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# SOME PHILOSOPHICAL NOTIONS ON THE PROBLEM OF ACCOUNTING PRINCIPLES



J. F. Finn

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# CHAPTER I

## INTRODUCTION

The purpose of this paper is to discuss the problem of accounting principles. Section II will deal with the question from a historical perspective and will attempt to show that there are basically two schools of thought, the "sociological" school and the "analytical" school, which, because they fail to define the word "principle" adequately enough, arrive at erroneous conclusions, or conclusions which are too obvious to be operative.

Section III will discuss the general notion of income and its relation to the various economic valuation concepts which have been devised to value the firm. It will be shown that the valuation techniques are justifiable as long as they fulfill the requirements of the ultimate user of the accounting data.

Section IV will criticize economic valuation techniques in the light of "informal logic" philosophy. It will conclude that there is no single valuation technique applicable to all economic situations, and that the accountant is not the real evaluator of the firm, but is a functionary in the evaluation process.

CHAPTER II

# HISTORICAL PERSPECTIVE

For a number of years the accounting profession has concerned itself with the quest for accounting principles. Indeed this quest has been so intense that a mountain of literature has been written on the subject; this naturally attests to the sincerity and assiduousness with which the profession has attacked the problem. In spite of all this activity, the profession remains firmly unenlightened as to what accounting principles (or postulates) really are.

One school of thought holds that accounting, is a social science, its principles and postulates are therefore the result of a bargaining process in which the various parties at interest in the corporation determine what the principles should be. The resulting principles would then satisfy all concerned.

Roy B. Kester[1] in a 1942 article has taken this position:

> "Accounting principles" is a phrase used to indicate that there are recognized methods, rules and standards of legal, business, and professional conduct in accordance with which the formal accounting works of a business unit or combination of such units should be carried on."

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1 Roy B. Kester, "Sources of Accounting Principles" in M. Moonitz and A. C. Littleton, eds., Significant Accounting Essays (Englewood Cliffs, New Jersey: Prentice-Hall, 1965), P. 151.

Kester holds that the principles are the result of a confluence of a number of interests, viz., management, owners, creditors, and the public through government agencies, in order to arrive at a balancing point at which all parties are satisfied.[1] And it is for this reason that he finds accounting similar to law and therefore a social science.[2]

E.B. Wilcox and R.H. Hassler in a 1941 article tried to rise above everything by calling for a broad concept of accounting.[3] What they proposed as a fundamental principle of accounting was usefulness.[4] "Everything which follows in any statement of accounting principles must be judged by the standard of usefulness."[5] As will be shown below, Wilcox and Hassler came close to providing a very real insight, but their article was too broad and vague to help matters.

George O. May also felt that usefulness was the fundamental principle of accounting. "... accounting principles are founded on considerations of utility."[6] But May seemed to feel that this utility was limited or bounded by "controlling conventions"[7] which seemed similar to

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1 Ibid., P. 156.

2 Ibid., P. 157.

3 E.B. Wilcox and R.H. Hassler, "A Foundation for Accounting Principles" in Moonitz and Littleton, op. cit., P. 142.

4 Ibid., P. 143.

5 Ibid.

6 George O. May, "Accounting Principles and Postulates" in Moonitz and Littleton, op. cit. P. 172.

7 Ibid., P. 177.

the convergence of variables idea of Kester.

Indeed, this idea has been so pervasive that over twenty years later Leopold Bernstein was advocating the sociological approach to accounting principles. "... every actual (accounting) practice represents an equilibrium point in a remarkable system of checks and balances."[1] Accounting is a social science whose concepts are rooted in the value system of society. "These concepts are socially determined and socially expressed."[2] Bernstein, therefore, wishes to concentrate attention in the search for principles upon "applied accounting research" which "has more limited objectives and addresses itself to finding more feasible and best possible solutions to specific problem areas."[3] Applied research would be more concerned with the "possible" and would try to determine if the accounting environment was ready for a change.

Ironically enough it seems George R. Catlett also felt that accounting principles were the result of a bargaining process among the parties at interest in the business enterprise.[4]

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1 Leopold Bernstein, "Whither Accounting Research", Journal of Accountancy, December 1965, P. 37.

2 Ibid., P. 34.
3 Ibid., P. 36.

4 George R. Catlett, "Factors That Influence Accounting Principles, "Journal of Accountancy, October, 1960, P. 44.

> The purpose of accounting for a business entity and of the financial statements prepared from its accounts might be stated briefly as follows: to fairly reflect all material and significant facts in the light of current economic and social conditions in such a manner that these facts are most useful, meaningful and fair to the affected segments of our society (such as stockholders, managements, creditors, employees, governmental agencies...) for the purpose of exercising judgment and making decisions with respect to the reporting business entity.

In another place, Catlett cogently argues for the development of "sound" accounting principles and argues against those principles which, although "generally accepted", are unsound.[1] He does not seem to realize that if the principles were to satisfy all interested parties, then they necessarily would have to be "unsound". Reasons for this will be developed in the second section of this paper, but let it be sufficient to say that the determination of income varies with the requirements of the parties at interest; so that one, single concept of income applicable to all parties is theoretically impossible. Finally, Maurice Moonitz, following the AICPA Terminology Bulletin, also held that postulates were the result of a sociological process. He adopted the definition given in the Journal of Accountancy in December, 1958.[2]

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[1] George R. Catlett, "Relation of Acceptance to Accounting Principles", Journal of Accountancy, March, 1960, PP. 33-38.

[2] Maurice Moonitz, The Basic Postulates of Accounting, Accounting Research Study No. 1 (New York: American Institute of Certified Public Accountants, 1961), P. 1.

> 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... (postulates) provide a meaningful foundation for the formulation of principles and development of rules ...

