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ORIGINS OF THE ACCOUNTING REVOLUTION

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Abstract

This paper utilizes various definitions of accounting as proclaimed by authoritative bodies and others to trace the origins of the phenomena known collectively as the Accounting Revolution.

Purpose

The purpose of this paper is to trace the origins of the recent changes and pressures for change in accounting – phenomena that are known collectively as the Accounting Revolution. While several different perspectives could have been utilized for this analysis, the one chosen was that of the definitions of accounting. As change has come to accounting, it has manifested itself in the guise of the definitions proclaimed by authoritative bodies and others. The definitions themselves then loom as a singular mechanism for sketching fundamental changes in accounting.

Introduction

In 1941 the Committee on Terminology of the American Institute of Certified Public Accountants (AICPA) in Accounting Terminology Bulletin No. 1 defined accounting in terms of what accounting did, i.e., record, classify, and summarize the transactions of an entity and interpret the results. In 1970 the 1941 definition was superceded by the Accounting Principles Board (APB) of the AICPA in its Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises [1970, para. 40] which defined accounting in terms of what accounting ought to do, i.e., provide information useful in making economic decisions. The difference in these two viewpoints, the difference between accounting being a history of the firm versus a provided of information useful for decision making, is a capsule indication of the conflict that has plagued financial accounting for most of the second half of the 20th century.

Analysis

The Rise of the Transaction Based Definition

The 1941 Committee on Terminology definition is not significantly different from that of W. A. Paton in Accounting [1924, p. 1] and other contemporary writers on accounting and reflects the beliefs held at that time. The basis of these beliefs was the stewardship function of management, and therefore the function and purpose of accounting was to report on this stewardship. It is clear that in 1941 when the definition was formulated a consensus of accountants accepted this view of accounting. If so, then what propelled the departure from this definition? To answer this question requires an analysis of why a consensus was achieved inthe first place.

The definition of accounting (or any subject) is not far removed from the theoretical basis underlying that subject. But a theoretical basis of accounting (other than the double–entry mechanism) was nonexistent in the early part of the 20th century. Though accounting was a well understood ritual by its participants, the application of that ritual to the evolving modern business phemonenon was less understood as was accounting's relationship to the emerging profession of public accounting. There was a vagueness as to accounting's role (as well as the new public accounting profession's role) in the increasingly complex socio–economic environment. New phenomena, for example, depreciation, were encountered that created problems and increased the pressures on this relationship.

Though a need for a theoretical basis to resolve these problems was beginning to become evident, it was the stock market crash of 1929, the resultant securities acts of 1933 and 1934, and the role of the Securities Exchange Commission (SEC) that hastened efforts to derive a theoretical foundation. The search was on for principles of accounting that had general acceptance; the anticipation was that such a conceptual foundation would aid in solving current and future problems. Given the tenor of the times, it is not surprising that the stewardship function and the transaction basis (which afterall was what accounting dealt with) formed the basis of the official definition that eventually was recognized and promulgated in 1941. It is important to note that the search for accounting theory was to be conducted by two different groups; the AICPA (practitioners), and the American Accounting Association (AAA) (academics).

It was around this time that Gilbert R. Byrne in a classic article "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards" [1937] proposed that accounting and reporting be separated. He was almost alone among writers of his day in making this distinction.

The 1930s also witnessed the general acceptance of historical cost (prompted perhaps by the SEC) and the matching concepts by both practitioners and the academic accounting community. Thus, a consensus was reached on both a theory and a definition of accounting, but the seeds of discord had already been unknowingly sown.

Most of the academic community of the 1941 era accepted the transaction– based view of accounting and continued to do so. This is true of the W. A. Paton and A. C. Littleton collaboration An Introduction to Corporate Accounting Standards [1940] and the A. C. Littleton book Structure of Accounting Theory [1953]. Even those of the academic community who seemed to imply accounting should report useful information (as the Paton and Littleton monograph also did) made such stipulation within the framework and limitations of transaction based accounting.

The Rise of the Usefulness Criteria

But some in the academic community grew dissatisfied with the theoretical implications of cost based accounting and its limitations, for example, arbitrary cost allocations. These academics were trained not only in accounting but also in other areas such as economics and finance, and sought to either incorporate these other disciplines within the existing accounting framework or, if need be, create a revolutionary new framework.

Beginning with R. J. Chambers' "Blueprint for a Theory of Accounting" [1955] there began to appear in the accounting literature a thread of argument and research in favor of recognizing that the purpose of financial accounting was to provide information useful in economic decision making. It was around this same time, the early 1960s, that accounting as an academic discipline began to evolve. This movement, adopting the empirical research paradigm, was given impetus by the new accounting academics. The movement began to gather momentum.

