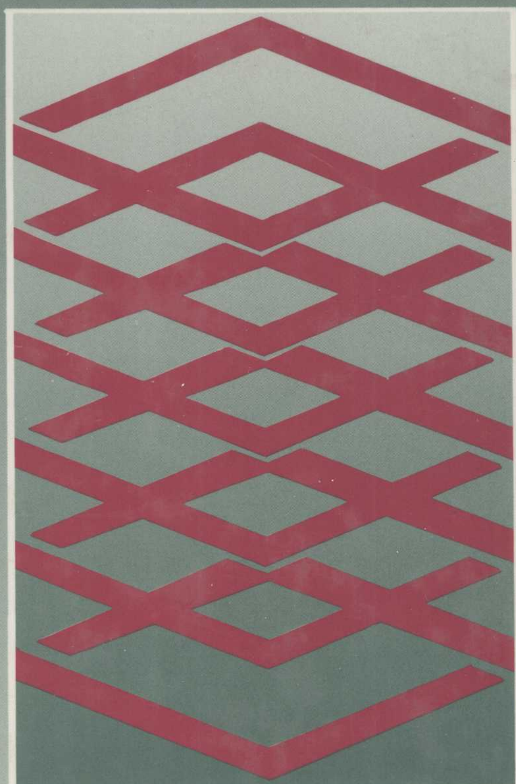
FOURTH EDITION

ACCOUNTING THEORY

TEXT AND READINGS



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ACCOUNTING THEORY:

TEXT AND READINGS

Fourth Edition

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Preface

As the literature of financial accounting theory is expanding at an ever-increasing rate, today's accounting student has the monumental task of attempting to assimilate and evaluate readings from various sources. While the point of general agreement on a theory of accounting has yet to be reached, there are certain concepts and principles that have general acceptance. The objective of this book is to provide the student with a framework within which to operate by discussing various financial accounting topics and expanding on these topics by including readings directly connected with each of the chapters.

The text part of the book is primarily a descriptive interpretation of the Opinions and Standards issued by the Accounting Principles Board (APB) and the Financial Accounting Standards Board (FASB). The readings at the end of each chapter were selected either to provide additional discussion of complex material or a dissenting opinion from current generally accepted accounting principles (GAAP). Additionally, each chapter contains several multiple-choice and essay questions related to the text material. Adapted from recent Uniform CPA Examinations, these questions provide exposure to the types of issues the Board of Examiners has stressed in recent years.

This book is designed to be used by undergraduate accounting students as well as graduate students and those wishing to review for the theory section of the Uniform CPA Examination. The hope is that this work will provide students with a broader view of accounting theory than can be provided by using only techniques and procedures.

This book may be used in several ways: (1) It may be used by itself in a course that is descriptive of existing accounting theory while critically examining alternatives to current practice through the use of the articles contained at the end of each chapter. (2) It may be used in a course designed to explore existing accounting theory in depth. In such a course, the text material could be used in conjunction with Commerce Clearing House Accounting Principles—Current Edition. (3) It may be used in a normative accounting theory course in which the text is supplemented by the use of the discussion memoranda that preceded the issuance of APB Opinion and FASB Statements. (4) It may be used in a course designed to evaluate the conclusion reached by the

APB and FASB through the use of the research articles contained at the end of each chapter and the supplemental readings.

We are indebted to many colleagues whose comments and criticisms contributed to the fourth edition and we single out for special thanks: Clifford D. Brown, Bentley College; Joseph Hilmy, George Washington University; Paul A. Copley, University of Georgia; and Alan K. Ortegren, Southern Illinois University–Edwardsville. We are also indebted to our research assistants, Cheryl Baldridge and Viola Pike; their contributions were invaluable, as was the assistance provided by our typist Sylvia De La Cruz. Appreciation is also extended to our editorial and production staff including Lucille Sutton and Linda Muriello.

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CHAPTER 1

Source and Methodology of Accounting Principles

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."[1] 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.[2]

Although the Zenon papyri and other records indicate accounting *practice* has a long history, most organized efforts at developing accounting *theory* have occurred since 1930. Individual writers such as Sprague, Hatfield, Kester, and Paton made significant contributions before that time (in the early 1900s), but those contributions did not receive widespread acceptance and did not have the influence of the more organized efforts of recent years.

One of the first attempts at improving accounting began shortly after the

[1]H. P. Hain, "Accounting Control in the Zenon Papyri," *The Accounting Review* (October 1966), p. 699.
[2]Ibid., pp. 700–701.

Great Depression with a series of meetings between representatives of the New York Stock Exchange (NYSE) and the American Institute of Accountants (now American Institute of Certified Public Accountants or AICPA). 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.

