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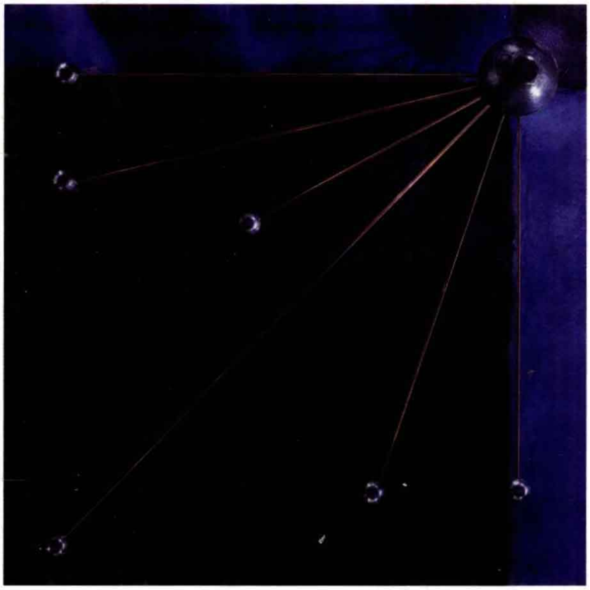

A CONCEPTUAL AND INSTITUTIONAL APPROACH

ACCOUNTING Theory

Fifth Edition

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A Conceptual and Institutional Approach

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PREFACE

We have entered a new millenium and extensive change has come to education in general and accounting education in particular. We are, however, still "in process" because much remains to be done in terms of developing content and direction of accounting programs. In a similar fashion, the development of accounting standards in both the United States and around the world is in need of improvement at the individual-nation level as well as harmonization at the multination level. We believe that a solid understanding of accounting theory can play a very important role in terms of (1) helping to appreciate how accounting rules have developed within the institutional structure of financial accounting, (2) bringing about improvement in the formulation of new standards, and (3) helping to integrate accounting standards on a regional if not a worldwide basis.

This book is intended for one-semester accounting theory courses at either the senior or graduate levels. It assumes that students are thoroughly grounded in intermediate accounting. At the graduate level, the book is appropriate for courses in MBA programs with accounting concentrations and for MS programs in accounting. However, in light of the aforesaid new developments in accounting education, other possibilities exist. For example, at one of our two universities, many of the elements of accounting theory from the first half of the text will be introduced at the start of the intermediate accounting sequence. Individual chapters in the last half of the book will then supplement specific subject matter as it arises as the courses develop (a three-course series will be used covering what has previously been called intermediate and advanced accounting).

In the traditional accounting theory course, the first nine chapters, which are concerned with the elements of accounting theory as well as material on the structure and development of accounting policy-formulating agencies, will usually be assigned. Beyond this point, chapters can be taught in any order desired.

OBJECTIVES OF THE TEXT

Our basic objective is to clearly identify the elements of accounting theory in the first part of this text and then relate these elements to significant problem areas in accounting in the second part. Both parts bring in extensive coverage of the accounting literature. As the title indicates, we have attempted to integrate the theoretical and institutional aspects of accounting theory. The reader should thus acquire an increased depth of understanding of the major problem areas of accounting and the related standards going well beyond a mere technical grasp of debits and credits.

FEATURES OF THE FIFTH EDITION

All chapters of the book have been updated where either new standards have been promulgated or new theoretical findings or insights have appeared in the accounting literature. We have also reversed the order of Chapters 10 and 11 putting the balance sheet chapter ahead of the income statement chapter giving preference of order to the theoretically more fundamental financial statement. We have also expanded the cash flow statement coverage in Chapter 12, and provided a better organization of the disclosure section of Chapter 9.