There is a second stream of thought which has grown in importance, namely there are those who feel accounting is a technique or a method for understanding accounting data. Accounting for them is not a social science, but an undeveloped natural science. Gilbert Byrne in a 1937 article maintained that accounting is a science, and its principles are compelling in the sense that they are self-enforcing. A natural sanction is attacked to not following them. [1]

R. J. Chambers is one of the most lucid proponents of the scientific approach.

> It is sufficient to stipulate that the scientific study of accounting, as a subject, requires the application of scientific methods to observable phenomena, and that, in carrying out such a study, the student (or theorist) is free to observe and to adopt the conclusions of any other scientific study as he requiresthem. The study will proceed from observations, from the conclusions of other sciences, or from assumptions to build up by logical processes, a body of propositions which is self-consistent and consistent with reality. [2]

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1 Gilbert R. Byrne, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards" in Moonitz and Littleton, op. cit., P. 109.

2 R. J. Chambers, "Detail for a Blueprint," Accounting Review, Volume 32, P. 208.

Chambers strongly emphasized the use of reason to describe the phenomena of the situation and then to form generalizations, laws and principles which constitute a science.[1] In a later article, he stated that "accounting is, fundamentally, a means of economic calculation. . . ."[2] And in his book, which will be reviewed more thoroughly below- entitled Accounting, Evaluation and Economic Behavior,[3] he carried his approach to accounting to its logical conclusion when he made a sharp distinction between measurement and valuation. The accountant should be concerned with measurement and the development of measurement techniques and not with valuation.[3]

Richard Mattessich also fell into the group who held that accounting is a measurement technique. "Accounting is concerned with the theoretical and practical problems of measuring various aspects of the income and flow of wealth phenomenon. . ."[4] And he urged a scientific approach to this problem.[5] Accounting is one part or form of an overall superdiscipline of the economic science which employes quantitative methods to understand reality.[6]

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1 R. J. Chambers, "Detail for a Blueprint, "Accounting Review, Volume 32, P. 206.

2 R. J. Chambers, "The Conditions of Research in Accounting", Journal of Accountancy, December, 1960, P. 35.

3 R. J. Chambers, Accounting, Evaluation and Economic Behavior (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1966), PP. 180-181.

4 Richard Mattessich, Accounting and Analytical Methods (Homewood, Illinois: Richard D. Irwin, Inc., 1964), P. 12.

5 Ibid., P. 8.

6 Ibid., P. 19.

He concerned himself quite vigorously with the problem of measurement and valuation and held that one of the concerns of accounting was to draw up various valuation techniques which will be useful to interested parties.

It is difficult to tell where Moonitz and Sprouse stand on this point since in their book they addressed themselves quite specifically to formulating principles. As was shown above, Moonitz, alone, would seem to hold that postulates were the result of a sociological process, but he seemed to have modified his stand in his study with Sprouse. They stated that the purpose of accounting was to supply information to management so it can fulfill its responsibility in reporting to owners, creditors, government and other bona fide interests.[1] This would seem to indicate that accounting information and techniques used to interpret data for owners may be quite different from those used for creditors or government. But unfortunately the rest of the study develops principles, and their derivative techniques, for apparently only one group of listeners when it should have developed valuation techniques for all the interested parties.

There are some conclusions which can be drawn from this brief survey. In the first place, except for Mattessich, all of the commentators who were reviewed saw accounting postulates and principles as something basic to, or fundamental to, or "behind", or at the root of the practices,

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[1] Robert T. Sprouse and Maurice Moonitz, "*A Tentative Set of Broad Accounting Principles for Business Enterprises*, Accounting Research Study No. 3, (New York: American Institute of Certified Public Accountants, 1962), P. 1.

and procedures of current accounting theory. For example Gilbert Byrne in his article quoted above stated: [1]

> ...there is no clear distinction, in the minds of many, between the body of fundamental truths, underlying the philosophy of accounts which are properly thought of as principles, and the larger body of accounting rules, practices and conventions which derive from principles, but which themselves arenot principles.

Chambers carried this idea to its logical conclusion in his book in which he devoted considerable thought to developing the nature of man, his environment and the place of economics and accounting in this scheme.

It is to be admitted that the word principle is exceedingly difficult to define with a wide variety of meaning and application. A rather broad and vague definition would be:

A principle is that from which something proceeds. But principle generally does not mean, and in the case of accounting principles does not mean, something from which practice or procedures comes in a direct, logical and/or causal relationship. The principles of accounting cannot be found by pushing back or going behind current practice to the more basic or fundamental concept. Instead of arriving at a more universal and primary understanding of reality, such speculation produces only vague, meaningless statements, or statements

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[1] Gilbert R. Byrne, op. cit., P. 106.

which are so obvious they are not functional. First principles transcend and are analogous to the situation which proceeds from them. The principles sought should take their origin in experience, but knowledge of these principles is such that it rises above experience; it transcends experience.[1] Wilcox and Hassler, May, and Moonitz and Sprouse came close to such a first principle of accounting when they maintained that accounting rules and procedures must be useful in order to have validity or relevance to a situation. They did not develop this idea fully, however, beyond making the bland assertion that a procedure must be useful to be valid.

A second observation that can be made concerns the scientific method which both Chambers and Mattessich hold. It is difficult to resist the ease and forcefulness with which it can approach reality. The real danger lies in making this method or technique coterminous and coextensive with reality. On the other hand, it may be held, as Chambers and Mattessich did, that since the object of science is the mathematico-mechanical world, accounting clearly would fall within its province. But this seems to engage in circular reasoning since everything that can be scrutinized in the light of the scientific method then becomes the mathematico-mechanical world. It remains to be seen whether accounting can and should

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[1] Robert J. Kreyche, First Philosophy (New York: Holt, Rinehart and Winston, Inc., 1959), PP 157-158.

be subjected to the scientific method. And indeed this question, in more general terms of course, is being heatedly debated in philosophical circles today. The thesis of this paper, however, assumes that it can be although this cannot be proven.

