Expenses with Revenues

Littleton defined matching in these words:

The central problem of accounting is to bring into association, in the present, the revenues identified with the present and their related costs, and to bring into association, in the future, the revenues identified with the future and their related costs. In solving this problem, those who use accounting are, in effect, matching enterprise efforts and accomplishments. Some efforts are effective in the present; they are measured by the costs (effort) currently deductible from revenue (accomplishment); they are the revenue costs of the present. Other efforts are expected to be effective in the future; they are measured by the costs that are deferred as being revenue costs of the future (assets). Some efforts prove ineffective in the present and are judged unlikely to be effective in the future; they are measured by the costs that must be currently deducted from revenue as recognized losses. The fundamental problem of accounting therefore is to cut through a continuing stream of costs and correctly assign portions to the present and to the future. . . .[7]

This view was to dominate accounting thought for several decades.

than specific rules; however, many members of the AAA served, and continue to serve, on rule-making committees where the broad principles were applied. Among the changes induced by altering theoretical perspectives was the nature of the presumed user group. The definition of this group has tended to broaden over the years. There has also been a consistent recommendation of the all-inclusive concept of income, partly as a result of that distrust of academics of the individual judgments of accountants and managements of corporations alluded to above. This judgment coincided with the views of the SEC and ultimately won out as the ruling view.

Early Foundations

The AAA's *Tentative Statement on Accounting Principles*, described in the previous section, did not appear in a vacuum. Paton himself had written a doctoral thesis which was published under the title of *Accounting Theory* in 1922. The book is radical even by today's standards. In it he espouses the "liberal view that, ideally, all bona fide value changes in

EXHIBIT 4-3 Paton's Postulates

According to Paton, only if "the accountant sees clearly the foundation upon which she (or he) is standing" will she avoid "improper applications and erroneous general conclusions." Toward that end he listed six postulates together with their limitations:

1. The *existence of a distinct business entity*: This is universally assumed even though in reality it is only a figure of speech.
2. The *continuity of this entity*: The assumption of a going concern is largely one of convenience.
3. The *balance-sheet equation*: The equality occurs only because we "plug" whatever gaps might exist by adjusting the owners' equity accounts.
4. The *monetary* postulate: This is the unfounded assumption that "a statement of assets and liabilities in dollars and cents is a complete representation of the financial condition of the enterprise on the date of the statement."
5. The *cost* postulate: This is the equally unfounded assumption that "cost gives actual value for purposes of initial statement."
6. The *revenue recognition* postulate: This assumes that "net revenue or profit suddenly appears, full-blown, on some specific occasion, commonly that of the sale," which is clearly not true.

Never before, and seldom since, has an author so succinctly and so beautifully captured the limitations of historical cost accounting. As with Pacioli, Paton's acerbic comments read as freshly today as when they were written.

either direction, from whatever cause, should be reflected in the accounts. . . ."[9] "It is above all important," he says, "that the accountant's statements present as accurate a picture of *current* data in terms of the actual dollar as of the date of the statement."[10] He is equally insistent that by "no reasonable line of analysis can the interest paid to the bondholder be classed with operating expense while the return to the stockholder is treated as a distribution of net revenue," that is, what we now call net income.[11] The book ends with its list of postulates appearing in Exhibit 4-3, which he describes as the basic assumptions of accounting.

Paton was not the only one to make an early and notable contribution to the literature. Stanford professor John Canning made a valuable contribution to accounting theory in his *Economics of Accountancy*.[12] The subtitle, "A Critical Analysis of Accounting Theory," helps explain his contribution. While Canning acknowledged in his preface that he drew from the writings of Cole, Hatfield, McKinsey, Montgomery, Paton, Stevenson, and Sprague, he also compared then-current accounting thought with economic theory, particularly with that set forth by the American economist Irving Fisher. The two most important areas discussed by Canning were asset valuation and income measurement. His comments on these areas and his definitions of assets and liabilities, rooted as they are in economics, are still quoted today in FASB discussion memoranda and appear in later chapters of this book.

The Rise of the Investor

The most important shift in basic accounting thought coming out of these writings and the discussions of the late 1920s and early 1930s was the change in the objective of accounting from that of presenting information to management and creditors to that of providing financial information for investors and stockholders. The pressure for this change in objective came from the financial sector and stock exchanges rather than from accountants. The rapid growth in the widespread ownership of corporations, particularly during the first few years following World War I, created new needs for accounting information. The average number of shares listed on the New York Stock Exchange in 1900 was about 60 million, compared with 180 million in 1917 and 1,212 million in 1930 (unadjusted for stock splits).[13]

The change in the objective of financial statements led to:

1. A de-emphasis of the balance sheet as a statement of values.
2. A consequent increased emphasis on the income statement and a uniform concept of income.
3. A need for full disclosure of relevant financial information, by present-

ing more complete financial statements and increasing the use of footnotes.

4. An emphasis on consistency in reporting, particularly with respect to the income statement.

There is also evidence of an increasingly arbitrary use during this period of deferrals of losses and income items to permit a smoothing of income from one year to the next. These actions led to the attempts in the 1930s to establish better standards for the presentation of the income statement.