This edition contains extensive new materials at the end of each chapter under cases, problems, and writing assignments. They relate to both accounting standards and theoretical issues and they should help to reinforce chapter content. In addition, we hope that this material can, at least partially, fill the writing void that is present in many accounting programs. There are also many new questions at the end of each chapter. A new feature of this edition is called "Critical Thinking and Analysis." These questions are indicated by a "bullet" sign (•). These questions are intended to be thought-provoking and to have relatively open-ended answers. A very important new feature of this edition is a test bank containing questions for each chapter and numerous PowerPoint presentations for each chapter that should facilitate classroom teaching and presentation. The computerized test bank, authored by Jeanie Curry of Ouachita Baptist University, is available on CD-ROM and on the Web site at *http://wolk.swcollege.com*. The PowerPoint presentations, authored by James L. Dodd, are available on the Web site.

The instructor's manual contains answers to the questions appearing at the end of each chapter as well as solutions to cases and problems and suggestions for writing assignments. In addition, the instructor's manual also contains the author index.

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Over the years we have received many valuable reviews, critiques, and comments from reviewers of the current and previous editions of the book. From these reviewers of *Accounting Theory*, we would like to thank the following individuals:

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We welcome a new co-author to this text, Jim Dodd of Drake University. Jim brings extensive work experience and publication to the book. In addition, he is an excellent classroom teacher. We would also like to thank Dave Shaut, Accounting Team Director; Rochelle Kronzek, Acquisition Editor; Carol Bennett, Developmental Editor; Marge Bril, Production Editor; and Dan Silverburg, Marketing Manager from South-Western College Publishing. Their extensive efforts to make this an outstanding

revision are greatly appreciated. As usual, our typist, Ginger Wheeler, did an excellent job of getting us from the fourth to the fifth edition of this book. Finally, we also received many useful insights from previous users and other interested parties. We greatly appreciate all of their efforts.

CONTENTS

ABBREVIATIONS USED IN THIS TEXT

AAA	American Accounting Association
AcSEC	Accounting Standards Executive Committee
AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board (When used with a number it refers to an Accounting Principles Board Opinion)
ARB	Accounting Research Bulletin issued by the Committee on Accounting Procedure
ARS	Accounting Research Study issued by the Accounting Principles Board
ASR	Accounting Series Release issued by the Securities and Exchange Commission
CAP	Committee on Accounting Procedure
ED	Exposure Draft
EITF	Emerging Issues Task Force
EPS	Earnings Per Share
FAF	Financial Accounting Foundation
FASAC	Financial Accounting Standards Advisory Council
FASB	Financial Accounting Standards Board
FC	Full Costing
FEI	Financial Executives Institute
GAAP	Generally Accepted Accounting Principles
GASB	Government Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
NYSE	New York Stock Exchange
OPEB	Postretirement Benefits Other than Pensions
RRA	Reserve Recognition Accounting
SCFP	Statement of Changes in Financial Position
SE	Successful Efforts
SEC	Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concepts issued by the Financial Accounting Standards Board
SFAS	Statement of Financial Accounting Standards issued by the Financial Standards Board
SOP	Statement of Position

CHAPTER

1 AN INTRODUCTION TO ACCOUNTING THEORY

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Understand the meaning of accounting theory and why it is an important topic.
- Understand the relationship between accounting theory and policy making.
- Understand what measurement is and its role in accounting.
- Gain an insight into the principal valuation systems in accounting.

While accounting has not been called the "dismal science," it is frequently viewed as a dry, cold, and highly analytical discipline with very precise answers that are either correct or incorrect. Nothing could be further from the truth. To take a simple example, assume that two enterprises that are otherwise similar are doing their inventory and cost of goods sold accounting differently. Firm A selects LIFO and Firm B selects FIFO, giving totally different but equally "correct" answers.

However, one might say that a choice among inventory methods is merely an "accounting construct": the type of "games" accountants play that are of interest to them but have nothing to do with the "real world." Once again this would be totally incorrect. The LIFO versus FIFO argument has important income tax ramifications resulting—under LIFO—in a more rapid write-off of current inventory costs against revenues (assuming rising inventory prices), which generally means lower income taxes. Thus an accounting construct has an important "social reality": how much income tax is paid.[1]

1 For a brilliant discussion of accounting constructs and their relation to social reality, see Mattessich (1991) and (1995, pp. 41–58).