These activities are cited simply to illustrate that the history of accounting theory is relatively short. Thus, when accounting is compared to professions that have had a theoretical base for hundreds of years, it is readily apparent why so much remains to be done in developing a coherent and consistent theoretical basis for the practice of accounting.

One result of the meetings between the AICPA and members of the NYSE was a revision in the wording of the certificate issued by CPAs. The opinion paragraph formerly said something to the effect that the financial statements had been examined and were accurate. The terminology was changed to say that the statements are "fairly presented in accordance with generally accepted accounting principles." This expression is now interpreted as encompassing the conventions, rules, and procedures that are necessary to explain accepted accounting practice at a given time. Therefore, financial statements are fair only to the extent that the principles are fair and the statements comply with the principles.

The expression *generally accepted accounting principles* (GAAP) has thus come to play a significant role in the accounting profession. The precise meaning of the term, however, has evolved rather slowly. In addition to official pronouncements promulgated by authoritative organizations, another method of developing principles is to determine whether other accountants are actually following the particular practice in question. There is no need for complete uniformity; rather, when faced with a particular transaction, the accountant is to review the literature and current practice to determine if a treatment similar to the one proposed is being used. For example, if many accountants are using sum-of-year's-digits (SYD) depreciation for assets, this method becomes a GAAP. In the theoretical sense, depreciation may not even be a principle; however, according to accounting theory formation, if many accountants are using SYD, it becomes a GAAP.

Another example of the approach to establishing GAAP is illustrated by the last in, first out (LIFO) inventory method. The use of LIFO inventory was originally sanctioned by the Internal Revenue Service under a particular set of circumstances. Because LIFO inventory will result in lower income taxes during periods of rising prices, more and more people begin searching for those special circumstances in order to use LIFO. Over time many firms began using

LIFO, and LIFO acquired the status of a GAAP; therefore, anyone could use LIFO and the CPA could attest that the statements were prepared in accordance with GAAP.

According to the Accounting Principles Board (APB), generally accepted accounting principles

> *incorporate the consensus at any time as to which economic resources and obligations should be recorded as assets and liabilities, which changes in them should be recorded, when these changes should be recorded, how the recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.*[3]

This statement does not mean that a GAAP is based on what is most appropriate or reasonable in a given situation but simply that the practice represents a consensus. However, even this definition lacks clarity, since a variety of practices may exist despite a consensus in favor of one or the other. For example, such variation occurs in inventory and depreciation methods.

In 1975 the Auditing Standards Executive Committee of the AICPA issued its Statement on Auditing Standards (SAS) No. 5 with the purpose of explaining the meaning of the phrase "present fairly . . . in conformity with generally accepted accounting principles" as used in the report of independent auditors. According to the committee, the auditor's opinion on the fairness of an entity's financial statements in conformity with GAAP should be based upon his judgment as to whether

> *(a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation; (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and (e) the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and changes in financial position stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.*[4]

A GAAP thus serves to provide the auditor with a framework for making judgments about the fairness of financial statements on the basis of some uniform standard.

The most precise criterion that has been set forth for determining whether a practice has gained the stature of a GAAP was set forth by the AICPA and

[3]Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: American Institute of Certified Public Accountants, 1970), par. 27.

[4]Statement on Auditing Standards No. 5, "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles' in the Independent Auditor's Report" (New York: American Institute of Certified Public Accountants, 1975), par. 4.

NYSE committee. Those principles having "substantial authoritative support" were to be classified as GAAP. The meaning of the term was not specifically defined at that time, and no single source exists for all established accounting principles. However, Rule 203 of the AICPA Code of Professional Ethics requires compliance with accounting principles promulgated by the body designated by the Council of the Institute to establish such principles, except in unusual circumstances. (Currently that body is the Financial Accounting Standards Board [FASB].)

Later, SAS No. 5 was amended by SAS No. 43. This amendment classified the order of priority that an auditor should follow in determining whether an accounting principle is generally accepted. Also, it added to the sources of established accounting principles certain types of pronouncements that did not exist when SAS No. 5 was issued. This release noted that the determination that a particular accounting principle is generally accepted may be difficult because no single source exists for all such principles. The sources of generally accepted accounting principles were identified as

1. Pronouncements of an authoritative body designated by the AICPA Council to establish accounting principles, pursuant to Rule 203 of the AICPA Code of Professional Ethics (FASB Statements, FASB Interpretations, APB Opinions, Accounting Research Bulletins).
2. Pronouncements of bodies composed of expert accountants that follow a due process procedure, including broad distribution of proposed accounting principles for public comment, for the intended purpose of establishing accounting principles or describing existing practices that are generally accepted (AICPA Industry Audit Guides).
3. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted (FASB Technical Bulletins).
4. Other accounting literature.[5]

These recommendations have evolved from the sources identified by the Accounting Principles Board in 1964 for determining whether an accounting practice had substantial authoritative support. Those sources were

1. Published opinions by committees of the AICPA.
2. Published opinions by committees of the AAA.
3. Affirmative opinions of practicing and academic certified public accountants.
4. Regulations and opinions issued by the Securities and Exchange Commission (SEC).
5. Pronouncements by other regulatory agencies about the accounting to be employed in reporting to the agency.