The AAA prepared statements on accounting theory (principles) in 1936, 1941, 1948, and 1957. Each of these statements was in agreement with the old (1941) definition of accounting (or one similar to it). Then, in 1966 the AAA announced the radically different A Statement of Basic Accounting Theory (ASOBAT). ASOBAT not only defined accounting as a three phase process that identifies, measures, and communicates economic information that permits informed decisions by users, but also explicitly claimed that "(t)here is no implication that accounting information is necessarily based only on transaction data." The revolution in accounting was becoming wide-spread.

ASOBAT was soon followed by APB Statement No. 4 in 1970 (discussed above) and the AICPA Study Group on Objectives of Financial Statements's Objectives of Financial Statements [1973] which held the view that the basic objective of financial statements was to provide information that is useful in making economic decisions. It is worth noting that in the latter statement Byrne's accounting/reporting dicotomy seems to be implicitly recognized in that the publication focuses on reporting, i.e., financial statements. Around this same period in time the pressures of accounting problems on public accounting forced the separation of accounting from public accounting (auditing) as represented by the establishment of the Financial Accounting Foundation and the Financial Accounting Standards Board (FASB). The AICPA was dropping out of the accounting theory endeavor.

FASB swiftly embarked on its own search for a theoretical basis of accounting in the form of the Conceptual Framework Project. The initial result was FASB Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises [1978] which, like its recent predecessors, also asserted that financial reporting should provide information useful in economic decision making and, in addition, be useful in determining present and future cash flows. At this point in time the concept of usefulness had become well entrenched in authoritative literature. (Note that FASB did indicate that the type of information it envisioned could be provided within an accrual accounting framework, though it did not demonstrate that this is so or state how it could be accomplished.)

Clearly, stewardship had been discarded as the primary purpose of accounting by FASB; and just as clearly a view endorsing what accounting "ought to do" was being placed in its stead. This is so because orthodox accounting circa 1978 did not provide information explicitly useful in either making economic decisions or predicting future cash flows. Accounting stood at a point where the authoritative body, FASB, had discarded the old and embraced the new.

The Current Situation

But have accountants in general, academic and practitioner, accepted this change? In the main the answer is no. Those who learned accounting as a transaction based discipline seem reluctant to abandon a fundamental belief. Another reason may be that FASB has yet to bo able to restructure accounting theory around their definition in such a way that the theory wooks in practice. Though FASB has consistently sought to retool the balance sheet since Concept Statement No. 1 and subsequent statements, the overall implementation of Concept Statement No. 1 and what it truly implies has, as of 1992, yet to occur.

Accounting is left with an authoritative definition very similar to a normative theory, that is to say, a definition of what ought to be, and along with this it faces all of the problems inherent in obtaining agreement on a theory of what ought to be. The difficulties regarding accounting theory acceptance have been examined by the AAA in its Statement on Accounting Theory and Theory Acceptance [1977]. The Statement's conclusion (which is open to debate) was that theory closure (agreement) cannot be dictated. Agreement is an emotional, not a rational, process. If that conclusion is valid for theory, then it seems reasonable to presume that the conclusion holds for a definition, especially one that is based on or implies a theory.

If agreement cannot be dictated how might it be achieved, assuming that FASB is concerned about closure? Time and attrition seem the most likely method. FASB's conceptual framework (including Concept Statement No. 1) dominates the theoretical discussion of most (if not all) current textbooks on accounting; this tends to indicate that eventually new generations of accountants will come to accept the new definition and the theory it implies, especially if the old viewpoint is not presented. However, regardless of any theory or definition to the contrary, accounting still proceeds based on transactions and the limitations that this implies.

By incorporating the usefulness criteria in Concept Statement No. 1, FASB has placed the seeds of revolution in a most visible field. But will the seeds germinate?

The Future?

The definitions of accounting are inherently intertwined with WHAT accounting is, i.e., the definition evolved as accounting itself did (and still does). Perhaps the new definitions, resulting as they did from the revolutionary pressures in accounting, bear witness to a new phenomenon, the rise of a new discipline as different from accounting as sociology is from mathematics.

William J. Schrader in "An Inductive Approach to Accounting Theory" [1962] has shown that to change the focal point of accounting from transactions to some other activity can only be done by "changing the character of accounting." Given the new definition of accounting, i.e., the process of providing information useful in making economic decisions and predicting future cash flows, one is left with the ponderable difficulty that in order to accomplish this no one yet knows just what the character of accounting will be.

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