

An abstract geometric design featuring a central point from which several lines radiate outwards. A prominent rainbow spectrum is visible, with colors transitioning from red at the top to blue at the bottom. The design is set against a dark background with some lighter, textured areas at the top.

FIFTH EDITION

ACCOUNTING THEORY

TEXT AND READINGS

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MYRTLE CLARK

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ACCOUNTING

THEORY

TEXT AND READINGS

Preface

The major objective of this fifth edition is to provide accounting students a theoretical background with which to evaluate current accounting practice. This edition represents a major revision from its predecessors and is designed to suit the needs of accounting professionals into the 21st century. Additional material has been added on the historical development of accounting. The approaches to accounting theory, theories on the uses of accounting information and the Conceptual Framework project are presented at the beginning of the text, and serve as the framework for the discussion of various issues throughout the book.

Accounting education has experienced dramatic changes over the life of this accounting theory text. At its inception, much of what was then considered theory was in reality rule memorization. In recent years, external and internal pressures have emerged that are influencing how accounting is taught. Emphasis is now being given to the development of critical thinking skills, the incorporation of ethics into the curriculum, the development of communication skills, and the use of group projects to develop cooperative skills. Among the changes in this edition that were designed to address these new emphases are:

1. Greater emphasis on the relationship of the approaches to theory development with each of the topics discussed throughout the text.
2. Early coverage of theories on the uses of accounting information including: the efficient market hypothesis, agency theory, the capital asset pricing model, human information processing, and critical perspective research.
3. Integration of these theories on the uses of accounting information with various topics throughout the text.
4. Expanded coverage of the FASB's Conceptual Framework project, and a discussion of the relationship of this material to various topics throughout the text.
5. A new section on ethics.
6. Expanded coverage of international accounting.
7. The inclusion of 15 new replacement articles.
8. The inclusion of many cases at the end of each chapter.

As with earlier editions, each chapter contains one or two readings from the ever expanding accounting literature. Each of these readings was selected to provide additional explanation of a particularly complex topic, or to provide a dissenting opinion from existing generally accepted accounting principles. In using these readings we have found it useful to ask the student to answer the following questions:

1. What is the issue the author(s) is addressing?
2. What methodology did the author(s) use to address the issue?
3. Did the author(s) clearly and adequately illustrate the solution?
4. Were you convinced of the author(s)' proposed treatment or solution?

As noted above, each chapter also contains a number of cases. These cases are designed to improve critical thinking skills, and many can be used as group projects to be communicated to the class. In several cases additional research is suggested to assist in solving the cases and specific references are included.

We are indebted to many colleagues whose comments and criticisms contributed to the fifth edition, and we single out for special thanks: Linda Bowen, University of North Carolina at Chapel Hill; Gyan Chandra, Miami University; Don Deis, Louisiana State University; Harry Dickinson; Dan Edwards, Indiana University—Purdue University at Fort Wayne; Ann Gibson, Andrews University; Joseph Hilmy, George Washington University; Anna Lee Meador, Marshall University; Wilda Meixner, Southwest Texas State University; Barbara Shiarappa, Trenton State College; Kevin Stevens, DePaul University; and Ray Thoren, State University of New York at Plattsburgh. We are also indebted to our research assistant Dessa Bergquist; her contributions were invaluable, as was the assistance provided by our typists Elizabeth Brown and Velma Prunner. Appreciation is also extended to our editorial and production team including Mike Reynolds, Tracy Fisher, Jennifer Knapp, Edward Winkleman, and Genevieve Scandone.

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CHAPTER

1

The Development of Accounting Theory

In its simplest form theory may be just a belief, but in order for a theory to be useful it must have wide acceptance. Webster defines theory as: "a systematic statement of principles . . ." and "a formulation of apparent relationships or underlying principles of certain observed phenomena which has been verified to some degree. . . ."¹ The objective of theory is to explain and predict. Consequently, one of the basic goals of the theory of a particular discipline is to have a well-defined body of knowledge that has been systematically accumulated, organized, and verified well enough to provide a frame of reference for future actions.

Theories may be described as normative or positive. Normative theories explain what should be, whereas positive theories explain what is. Ideally, there should be no such distinction because a well-developed and complete theory encompasses both what should be and what is.

The goal of accounting theory is to provide a set of principles and relationships that provide an explanation for observed practices and predict unobserved practices. That is, accounting theory should be able to explain why business organizations elect certain accounting methods over other alternatives and predict the attributes of firms that elect various accounting methods. Accounting theory should also be verifiable through accounting research.