[5]Statement on Auditing Standards No. 43, "Omnibus Statement on Auditing Standards" (New York: American Institute of Certified Public Accountants, 1982), par. 5–7.

6. Practices commonly found in business.
7. Writings and opinions of individual accountants found in textbooks and articles.

In this chapter and throughout much of the book, special attention will be given to the pronouncements referred to in Rule 203 of the AICPA Code of Professional Ethics. The reason for this special attention is apparent: Practicing CPAs have an ethical obligation to consider such pronouncements as the primary source of generally accepted accounting principles in their exercise of judgment as to the fairness of financial statements. Opposing views as well as alternative treatments will be considered in the text narrative and in the selected articles; however, the reader should keep in mind the significance of the primary source in current practice.

The AICPA and Accounting Principles

Over the years, the American Institute of Certified Public Accountants has established several committees and boards to deal with the need for 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 as discussed later. In each case the pronouncements are intended to 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. 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, such pronouncements did not dictate mandatory practice and received authority only from their general acceptance.

These publications were consolidated in 1953 into Accounting Terminology Bulletin No. 1, "Review and Resume,"[6] and Accounting Research Bulletin No. 43.[7] From 1953 until 1959 Accounting Research Bulletins No. 44 through No. 51 were published. The recommendations of these bulletins, which have

[6]Accounting Terminology Bulletin No. 1, "Review and Resume" (New York: American Institute of Certified Public Accountants, 1953).

[7]Accounting Research Bulletin No. 43, "Restatement and Revision of Accounting Research Bulletins" (New York: American Institute of Certified Public Accountants, 1953).

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 formation of accounting principles was sought by accountants and financial statement users. The AICPA reacted by forming the Accounting Principles Board. 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[8] and subsequent partial retractions contained in APB Opinion No. 4[9] 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 Opinion No. 2, which stated that this tax deduction 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 credit only in the period in which it occurred. The APB was thus faced with a serious threat to its authority.

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

The lack of support for its 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 required departures from accounting principles published in APB Opinions or Accounting Research Bulletins to be disclosed in footnotes to financial statements or in independent auditors' reports when the effects of such departures were material. This action had the effect of requiring companies and public accountants who deviated from APB Opinions and Accounting Research Bulletins to justify such departures.

[8]Accounting Principles Board Opinion No. 2, "Accounting for the 'Investment Credit'" (New York: American Institute of Certified Public Accountants, 1962).

[9]Accounting Principles Board Opinion No. 4, "Accounting for the 'Investment Credit'" (New York: American Institute of Certified Public Accountants, 1964).

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.

1. The independence of the members of the APB. The individuals serving on the board had full-time responsibilities elsewhere that might have an impact on their views of certain issues.
2. The structure of the board. The largest eight public accounting firms (at that time) were automatically awarded one member and there were usually five or six other public accountants on the APB.
3. Response time. The emerging accounting problems were not being investigated and solved quickly enough by the part-time members.

The Financial Accounting Standards Board

As a result of the growing criticism of the APB, the board of directors of the AICPA appointed two committees in 1971. The Wheat Committee, named after its chairman, Francis Wheat, was to study how financial accounting principles should be established. The Trueblood Committee, named after its chairman, Robert Trueblood, was to determine the objectives of financial statements.

The Wheat Committee issued its report in 1972 with a recommendation that the APB be abolished and the Financial Accounting Standards Board (FASB) be created. This new board was to be composed of representatives from various organizations, in contrast to the APB, whose members were all from the AICPA. The members of the FASB were also to be paid and were to work full time, unlike the APB members, who served part time and were not paid.

The Trueblood Committee, formally known as the Study Group on Objectives of Financial Statements, issued its report in 1973 after substantial debate and with considerably more tentativeness in its recommendations about objectives than the Wheat Committee had with respect to the establishment of principles. The study group requested that its report be regarded as an initial step in developing objectives and that significant efforts should be made to continue progress on the refinement and improvement of accounting standards and practices. The objectives enumerated by the Trueblood Committee later became the basis for Statement of Financial Accounting Concepts No. 1 (discussed later in the chapter).

The AICPA quickly adopted the Wheat Committee recommendations, and the FASB became the official body charged with issuing accounting standards. The structure of the FASB is as follows. A panel of electors from nine organizations that support the activities of the FASB is selected. (The nine organizations selecting the electors are representative of the breadth of support for the activities of the FASB in the business community. They are the AICPA, the Finan-