Income tax payments are not the only social reality that accounting numbers affect. Here are some other examples:

1. Income numbers can be instrumental in evaluating the performance of management, which can affect salaries and bonuses and even whether individual management members will maintain their jobs;
2. Income numbers and various balance sheet ratios can affect dividend payments and security prices;
3. Income numbers and balance sheet ratios can affect the firm's credit standing and therefore the cost of capital.

Since it is the case that accounting numbers have important social consequences, why is it the case that we cannot always measure "economic reality" accurately? Different perceptions exist of economic reality. For example, we may say—on the one hand—that the value of an asset may be equal to the amount paid for it in markets where the asset would ordinarily be acquired or—on the other hand—some may see an asset's value represented by the amount the firm could acquire by selling the asset. These two values are not the same. The former value is called *replacement cost* or *entry value* and the latter is called *exit value*. Both values are discussed in the appendix to this chapter and, in more detail, in Chapter 13. Exit values are usually lower than entry values because the owning enterprise does not usually have the same access to buyers as firms that regularly sell the asset through ordinary channels. Hence, there is a valuation choice between exit and entry values. Suppose, however, that we take the position that both of these valuations have merit but they are not easy to measure because market quotations may not be available and users may not understand what these valuations mean. Hence, a third choice may arise: historical cost. While entry and exit values represent some form of economic reality, the unreliability of the measurements may lead some people to opt for historical cost on the grounds that users understand it better than the other two approaches and measurement of the historical cost number may be more reliable.

The question we have just been examining, the choice among accounting values including historical cost, falls within the realm of accounting theory. There are, however, other issues that arise in this example, both implicit and explicit:

1. For what purposes do users need the numbers (e.g., evaluating management's performance, evaluating various aspects of the firm's credit standing, or even using the accounting numbers as an input for predicting how well the enterprise will do in the future);

2. How costly might it be to generate the desired measurement.

The choice among the different types of values as well as the related issues fall within the domain of accounting theory. The term "accounting theory" is actually quite mysterious. There are many definitions throughout the accounting literature of this somewhat elusive term. *Accounting theory* is defined here as the basic assumptions, definitions, principles, and concepts—and how we derive them—that underlie accounting rule making by a legislative body—and the reporting of accounting and financial information. There has been and will continue to be extensive discussion and argumentation as to what these basic assumptions, definitions, principles, and concepts should be; thus, accounting theory is never a final and finished product. Dialogue always continues, particularly as new issues and problems arise. As the term is used here, it applies to financial accounting and not to managerial or governmental accounting. *Financial accounting* refers to accounting information that is used by investors, creditors, and other outside parties for analyzing management performance and decision-making purposes.

We interpret the definition of accounting theory broadly. Clearly, the drafting of a conceptual framework that is supposed to provide underlying guidance for the making of accounting rules falls within the coverage of accounting theory. Analyzing accounting rules to see how they conform to a conceptual framework or other guiding principles likewise falls within the accounting theory realm. While the actual practice of accounting is generally of less theoretical interest, questions such as why firms choose particular methods where choice exists (the LIFO versus FIFO question, for example) *are* of theoretical interest because we would like to know the reasons underlying the choice. In a pragmatic sense, one can say that accounting theory is concerned with improving financial accounting and statement presentation, though conflict may exist between managers and investors, among other groups, relative to the issue of what improves financial statements, because their interests are not exactly the same.

We can also examine the types of topics, issues, and approaches discussed as part of accounting theory. In addition to conceptual frameworks and accounting legislation, **accounting theory** includes concepts (e.g., realization and objectivity), valuation models (discussed in Appendix 1-A), and hypotheses and theories. Hypotheses and theories are based on a more formalized method of investigation and analysis of subject matter used in academic disciplines such as economics and other social sciences employing research methods from philosophy, mathematics, and statistics. This newer and more formal approach to the development of accounting theory is a relatively recent innovation in our