These changes are evident in the literature and in the pronouncements of several interested organizations before and after 1930. It is interesting to note that these changes in accounting thought were not the direct result of the stock market crash of 1929 nor the Great Depression of the 1930s, but rather they were the result of institutional changes which had begun much earlier and to which accountants had not yet adapted. Of course they were made more urgent by the events of the period.

Other Notable Attempts

In 1938, at the request of the Haskins & Sells Foundation, Harvard professor Thomas Henry Sanders, California professor Henry Rand Hatfield, and Yale Law School professor Underhill Moore published *A Statement of Accounting Principles*,[14] which purported to "set forth the principles and rules of accounting which dictate what should appear in a balance-sheet and an income statement and in the accounts from which they are compiled." The content of the monograph reveals that the authors were more concerned with accepted practices—practices which deviate quite radically in certain instances from accepted practice today. For instance, the authors would permit companies to defer losses by placing them on the balance sheet as assets and amortize them slowly over time. They also would permit companies to record bond discounts as assets.[15] It was practices such as these which caused the FASB to set its face so firmly against deferred assets and liabilities. The authors do devote a small section of the monograph to what they call *conventions*, which they describe as "hardened practices" underlying the preparation of balance sheets. They include the historical-cost basis for assets and the going-concern concept as two examples of conventions. For all its faults, this monograph is a fascinating repository of accounting practice at the time and an important source of data for positive research in accounting.[16]

Stephen Gilman's *Accounting Concepts of Profit*, the first comprehensive discussion of accounting theory since the shift in emphasis from the balance sheet to the income statement point of view, effectively closes this period of accounting theory development.[17] He attempts to sort out the terminological tangle caused by the introduction of the word *principles* into the audit report. He distinguishes between rules, which can be made, and principles, which cannot. He suggests that the term *doctrine* more accurately describes the "teachings" of accountants. He also points out that many books which describe themselves as Principles of Accounting do not even have the word *principles* in the index.[18] But in the end the problem of how to define generally accepted accounting principles was seen to lie deeper than mere semantics. The debate over words hid a far more serious issue: who was to determine the disclosure of financial information and by what means.

CHECKPOINTS

1. What do you think a principle is? How does your own definition compare with that of May and Byrne? On whose side are you?
2. Explain in your own words why Paton and Littleton preferred the term *standards* to the term *principles*.
3. What did Paton mean by the term *postulate*? How does this compare with Byrne's use of the word *principle*?
4. What impact did returning GIs have on accounting and why?
5. Why did the AAA in 1936 think principles were important?

THE SEARCH QUICKENS*

The search for broad accounting principles was renewed immediately after the war. Again, the AAA led the way by releasing its 1948 revision of the Tentative Principles now relabeled *Accounting Concepts and Standards*.[19] The AIA's Committee on Accounting Procedures also resumed its work and by 1953 had issued 17 new bulletins. As before, though, they were piecemeal in approach and not intended to forward the search of broad principles. Also, they were not binding on the membership of the AIA. They were required only to find *substantial authority* for the practices they selected.

The Accounting Research Division

In 1959, acting on the recommendations of the Special Committee on Research Programs, the Institute was reorganized to advance "the writ-

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* This section of the chapter relies heavily on John L. Carey, *The Rise of the Accounting Profession*, vol. II (AICPA, 1970).

ten expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others."[20] One of the objectives of the reorganization was to be able to attack the broad problems of financial accounting at four levels:

1. Establishment of basic postulates.
2. Formulation of broad principles.
3. Development of rules or other guides for the application of principles in specific situations.
4. Research.

A permanent accounting research staff was recruited to carry out the research program with the intent that the results of its efforts, "as adopted by the [Accounting Principles] Board, should serve as the foundation for the entire body of future pronouncements by the Institute on accounting matters, to which each new release should be related."[21]

California professor Maurice Moonitz, the newly appointed research director and a disciple of J. B. Canning, whose work was mentioned earlier, was commissioned to produce *Accounting Research Study No. 1 (ARS 1)* on the basic postulates in accounting.[22] Some examples of postulates appear in Exhibit 4-4. Moonitz and Robert T. Sprouse, then a professor at Stanford and later to become a member of the Financial Accounting Standards Board, were subsequently commissioned to produce *Accounting Research Study No. 3 (ARS 3)* on the subject of principles of accounting.[23] Some examples of principles appear in Exhibit 4-5.

Postulates in *ARS 1* were seen as basic assumptions or fundamental propositions concerning the economic, political, and sociological environment in which accounting must operate.[24] As the American Institute of Certified Public Accountants (AICPA) put it in 1958:

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

It was argued then that, if principles of accounting were actually just rules, it should be possible to deduce them from the more basic assumptions called *postulates*.[26]

The response to these two studies, which appeared in 1961 and 1962, respectively, was swift and fairly dramatic. They were issued with a loose insert stating that they were not acceptable to the Board because they were too different from generally accepted accounting principles at the time. Comments from individual Board members were published at the end of the studies. Leonard Spacek, managing partner of Arthur Andersen, commented that there was only one postulate. He summed this up as