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Accounting Historians Journal

Volume 11
Issue 2 *Fall 1984*

Article 2

1984

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Previts, Gary John (1984) "Frameworks of American financial accounting thought: An historical perspective to 1973," *Accounting Historians Journal*: Vol. 11 : Iss. 2 , Article 2.
Available at: https://egrove.olemiss.edu/aah_journal/vol11/iss2/2

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The Accounting Historians Journal
Vol. 11, No. 2
Fall 1984

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FRAMEWORKS OF AMERICAN FINANCIAL ACCOUNTING THOUGHT: AN HISTORICAL PERSPECTIVE TO 1973

Abstract: The debate among accounting theoreticians as to the content and usefulness of the Financial Accounting Standards Board's concept statements and its conceptual framework project can better be understood if a perspective of prior "framework" efforts is used. This paper interprets the principal prior efforts to produce a comprehensive conceptual framework for financial reports down to the time the FASB was formed in 1972. It shows that previous efforts were slow to evolve, and to respond to environmental changes. There is also evidence that a continuing "dynamic tension" has existed between the patterns proposed by practitioner groups and those of groups of academics.

Antecedent Structures

Medieval Origins

The emergence of western market economies can be traced to about 1200 A.D., during the decline of the age of feudalism.

> It is from thirteenth century Tuscany, and especially from Florence and Siena, that modern accounting takes it roots. From this period and region came the earliest business accounts in debit and credit form; as distinct from manorial and public accounts in charge and discharge form, whose history goes back to classical Greece and Rome, and even, in some respects, to ancient Mesopotamia, Egypt, Crete and Mycenae. It was Tuscans also who, by a series of insights and tentative improvements, evolved, probably by 1300, that scheme of double entry bookkeeping which is now in use throughout the civilized world as the basis of every well-ordered accounting system. . . .[1]

The author wishes to acknowledge the helpful comments provided by Edward Coffman, Kenneth Most, and the anonymous reviewers. An early version of this paper was presented at the DR Scott lectures in 1983.

Texts appearing after 1869, when Professor Lucchini presented Luca Pacioli's 1494 work to the Milan Academy of Accounting, were mostly content to acknowledge this treatise as the "source" of double-entry, which it clearly is not. Others found it useful to cite Pacioli's statement "The debit must be the same as the credit . . . both must add to the same total. . . ."[2]

The exchange transaction basis, and double entry accounting, are now fundamental elements of a market system, and provide the basis for a social role of accounting suggested in DR Scott's *The Cultural Significance of Accounts.*[3]

Scott foresaw the emergence of a social viewpoint which recognized scientific method and objective analysis as the unifying philosophy of our culture. "Accounting, as the primary vehicle of the scientific method, would replace the market system as the synthesis of our institutions and those of our culture."[4] He would not have been surprised to hear us use the term "bottom line" to describe a host of results and/or expectations in our culture.

If we are at the point of realizing Scott's "synthesis" it must be that a series of interesting and important institutional changes have occurred in western society in the centuries between Pacioli's treatise and its current state. It is not feasible to examine them all; however, several of them will be addressed in the historical context of American accountancy.

Colonial and Antebellum Constructs

The origins of American bookkeeping texts, now being traced to pre-revolutionary times, suggest that accounting in the American colonies was directly influenced by methods from England, Scotland, and the Netherlands.

Throughout this period, the forerunner of the modern "balance sheet" was most important, having evolved from the "balance account." As companies grew larger and trade and joint ventures increased, more persons had an interest in their operations. When stock companies appeared as a more common form of business entity in the 17th century, creditors and shareholders sought data from separate statements, because direct access to the ledger was limited.

A little before this time, Simon Stevin of the Netherlands had suggested that more than a list of assets and capital (balance sheet) items should be provided. He prepared a statement of "Proof of Estate" (Assets) detailing the expense and revenue items involved in the change in capital, which was a form of income determination.[5]

As the distinction between *nominal* and *real* accounts became understood, authors such as Thomas Jones of New York became innovators in the process of developing financial statements in the decades immediately preceding the Civil War. Chatfield concludes that the balance sheet and income statement (including the worksheet) emerged in their present form during the last 100 years.[6] Early financial reports bear a strong "family resemblance," and represent the origins of our present disclosure system.