A third observation concerns the division of thought into two distinct streams: those who hold the social science approach to accounting and those who hold the scientific method approach. It may have been bold to a arbitrarily assign commentators to one cause or the other since scientists and social scientists themselves have difficulty in determining where one ends and the other begins. If approaches to reality are divided into a scientific approach and, for lack of a better term, a humanistic or existential approach, then it is difficult to see how social science can be categorized as anything but a science since it deals in à posterior statements, it does not deal in normative discourse, and it takes a methodological approach to reality (the term "behavorial sciences" demonstrates the methodology more clearly). The ability to predict phenomena seems to be, however, lacking; and this aspect would be expected in a natural science. It would seem then that the scientific method and social sciences are, abstractly, different currents in the same stream and not in two different streams. A fourth observation concerns the social science stream. R.J. Chambers raised an interesting point when he said:[1]

> ....since accounting is practiced in a social matrix, the elements of which (habits, laws, regulations) cannot be altered or held constant for the purpose of testing a new idea, the conclusions from any attempt to experiment with accounting ideas are likely to be vitiated by the numerous concurrent extraneous influences.

Chambers felt that accounting was a science which happens to be practiced in a social matrix. None of the social science advocates met this objection head on; and, except for Bernstein, none specifically defined a social science or determined if accounting could be included in that class of discipline. Reed K. Storey seemed to give a truer picture of what is meant by the term "social science" when he said:[2]

> .... the use of formal logic did not play a significant part in the formulation of accounting principles. Accounting development has been essentially practice-oriented. The phrase "logically follows" which appears often in the literature to support some point of view is usually not used in its formal sense. Accounting is described as ~~an~~ art, and accounting principles are referred to as "generally accepted" rather than as "logically consistent."

Later on he expanded on this point:[3]

> ...."principles" distilled from practice are capable of leading so far, and no further. A point is reached at which principles of this type become meaningless unless and until a conceptual framework is developed which gives meaning to the procedures followed... Building a conceptual framework, which will be at once both the reasoning underlying procedures and a standard by which procedures are judged, is a long-run process.

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1 R.J. Chambers, "The Conditions of Research in Accounting, op. cit., P. 38

2 Reed K. Storey, The Search for Accounting Principles (New York: American Insitute of Certified Public Accountants, Inc., 1964), P. 25.

3 Ibid., PP. 60-61.

The fifth observation is drawn from Reed K. Storey's short study, which is a lucid and scholarly history of the search for accounting principles. In comparing the American Institute of Certified Public Accountants to the American Accounting Association, he noted that, while the former was practice or case-by-case oriented and the latter concentrated on a formal logical theory, both came to the same conclusions because:[1]

1. The two societies had exactly the same objective, i.e. the improvement of financial accounting and reporting practice by reducing the number of acceptable alternative procedures,
2. Both saw financial accounting as essentially a process of cost and revenue allocation rather than as a process of asset and liability valuation, and
3. Both looked upon accounting principles as being derived from accounting practice.

Note that accounting was not seen as a process of valuation, but as the matching of realized sales revenue to historical cost. It was not until 1957 that the first glimmer of the recognition of discounted cash flows, a valuation technique, appeared in the literature.[2] Storey regarded accounting then, as a valuation technique.

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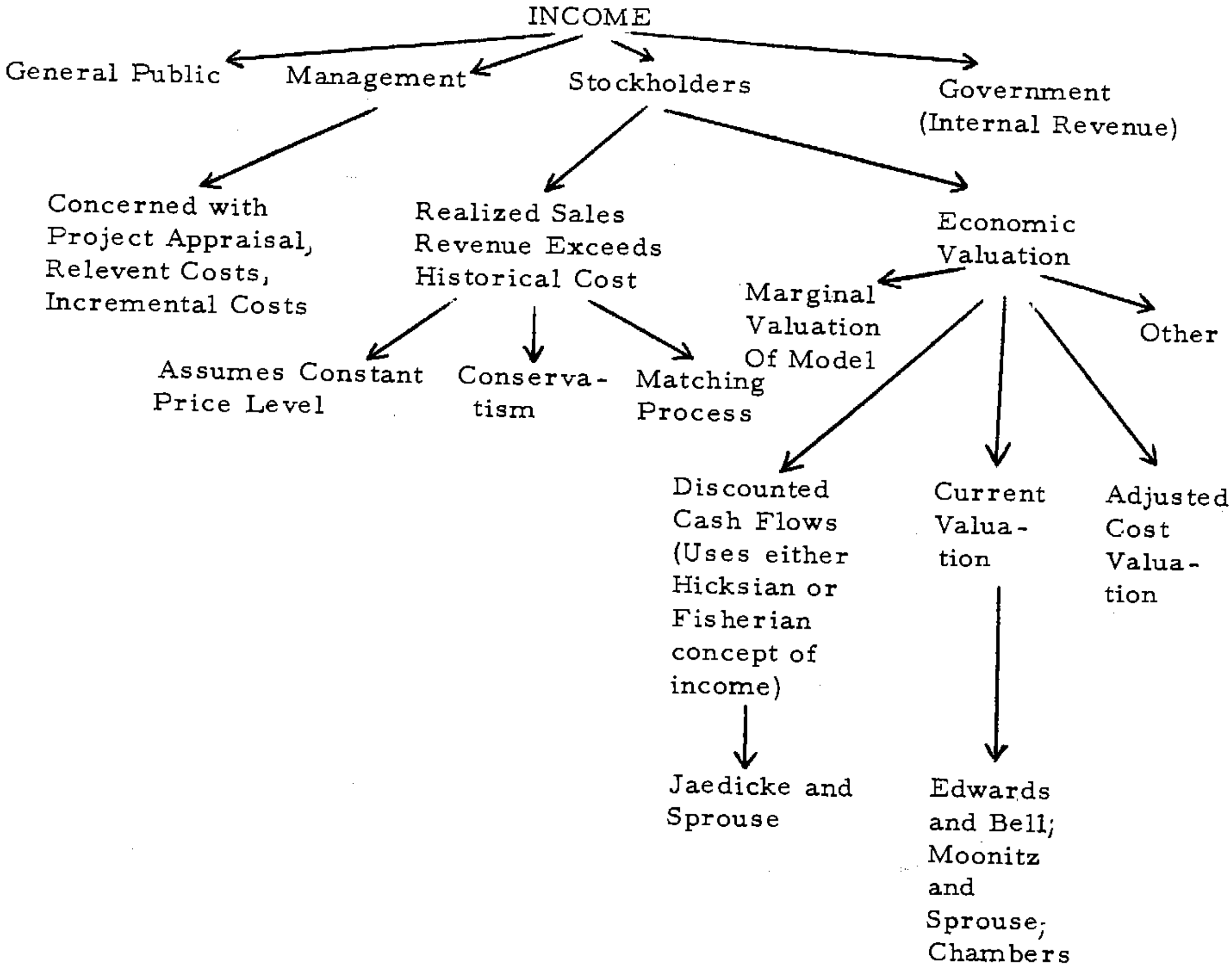
1 Ibid., P. 41,