The development of a general theory of accounting is important because of the role accounting plays in our economic society. We live in a capitalistic society, which is characterized by a self-regulated market that operates through the forces of supply and demand. Goods and services are available for purchase in markets, and individuals are free to enter or exit the market

¹ Webster's New Universal Unabridged Dictionary, 2nd ed. (New York: Simon & Schuster, 1983).

to pursue their economic goals. All societies are constrained by scarce resources that limit the attainment of all individual or group economic goals. The role of accounting in our society is to report how organizations utilize scarce resources and the status of resources and claims to resources.

As discussed in more detail in Chapter 2, there are various "theories of accounting" including: the efficient markets hypothesis, the capital asset pricing model, the human information processing model, positive accounting theory, and the critical perspective model. These various and often competing theories exist because accounting theory is still in its developmental stage.

Accounting research is needed to attain a more general theory of accounting. The various theories of accounting must be subjected to verification. A critical question concerns the usefulness of accounting data to users. That is, does the use of a theory help decision makers make more correct decisions? Various suggestions on the empirical testing of accounting theories have been offered.² As theories are tested and either confirmed or discarded, we will move closer to a general theory of accounting.

The Early History of Accounting

Accounting records dating back several thousand years have been found in various parts of the world. These records indicate that at all levels of development people desire information about their efforts and accomplishments. For example, the Zenon papyri, which were discovered in 1915, contain information about the construction projects, agricultural activities, and business operations of the private estate of Apollonius for a period of about 30 years during the third century B.C.

According to Hain, "The Zenon papyri give evidence of a surprisingly elaborate accounting system which had been used in Greece since the fifth century B.C. and which, in the wake of Greek trade or conquest, gradually spread throughout the Eastern Mediterranean and Middle East."³ The accounting system used by Zenon contained provisions for responsibility accounting, a written record of all transactions, a personal account for wages paid to employees, inventory records, and a record of asset acquisitions and disposals. In addition, there is evidence that all the accounts were audited.⁴

Later, the Romans kept elaborate records, but since they expressed numbers by letters of the alphabet, they were not able to develop any structured system of accounting. It was not until the Renaissance period, approximately 1300–1500, when the Italians were vigorously pursuing trade and commerce, that the need to keep accurate records was felt. Italian merchants borrowed the Arabic numeral system and the basis of arithmetic, and an evolving trend toward the double-entry bookkeeping system we now use developed.

²See for example, Robert Sterling, "On Theory Structure and Verification," *The Accounting Review* (July 1970), pp. 444–457.

³H. P. Hain, "Accounting Control in the Zenon Papyri," *The Accounting Review* (October 1966), p. 699.

⁴*Ibid.*, pp. 700–701.

In 1494 an Italian monk, Fra Luca Pacioli, wrote a book on arithmetic that included a description of double-entry bookkeeping. Pacioli's work *Summa de Arithmetica Geometria Proportioni et Proportionalita*, did not fully describe double-entry bookkeeping, but rather formalized the practices and ideas that had been evolving over the years. Double-entry bookkeeping enabled business organizations to keep complete records of transactions and ultimately resulted in the ability to prepare financial statements.

Statements of profit and loss and statements of balances emerged about 1600.⁵ Initially, the primary motive for separate financial statements was to obtain information regarding capital. Consequently, balance sheet data were stressed and refined in various ways, while expense and income data were viewed as incidental.⁶

As ongoing business organizations replaced isolated ventures, it became necessary to develop accounting records and reports that reflected a continuing investment of capital employed in various ways and to periodically summarize the results of activities. By the 19th century, bookkeeping expanded into accounting, and the concept that the owner's original contribution, plus or minus profits or losses, indicated net worth emerged. However, profit was considered an increase in assets from any source, as the concepts of cost and income were yet to be developed.

Another factor that influenced the development of accounting during the 19th century was the evolution of joint ventures into business corporations in England. The fact that many individuals, external to the business, needed information about the corporation's activities created the necessity for periodic reports. Additionally, the continuing existence of corporations created the need to distinguish between capital and income.

The statutory establishment of corporations in England in 1845 stimulated the development of accounting standards, and laws were subsequently passed that were designed to safeguard shareholders against improper actions by corporate officers. Dividends were required to be paid from profits, and accounts were required to be kept and audited by persons other than the directors. However, initially anyone could claim to be an accountant, as there were no organized professions or standards of qualifications.

The industrial revolution and the succession of Companies Acts in England also served to increase the need for professional standards and accountants. In the later part of the 19th century, the industrial revolution arrived in the United States, and with it came the need for more formal accounting procedures and standards. This period was also characterized by widespread speculation in the securities markets, watered stocks, and large monopolies that controlled segments of the United States economy.

In the late 1800s the progressive movement was established in the United States, and in 1898 the Industrial Commission was formed to investigate and report on questions relating to immigration, labor, agriculture, manufacturing,

⁵A. C. Littleton, *Accounting Evolution to 1900* (New York: AICPA, 1933).