2 Ibid., P. 45,

It is necessary now to move from the realm of history and what has transpired to the present and, hopefully, to the future. The valuation technique proposed by Mattessich and the one proposed by Chambers will be reviewed and set into the perspective of the business enterprise and its relationship to the parties of the enterprise. The next section will deal specifically with some of the valuation techniques discussed by Mattessich and will follow his book quite closely. The final section of the paper will move from the realm of practiceto the realm of abstraction. The notions of valuation, evaluation processes and value judgments will be explained as they have been in philosophy. And it is hoped that this interdisciplinary approach will provide fruitful insight into the problem of economic valuation of the firm which at this point in history becomes the purpose of accounting, and not the matching of realized sales revenue to historical cost.

# CHAPTER III

## VALUATION TECHNIQUES AND THEIR RELATION TO INCOME CONCEPTS




What is income? It can be seen from the diagram that a generic definition of income cannot be given, but income must be determined in specific instances. The questions "Income for Whom?" and "Income to What End?" must be asked prior to asking the question, "What is income?" There can be as many definitions of income as there are listeners. The concern of revenue authorities is the collection of cash from the corporation to run the Government, for this reason they tend to disallow non-cash expenses as a deduction in arriving at net taxable income. The U.S. Internal Revenue, for example, will not allow a write-down of obsolete inventory until the items have been physically removed from the plant or warehouse and disposed of. The general public includes, among others, creditors who are interested in the ability of the corporation to pay its debts. Income for them amounts to debt paying ability. Income for management and for stockholders will be explained in more detail below. In general, however, the financial statements are issued for the benefit of the stockholders. Moreover, the stockholders require this information on a periodic basis.

It is necessary to realize then that income figures can be justified only by understanding the situation from which they arise and the uses to which they are being put. As Sidney Alexander states:

> Income for any purpose must be so defined as best to serve the general welfare and the interests of those concerned. When those interests are in conflict the issue must be resolved by a comparison of the merits of the various claims and interests, and not by recourse to a "true" concept of income, independent of the ends served by the use of the income measurements.[1]

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[1] Sidney S. Alexander, "Income Measurement in a Dynamic Economy" in W. T. Baxter and Sidney Davidson, Eds., Studies in Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1962), P. 130.

Or, as Messrs. Jaedicke and Sprouse state:

> The choice of the appropriate concept or concepts (used for income determination) obviously depends on the use of the income calculation. Certainly different decisions may require different quantitative data. This observation implies that a different income concept might be appropriate for each different use.[1]

Indeed taxable income, or stockholder income, or income for creditors cannot even be thought of approaches to or parts of a "true" concept of income (true means have a comprehensive, coherent theory with attendant set of rules which is applicable in all cases), but these income figures are unique or "true" in themselves because they fulfill the goal or standard that was demanded of them by the stockholder, or the government or the creditors.

As was noted above, the traditional determination of income was the excess of realized sales revenue over historical cost. But clearly this approach has severe limitations. As Mattessich states:[2]

> ... it (cost basis) violates one of the most fundamental constituents of any value theory: the fact that value of an object or event is bound to time and circumstances... a specific value is a momentary and highly unstable magnitude and may change abruptly. To assert continuity for valuation purposes is a very strong assumption and justifiable only in situations where there is no indication of the contrary or where no better information is available.

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[1] Robert K. Jaidicke and Robert T. Sprouse, Accounting Flows: Income, Funds, and Cash (Englewood Cliffs, New Jersey: Prentice-Hall, Inc. 1965), P. 14.

[2] Mattessich, op. cit., P. 163.

Mattessich concludes by stating when an unmodified cost basis would be acceptable:[1]

> To our mind the cost basis is acceptable only under realistic depreciation and price-level adjustments, in situations where other basis (market value, replacement value, appraisal value, etc.) are technically not feasible or not commendable for economic reasons.

Since accounting is unable to validly hold the historical cost procedure, income must be determined some other way. Income can be based on flow variables or stock variables; the former is Irving Fisher's concept of income and the latter J. R. Hicks'. In either case, if a change can be quantified, it can be quantified in two ways: "(1) by measuring the sum total of all contributing increments and decrements (flows) or (2) by measuring the difference between the two totals (stocks) connected by this change."[2] A valuation technique when it is used by the accountant is essentially a measurement technique which enables him to arrive at income; and this is the connection between valuation and income determination.

Let us examine the income concepts which seem to be applicable to the stockholder. For him the determination of periodic, usually yearly, income is the most important function of financial accounting. The main problem of financial accounting is not the measurement of total revenues and total expenses over the life of an investment, but the measurement of

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[1] Ibid., P. 164.

[2] Ibid., P. 23.

revenues and expenses for a particular segment of the investment life.[1] Abstractly speaking, the total expense over the life of an investment will be exactly equal to the amount of the cash disbursed; and the total revenue is equal to the cash received.[2] This excludes capital withdrawals or additions and repayments of loans.

The main dispute between accountants and economists is about the timing of the realization of pure profit and not about the total amount involved.[3] Because the accountant cannot foretell the future, he must follow that course of action which will be least likely to mislead the stockholder through the years. In general, this attitude has come to take the form of rules and conventions called "generally accepted accounting principles", which hold, for example, that income is the amount by which realized sales revenue exceeds historical cost. Another principle is to anticipate all losses, but not to anticipate any profits. And another is to match costs to their respective revenues and not to a particular accounting period. But the shortcomings of the generally accepted accounting principles have been mentioned before.

The interesting point to note, however, is that the basis for economic valuation of the firm is cash flows. And the methods or techniques

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[1] Reed K. Storey, "Cash Movements and Periodic Income Determination" in Stephen A. Zelf and Thomas T. Keller, eds., Financial Accounting Theory (New York: McGraw-Hill Books Company, 1964), P. 48.

[2] Ibid, P. 50.

[3] Diran Bodenhorn, "A Cash Flow Concept of Profit", Journal of Finance, March 1964, P. 29.

with which these cash flows are evaluated are discounted cash flows, or interval rate of return, or current market value, etc. [1] Chambers appears to be saying the same thing:[2]

> A monetary unit becomes a unit of account by virtue of its function as a medium of exchange. It becomes a unit of measurement for the same reason. If singular measurements are to be added and subtracted, it is necessary that all measurements be made in terms of the same units.

Chambers holds and moreover, that "... at any present time all past prices are simply a matter of history. Only present prices have any bearing on the choice of an action."[3]

But Chambers has limited himself at this point to the valuation technique open to him. The only logical conclusion he could draw follows quickly thereafter:[4]

> We propose, therefore, that the single financial property which is uniformly relevant at a point of time for all possible future actions in markets is the market selling price or realizable price of any or all goods held. Realizable price may be described as current cash equivalent.

The single relevant valuation technique for Chambers is current

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[1] Mattessich, op. cit., P. 79.

[2]. Chambers, Accounting, Evaluation and Economic Behavior, op. cit., PP. 93-94.

[3] Ibid., P. 91.

[4] Ibid., P. 92.

cash equivalent, and he made this statement despite the fact that he appeared to have a firm grasp of the dynamics of the general or theoretical evaluation procedure. For example, he stated later on:[1]

> ...the problem of evaluating the information produced, by reference to the actor's strains and goals remains the problem of the actor (or reader of the financial statements)...What the processor (or accountant) observes, he observes for the actor (or reader of the financial statements).

The very real question that can now be asked of Chambers: If the accountant is an agent or functionary of the stockholder, how can he (the accountant) adopt only one valuation technique? Why cannot the valuation techniquesadopted depend on the needs of the stockholder? This problem will be discussed in detail in section three of the paper, when the evaluation process will be examined from a philosophical point of view.

The first valuation technique to be discussed will be the marginal valuation model[2] which holds that in many situations the value of an object can be equated with the utility which the last increment of this object is supposed to yield. The value of a commodity is identified with its marginal utility; the decision to purchase or not is settled by the satisfaction derived from the last increment of the commodity.



1 Chambers, op. cit., P. 144.

2 Mattessich, op. cit., P. 218.

This concept extends to market pricing so that the market value of an object is determined by its marginal utility to both buyer and seller. The economic apparatus of marginal rate of substitution and indifference curves is appended to this; modern economic price theory results.[1]

The limitations of marginal utility are well known. Mattessich concluded this way:[2]

> ...it shall not be denied that ideally and basically value (of an object) may be regarded a marginal concept...but first, there exists extreme cases in which value of an object or event is an integral and not a differential concept ... second, many total value functions...are step functions, hence undifferentiable, and third the determination of these total value functions in actual practice is prohibitively expensive if not impossible.

A second valuation model advanced by Mattessich is called investment valuation.[3] It utilizes the actuarial calculation of discounting future revenues and expenses connected with an asset item. Mattessich states that the major exponent of this technique was Irving Fisher, but another commentator has maintained that discounted value of expected future net receipts is the logical consequence of the Hicksian, not Fisherian, concept of income which is that income is the maximum amount a firm can distribute as dividends and still be as well off at the end of the period as at the beginning.[4]

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[1] Mattessich, op. cit., P. 150.

[2] Ibid., PP. 160-161.

[3] Mattessich, op. cit., PP. 218-219.

[4] Emily Chen Chang, "Business Income in Accounting and Economics," The Accounting Review, Volume 37, P. 637.

"Being as well off" economically is interpreted as maintaining capital in tact in terms of the discounted value of expected future net receipts. Income accrues as soon as there is an increase in net worth."[1] But it does not seem to make any difference whether discounted cash flows is the result of the Hicksian concept of income, which is based on measuring changes in a stock, or the Fisherian concept of income, which is based on measuring flows. Mattessich himself did not seem to see any difference earlier in his book.[2]

This discounted cash flow technique is, however, based on four unrealistic assumptions:[3]

1. The ability to know the amounts of future cash flows;
2. The ability to know the timing of future cash flows;
3. The ability to choose an appropriate rate of discount;
4. The purchasing power of the unit of cash measurement will remain the same, or the ability to know the extent and timing of any changes.

In a word, discounted cash flow model of income assumes a world of certainty. Its use is only as a model or goal which can be approached, depending on the constraints of time and money, but never

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1 Ibid.