⁶John L. Cary, *The Rise of the Accounting Profession* (New York: AICPA, 1969), p. 5.

and business. Although no accountants were either on the Commission or used by the Commission, a preliminary report issued in 1900 suggested that an independent public accounting profession should be established in order to curtail observed corporate abuses.

Although most accountants did not necessarily subscribe to the desirability of the progressive reforms, the progressive movement conferred specific social obligations on accountants.⁷ As a consequence accountants generally came to accept three general levels of progressiveness: (1) a fundamental faith in democracy, a concern for morality and justice and a broad acceptance of the efficiency of education as a major tool in social amelioration; (2) an increased awareness of the social obligation of all segments of society and introduction of the idea of accountability to the public of business and political leaders; and (3) an acceptance of pragmatism as the most relevant operative philosophy of the day.⁸

The major concern of accounting during the early 1900s was the development of a theory that could cope with corporate abuses that were occurring at that time, and capital maintenance emerged as a concept. This concept evolved from maintaining invested capital intact, to the maintenance of the physical productive capacity of the firm, to the maintenance of real capital. In essence this last view of capital maintenance was an extension of the economic concept of income (see Chapter 3) that there could be no increase in wealth unless the stockholder or the firm were better off at the end of the period than at the beginning.

During the period 1900–1915 the concept of income determination was not well developed. There was, however, a debate over which financial statement should be viewed as most important, the balance sheet or the income statement. Implicit in this debate was the view that either the balance sheet or the income statement must be viewed as fundamental and the other residual, and that relevant values could not be disclosed in both statements.

The 1904 International Congress of Accountants marked the initial development of the organized accounting profession in the United States, although there had been earlier attempts to organize and several states had state societies. At this meeting, the American Association of Public Accountants was formed as the professional organization of accountants in the United States. In 1916, after a decade of bitter interfactional disputes, this group was reorganized into the American Institute of Accountants (AIA).

The American Association of the University Instructors in Accounting was also formed in 1916. Initially this group focused on matters of curriculum development, and it was not until much later that it attempted to become involved in the development of accounting theory.

World War I changed the public's attitude toward the business sector. Many people believed that the successful completion of the war could be,

⁷Gary John Previts and Barbara Dubis Merino, *A History of Accounting in America* (New York, Ronald Press, 1979), p. 136.

⁸Richard Hofstadter, *Social Darwinism in American Thought* (Philadelphia, University of Pennsylvania Press, 1944).

at least partially, attributed to the ingenuity of American businesses. As a consequence, the public perceived that business had reformed, and external regulation was no longer necessary. The accountant's role changed from a protector of third parties to the protector of business interests.

Critics of accounting theory during the 1920s suggested that accountants abdicated the stewardship role, placed too much emphasis on the needs of management, and permitted too much flexibility in financial reporting. During this time financial statements were viewed as the representations of management, and accountants did not have the ability to require businesses to use accounting principles they did not wish to employ.

The result of this attitude is well known. In 1929 the stock market crashed and the Great Depression ensued. Although accountants were not initially blamed for these events, the possibility of governmental intervention in the corporate sector loomed.

Accounting in the United States Since 1930

One of the first attempts at improving accounting began shortly after the inception of the Great Depression with a series of meetings between representatives of the New York Stock Exchange (NYSE) and the American Institute of Accountants. The purpose of these meetings was to discuss problems pertaining to the interests of investors, the NYSE, and accountants in the preparation of external financial statements.

Similarly, in 1935 the American Association of University Instructors in Accounting changed its name to the American Accounting Association (AAA) and announced its intention to expand its activities in the research and development of accounting principles and standards. The first result of these expanded activities was the publication, in 1936, of a brief report cautiously titled "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements." The four-and-one-half-page document summarized the significant concepts underlying financial statements at that time.

The cooperative efforts between the members of the NYSE and the AIA were well received. However, the post-Depression atmosphere in the United States was characterized by regulation. There was even legislation introduced that would have required auditors to be licensed by the federal government after passing a civil service examination.

Two of the most important pieces of legislation passed at this time were the Securities Act of 1933, and the Securities Exchange Act of 1934, that established the Securities and Exchange Commission (SEC). The SEC was created to administer various securities acts. Under powers provided by Congress, the SEC was given the authority to prescribe accounting principles and reporting practices. Although this authority has seldom been used, the SEC has exerted pressure on the accounting profession and has been especially interested in narrowing areas of difference in accounting practice. The role of the SEC is discussed in more detail in Chapter 16.

By 1937 the view was prevalent that if accountants did not come up with answers to issues the SEC would. The profession was also convinced that it

did not have the time necessary to develop a theoretical framework of accounting. As a result, the AIA agreed to publish the study by Sanders, Hatfield, and Moore titled *A Statement of Accounting Principles*.