2 Mattessich, op. cit., P. 23.

3 Jaedicke and Sprouse, op. cit., P. 29.

attained. Messrs. Jaedicke and Sprouse, however, strongly support counted cash flows. "Under certainty, the authors feel that there is a single best way (present value of future cash flows) to calculate income for stockholder reporting." [1] In the first three chapters of their book they develop an accounting model using discounted cash flows.

Some authors have tried to obviate the problem of the assumptions by making bland assertions that the difficulty of estimating future receipts can be by-passed by using good estimates. [2] Messrs. Jaedicke and Sprouse have a more reasonable view: [3]

> Its (present value of future cash flows) use is not feasible, however, for the valuation of individual assets and for the determination of incomes flowing from individual assets where the future cash flows resulting from holding and utilizing such assets are unknown and/or inextricately combined with those of other factors. In the manufacture and sale of most products, not only are the amount and timing of future cash flows uncertain, but the portions of those flows attributable to each factor of production (materials, labor, facilities, and the like) cannot be isolated.

A third valuation technique is the current valuation which is based on an informal but reliable inquiry about the amount to be paid for an asset

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[1] Jaedicke and Sprouse, op. cit., P. 18.

[2] David Solomon, "Economics and Accounting Concepts of Income," Accounting Review, July, 1961, P. 379.

[3] Jaedicke and Sprouse, op. cit., PP. 29-30.

in the current market, e.g., sales values, liquidation values, or replacement values, and purchase values.[1] The studies by Moonitz and Sprouse,[2] Edwards and Bell,[3] and Chambers[4] proposed this type of economic valuation of the firm. Messrs. Jaedicke and Sprouse, after having modified their stand on discounted cash flows because it assumes a world of perfect certainty, also moved toward this type of valuation.[5]

> The chief features of the recent trend are (1) the much stronger emphasis put upon market or replacement values and... (2) the articulate distinction between gains derived from holding assets, on one side, and from operating profits on the other.[6]

The main difference between Edwards and Bell and the traditional approach lies in the firm's evaluation of assets minus liabilities at current values rather than historical cost. They also classify and define a number of income terms relating to specific kinds of economic activity.[7]

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1 Mattessich, op. cit., P. 219.

2 Moonitz and Sprouse, op. cit.

3 Edgar O. Edwards and Philip W. Bell, The Theory and Measurement of Business Income (Berkeley, Calif.: University of California Press, 1961).

4 Chambers, Accounting, Evaluation and Economic Behavior, op. cit.

5 Jaedicke and Sprouse, op. cit., pp. 41-46.

6 Mattessich, op. cit., P. 166.

7 Mattessich, op. cit., PP 168-169.

Moonitz and Sprouse's approach to current valuation is a more compromising position in that they are trying to present a theory which would be more acceptable to the profession than a pure economic approach. As was mentioned above, Chambers also espouses a current valuation approach which he claims is the only relevent one. The purpose of this paper is not to review each of these theories in detail since their ideas are fairly well known by now.

The fourth valuation technique proposed by Mattessich is entitled: adjusted cost valuation. Historical cost can be justified only if the original cost is adjusted in two ways; (a) with regard to value changes due to utilization; (b) with regard to value changes due to price and price-level changes.[1] But as was noted above, Mattessich has rather severe reservations as to the suitability of even adjusted cost basis as a valuation technique.

A glance at the general schema at the beginning of this section will reveal an "other" category in relation to valuation techniques. There are, of course, other technique models that could be drawn up and examined and by now it is becoming apparent that the main thesis of this paper is that such models are justifiable as long as they fulfill the standards or requirements of the ultimate user of the accounting figures to enable him to make whatever decisions he may want to make.

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1 Mattessich, op. cit, P. 220.

But is such a principle (and here the word is used in the sense of a "first principle" of accounting) a valid one? Does such a statement amount to relativism? What exactly is a valuation model, an evaluation process, a value judgment, etc.? Does it ultimately create more confusion where clarity is needed? The answers to these questions were sought not within the field of accounting theory, for it was precisely because they were not dealt with by accounting theoreticians, that so much sterility has resulted. But it is necessary to wander outside the purview of accounting to philosophy to find the answers, or, if not the answers, at least some vigorous thinking.

# CHAPTER IV

## PHILOSOPHICAL COMPARED TO ECONOMIC NOTIONS OF VALUATION

The authority used to analyze economic evaluation will be Paul W. Taylor's, Normative Discourse which, in his opinion, "... is the first full scale attempt to use the "informal logic" approach in the general theory of value."[1] Other sources will be J. O. Urmson's article "On Grading";[2] Gabriel Marcel's Creative Fidelity;[3] Ralph Barton Perry's General Theory of Value;[4] C. I. Lewis' An Analysis of Knowledge and Valuation[5] was used sparingly.

At the outset it becomes necessary to clarify the terminology of Section III used: the terms "evaluation process" will be substituted for "valuation technique" and the result of an evaluation process is a value judgment. An evaluation process occurs when an evaluation is graded or ranked. The point Taylor makes in describing the evaluation process is that he is not describing a psychological, but a structural or logical account, account of what happens.[6] Taylor lists five elements

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1 Paul W. Taylor, Normative Discourse (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1961), P. XI.

2 J. O. Urmson, "On Grading" in Anthony Flew, ed., Logic and Language, second series (Oxford: Basil Blackwell, 1953).

3 Gabriel Marcel, Creative Fidelity (New York: The Noonday Press, 1964).

4 Ralph Barton Perry, General Theory of Value: Its Meaning and Basi Principles Constructed in Terms of Interest (Cambridge: Harvard University Press, 1950).

5 Clarence Irving Lewis, An Analysis of Knowledge and Valuation (La Salle, Illinois: The Open Court Publishing Company, 1946).