The publication of this work was quite controversial in that it was simply a survey of existing practice that was seen as telling practicing accountants "do what you think is best." The study was also used by some accountants as an authoritative source that justified current practice.

In 1937 the AIA merged with the American Society of Certified Public Accountants and a new, larger organization later named the American Institute of Certified Public Accountants (AICPA) was formed. This organization has had increasing influence over the development of accounting theory.

Over the years, the AICPA established several committees and boards to deal with the need for the further development of accounting principles. First, the Committee on Accounting Procedure (CAP) was established. It was followed by the Accounting Principles Board (APB), which was replaced by the Financial Accounting Standards Board (FASB). Each of these bodies has issued pronouncements on accounting issues. In each case the pronouncements apply to current and future financial statements and are not intended to be applied retroactively unless the pronouncement makes retroactive presentation mandatory.

Committee on Accounting Procedure

Professional accountants became more actively involved in the development of accounting principles following the meetings between members of the New York Stock Exchange and the AICPA and the controversy surrounding the publication of the Sanders, Hatfield, and Moore study. In 1938 the AICPA's Committee on Accounting Procedure was formed. This committee had the authority to issue pronouncements on matters of accounting practice and procedure in order to establish generally accepted practices. The works of the committee were published in the form of *Accounting Research Bulletins* (ARBs); however, these pronouncements did not dictate mandatory practice and received authority only from their general acceptance.

The ARBs were consolidated in 1953 into *Accounting Terminology Bulletin No. 1*, "Review and Resume"⁹ and ARB No. 43.¹⁰ From 1953 until 1959 ARBs No. 44 through No. 51 were published. The recommendations of these bulletins, which have not been superseded, are contained throughout this text where the specific topics covered by the ARBs are discussed.

Accounting Principles Board

By 1959 the methods of formulating accounting principles were being criticized, and wider representation in the development of accounting principles

⁹ *Accounting Terminology Bulletin No. 1*, "Review and Resume" (New York: AICPA, 1953).

¹⁰ *Accounting Research Bulletin No. 43*, "Restatement and Revision of Accounting Research Bulletins" (New York: AICPA, 1953).

was sought by accountants and financial statement users. The AICPA reacted by forming the Accounting Principles Board (APB). This body had as its objectives the advancement of the written expression of generally accepted accounting principles, the narrowing of areas of difference in appropriate practice, and the discussion of unsettled and controversial issues. The APB was comprised of between 17 and 21 members who were selected primarily from the accounting profession but also included individuals from industry, government, and academia.

Initially, the pronouncements of the APB that were termed "Opinions" were not mandatory practice; however, the issuance of *APB Opinion No. 2*¹¹ and subsequent partial retraction contained in *APB Opinion No. 4*¹² highlighted the need for more authority. This controversy was due to differences in accounting for the investment tax credit. In 1961 the investment tax credit was passed by Congress. This legislation provided for a direct tax reduction based on a percentage of the cost of a qualified investment. The APB, after a review of the accounting requirements of this legislation, issued *APB Opinion No. 2*, which stated that this tax reduction amounted to a cost reduction, and the effects of this cost reduction should be amortized over the useful life of the asset acquired. Nevertheless, several large public accounting firms decided to report the results of the investment tax credit only in the period in which it occurred. The APB was thus faced with a serious threat to its authority.

The lack of general acceptance of *APB Opinion No. 2* resulted in the APB partially retreating from its previous position. Though reaffirming the previous decision as being the proper and most appropriate treatment, *APB Opinion No. 4* approved the use of either of the two methods.

The lack of support for some of the APB's pronouncements and concern over the formulation and acceptance of "generally accepted accounting principles" caused the Council of the American Institute of Certified Public Accountants to adopt Rule 203 of the Code of Professional Ethics. This rule requires departures from accounting principles published in *APB Opinions* or *Accounting Research Bulletins* (or subsequently *FASB Statements*) to be disclosed in footnotes to financial statements or in independent auditors' reports when the effects of such departures are material. This action has had the effect of requiring companies and public accountants who deviated from *FASB Statements*, *APB Opinions*, and *Accounting Research Bulletins* to justify such departures.

In addition to the difficulties associated with the passage of *APB Opinions No. 2* and *No. 4*, the Accounting Principles Board encountered other problems. The members of the APB were, in effect, volunteers. These individuals had full-time responsibilities to their employers; therefore, the performance of their duties on the APB became secondary. By the late 1960s criticism of the development of accounting principles again arose. This criticism centered on the following factors.

¹¹ *Accounting Principles Board Opinion No. 2*, "Accounting for the 'Investment Credit'" (New York: AICPA, 1962).

¹² *Accounting Principles Board Opinion No. 4*, "Accounting for the 'Investment Credit'" (New York: AICPA, 1964).