6 Taylor, op. cit., P. 9.

in every evaluation process.[1]

1. A class of comparison whose members are the evaluatum, and all the things in comparison with which the evaluation is graded or ranked.
2. A norm or set of norms according to which the evaluatum is graded or ranked.
3. A pro-attitude, a con-attitude, or a neutral attitude on the part of the evaluator.
4. A set of good-making or bad-making characteristics possessed by the evaluatum.
5. A point of view within the framework of which the grading or ranking is carried out.

Mattessich holds generally that the models used in the economic sciences have the following five characteristics: the object of comparison; the basic state of exogenous variables; the valuation of operation; the time structure; and the value or end result.[2] These characteristics are incorporated in the valuation techniques discussed in section II.

The first step in Taylor's evaluation process is a class of comparison whose members are the evaluatum and all the things in comparison with which the evaluatum is graded or ranked. First there must be an object to be evaluated. Secondly, gradation or ranking can consist of 'good' or 'bad', 'superior', 'inferior' or 'equal to 'something

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[1] Taylor, op. cit., P. 4.

[2] Mattessick, op. cit., PP. 217-218.

else', [1] or numerical grading or ranking. The first characteristic in Mattessich's analysis states that in order to express a value at least two objects are needed: the object to be evaluated and the scale, which is usually an amount of cash. [2] There appears to be no conflict on this point.

The second characteristic for Taylor is that of a norm or set of norms to which the evaluatum is graded or ranked. This compares favorably with Mattessich's second one also, i. e., the basic state, which is "a set of exogenous variables (or functions), acceptable to the parties involved in generating and utilizing the measure to be derived. Frequently these given data are also values ... which must be distinguished for the value to be deduced." [3] In evaluating anything there is the claim that the evaluatum fulfills or fails to fulfill the norms that have been adopted by the evaluator. [4] Mattessich recognized this point when he made the statement: "... the belief lingers on that there must exist one approach that is neutral to all purposes, one way of assigning values that can satisfy all valuation needs." [5] The analyst J. O. Urmson supports

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1 Taylor, op. cit., P. 5
2 Mattessich, op. cit., P. 217
3 Ibid.
4 Taylor, op. cit., P. 5.
5 Mattessich, op. cit., P. 147.

Taylor and Mattessich on this point:[1]

> .... when there are differences of opinion about what grading criteria to adopt in a given situation is there not a right and wrong about it; can we not say that these are right, these are wrong criteria... ? In some cases we would perhaps be content to admit that there was no right or wrong about it; the differences in criteria arise from different interests, different environments, different needs; each set is adequate to its own sphere. But in others, we certainly do not want to say this; the distinction, for example, between higher and lower moral codes cannot be lightly brushed aside. Roughly the question of whether we wish to actually decide this issue appears to depend largely on whether the simultaneous use of different sets of grading (i. e., evaluating) criteria by juxtaposed groups is in departmental, dispensable matters, or in all-embracing matters such as moral codes... and manners...



Both Mattessich, with his comment that there is no one evaluation technique neutral to all purposes, and Urmson, with his comment that differences in criteria arise from different interests, different environments, different needs, seem to agree quite strongly with one of the points of this paper, i. e., that there is no one "true" concept of income and there is no one "true" value concept. This is the crucial point that Jaedicke and Sprouse miss when they champion discounted cash flows as "the single best way" under certainty, and that Chambers overlooks when he propounds current cash equivalent as the "single financial property which is uniformly relevant", and that, it seems, most of the theoreticians through the years by-pass.

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[1] Urmson, op. cit., P. 184.

As mentioned in section I, Wilcox and Hassler, May and Moonitz and Sprouse came close to developing this outlook when they proposed the "useful" criteria, but they did not carry it to its logical conclusion.

The third step in Taylor's schema is the existence of a pro-attitude, or a con-attitude, or a neutral attitude on the part of the evaluator toward the evaluatum. There seems to be nothing directly comparable to this point in Mattessick's analysis, but, as will be shown, it probably should not be included anyway. The pro- or con-attitude constitutes the essential part of valuing something. "A person values something when he has a certain sort of pro-attitude toward it."[1]



R. B. Perry stressed the same point:[2]

"It is characteristic of living mind to be for some things and against others... to be "for" or "against" is to view with favor or disfavor; it is a bias of the subject toward or away from... This duality appears in many forms, such as liking and disliking, desire and aversion, will and refusal... It is to this all pervasive characteristics of the motor-affective life, this state, act, attitude or disposition of favor or disfavor, to which we propose to give the name of "interest".

Perry continued:[3]

"This, then", we take to be the original source and constant feature of all value. That which is an object of interest is *eo ipso* invested with value. Any object, whatever it be, acquires value when any interest, whatever it be, is taken in it, . . .

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1 Taylor, op. cit., P. 297.
2 Perry, op. cit., P. 115.
3 Ibid., PP. 115-116.

The existential philosopher Gabriel Marcel also emphasized this aspect of evaluation in an example on scanning a newspaper:[1]

> At this point the 'question' of our confronting, envisaging, or of appraising, in the most personal sense of these terms, does not arise; we passively adopt this "system of values" of the editor - which amounts to saying that we are not evaluating, for to evaluate effectively, is to evaluate in one's own name, to commit oneself.

It would seem then that the accountant is not an evaluator in the strict sense of the word for he does not need to have a pro- or a con-attitude toward the evaluatum, but he needs only to interpret it according to the norms of the statement reader who is the person who does make a value judgment. For a number of years the accountant has assumed what stockholder norms were, and that the income measurement he derived from accounting data would facilitate their decision-making processes.[2] The accountant then is a quasi-evaluator, he is a functionary in the evaluation process. (As was mentioned above, Chambers recognized this point.) Clearly he must determine what the norms of the stockholder are, and he must act to fulfill them. This naturally gives rise to the multi-valuation of the firm concept proposed by Mattessich. As long as the assumption and procedures of the techniques are known to the stockholder, the accounting function has been performed.

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1 Marcel, op. cit., P. 112.

2 Jaedicke and Sprouse, op. cit., P. 16.

The fourth point of Taylor's schema is that there must be a set of good-making and bad-making characteristics possessed by the evaluatum.

> What counts as a good-making or bad-making characteristic is not merely that in virtue of which an object satisfied or fails to satisfy certain tests or criteria, but that in virtue of which it fulfills or fails to fulfill certain standards <u>and consequently is the object of pro-attitudes or con-attitudes.</u> [1]

This definition of good-making and bad-making characteristic seems to correspond to Mattessick's fifth point, the opportunity value, which is the end result of the valuation model. "The information-worth of V (the end result) will depend on the contest within which it is used and on the degree of relevance of the model."[2] The worth of an object is extrinsic to the object. Taylor does develop his notions of intrinsic and extrinsic value in his work,[3] but it is not the purpose of this paper to review this question.

Taylor's fifth point is that an evaluation process has a point of view within which framework the grading or ranking is carried on. Taylor gives eight basic points of view for evaluating an evaluatum: the moral, the aesthetic, the intellectual, the religious, the economic, the political, the legal and the point of view of etiquette or custom. [4]

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1 Taylor, op. cit., P. 19.
2 Mattessick, op. cit., P. 218.
3 Taylor, op. cit., Chapter 1.
4 Ibid., P. 300.

The point of view Mattessich takes is economic. His fourth characteristic, time structure, probably can be subsumed into Taylor's fifth point also. Time structure is a set of time points" "expressing the temporal relation between the time points of the valuation basis on one side and the date for which the value is to be expressed..."That is, a valuation must be set in a temporal context in order to be relevant. It seems certain that Taylor would imply this aspect in his own idea on having a point of view.

There are a number of areas left unexplored in this analysis which perhaps should be mentioned now. First, how are various norms to be determined? Can they be justified in any way? Taylor devoted a substantial portion of his work to showing how norms can be justified. Roughly, he felt that a norm can be justified by studying the implications of following it. If following a norm is detrimental to man, it should be abandoned. Connected with this is the idea that implied in every value judgment is the assertion that the norms used to judge were appropriate in that particular case.[1] Second, it may forcefully be argued that this logical, rational approach to reality is too logical and too rational, that is strips away too much of a value judgment to be of any use, that it results in a tight logical box and does not truly reflect reality. This analysis is an approach to reality and is not meant to say everything

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1 Taylor, op. cit., P. 5.

about it; it is not meant to be such an exclusive approach to reality to debar other approaches. Third, the question of "ought" and "is" has not been discussed. Once the stockholder has had the various evaluation processed described to him, it is extremely difficult to tell him which one he "should" or "ought" to use. The statement that might be made is that the stockholder should use that valuation technique which will enable him to make an investment decision most effectively. Or the stockholder should use that valuation technique which will enable him to form a value judgment using his own norms.

The strands of thought developed in this section may be drawn together now. First, there appears to be a good deal of justification in taking the approach that the "informal logic" approach to evaluation that Taylor holds can be used to understand and criticize Mattessich's valuation techniques. Indeed, there is a startling correspondence between Taylor's five elements of an evaluation process and Mattessich's basic characteristics of valuation models. There are similarities in the notions of the object of an evaluation process; the evaluatum; in the idea of a norm or set of norms used to evaluate; in the idea that the worth of an object is extrinsic to the object; and in the idea of evaluation taking place within a framework or point of view bound by space and time.

Secondly, both commentators conclude quite strongly that the norms used in the evaluation process differ from situation to situation as the needs of the evaluator dictate. In short, there is no one "true" valuation concept applicable to all cases.

Thirdly, all of the philosophers reviewed, Perry, Marcel, Lewis and Taylor, hold that a pro- or con-attitude is necessary to have an evaluation process. It would seem then that the accountant is not an evaluator since it is not necessary for him to have a pro- or con-attitude toward the evaluatum. As was mentioned above, a more apt name for him would be a "quasi-evaluator".

# CHAPTER V

# CONCLUSION

This paper has attempted to breathe some life into an issue which has been moribund for a number of years. By taking, initially, a historical approach, it has shown that even though there appeared to be sharp disagreement between two groups of theoreticians, there was actually a good deal of harmony, erroneous harmony. One group, the "sociological process" group, holds that principles can be arrived at through some sort of bargaining process among the various parties to the corporation. The other group feels that they can be learned through the application of logical and analytical thinking to current practice and procedure. Both groups fail to define the word "principle" adequately enough, and, for this reason, their approaches are erroneous. Both groups would probably hold that a principle is that from which something proceeds and they would seem to hold that the "proceeding from" is effected by a logical and causal relationship, i.e., current accounting practice and procedure proceeds causally and logically from a certain accounting principle. This paper, in the second section, holds that this relationship of principle and practice is not one of logical cause and effect; but the principles of accounting are analogous and transcendental to practice. To be more specific, this would lead to the [illegible] that one principle of accounting would be, for example, that the valuation technique used to value a firm must fulfill the norm or standard of the financial statement reader.

The third section of the paper concerns itself with the various valuation techniques that have been devised to value the firm. Marginal valuation, discounted cash flows, current valuation and adjusted cost valuation were examined and criticized. The main point which can be drawn from this section is that there are and should be a wide variety of valuation techniques used to value the firm, and that they are justified as long as they fulfill the requirements of the ultimate user.

The fourth section of the paper sought to validate the ideas developed in the second and third sections by criticizing them in the light of "informal logic" philosophy.

The conclusions of this section are: first, the "informal logic" approach can be used to gain fruitful insight into economic valuation techniques; secondly, there is no single valuation concept applicable to all economic situations; thirdly, since a pro- or a con-attitude is not required of the accountant in the evaluation process, he is not an evaluator in the basis sense of the word; he is a "quasi-evaluator.".

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