The Basic Accounting Equation

A Post Civil War Exposition

Historians trace the accounting *equation* to both European and American accounting literature in the 19th century, and even earlier.[7] Europeans viewed the results of deducting liabilities from assets as "business capital." Americans also asserted that "capital" should be viewed as a personification of proprietorship. Thus evolved in American literature what we shall call "proprietary theory."

It is important to credit Charles Sprague in his series of articles "The Algebra of Accounts," (1880) with a complete and complex mathematical exposition of the accounting equation.[8] When Sprague published his important work, *The Philosophy of Accounts,* (1908) the equation as we know it (Assets = Liabilities + Proprietorship) appeared within.[9]

Thus by the start of the 20th century, after years of evolution, accountants employed an *exchange price based proprietary theory,* and a *double entry methodology,* and provided "statements" of *nominal account balances and real account activity.* The legacy of thought and method of this system underlies all that we know today and suggests a deliberate pace of conventional evolution influencing our field.

The Origin of American Standards

The First American Professional Reporting 'Standard'

In 1887 the American Association of Public Accountants, the forerunner of the AICPA, was formed. This organization resolved at the 1894 meeting to establish a reporting standard dealing with the balance sheet for American financial reports.

> "Resolved, that the method of stating should be in order of quickest realization, viz:

Assets:
Cash,
Bills Receivable,
Book Accounts,
Stock in Trade,
Fixtures and Fittings,
Machinery and Plant,
Rolling Stock,
Real Estate and Buildings,
Leases, etc., etc.
Liabilities:
Direct liabilities, viz.:
Bills Payable,
Open Accounts, Loans,
etc., etc.

making total of same, and balance with the Surplus or Capital properly apportioned to the partners or stockholders as may be."[10]

The process of acceptance of the standard was slow, given the influence of the British balance sheet tradition which listed long term capital assets first. A comment by Robert Montgomery, American born auditing author and early CPA leader, at the 1904 World Congress, on a paper by Arthur Lowes Dickinson, British born managing partner of the U.S. practice of Price Waterhouse & Company, attests to this:

> Montgomery: Mr. Dickinson states that the captions are usually stated in the balance sheet in a certain order—in other words, we start with real estate, buildings, and other similar assets, and we finally come down to cash as the last item, and accounts and bills receivable as the immediately preceding item. I think that is hardly the general practice. I think the ordinary business man to whom our balance sheets go looks on it with better favor if the quick assets—the circulating assets—come first, and that among the liabilities those that are to be paid immediately should come first, such as accounts and bills payable, so that you have on the one hand the cash and accounts receivable, and the stocks on hand which are readily convertible into cash, and then follow it up with the fixed assets afterward, coming down to Good Will, and stating the same order on the other side among the liabilities. I think it

> conveys the status of the business better than the form in which Mr. Dickinson has stated in his paper.[11]

It was also at the 1904 Congress, in Dickinson's paper, that the accounting principles for determining profit or loss, and the format of a modern income statement, directed primarily to capital intensive industry, were established.

The Impact of Government

By the start of World War I, initial standards and principles of American balance sheet and income statement accounting and reports were in place. The standards were substantially *self-determined and self-imposed.* During the war years, however, as government agencies became concerned about uniform pricing and costing, accounting issues were no longer a matter of professional concern alone. At the same time, income taxation was introduced, and attention focused on developing regulations for income determination which would recognize accepted accounting techniques and concepts—principally accrual methods. A 1918 tax regulation stated: "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." Such vague instructions offered a challenge to accountants, to attempt to structure a theoretical basis for income determination and to reduce the number of alternatives.

The Federal Reserve Board was also interested in improving the consistency of reports submitted to banks, which represented the major conduit for enterprise capital, in order to insure that the risks of credit granting were minimized by uniform disclosure in business financial statements. In the April, 1917 issue of the *Federal Reserve Bulletin* the Board published *Uniform Accounting.* The document was later (1918) separately reissued and retitled "Approved Methods for the Preparation of Balance Sheet Statements, a tentative proposal submitted by the Federal Reserve Board (Washington) for consideration of Banks, Bankers and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants and Associations of Accountants."[12] [This also serves as an early example of bureaucratic redundancy, in that the two word title of the original was "explicated" into 39 words.]

This document built upon Dickinson's 1904 model of the income statement and further established fundamental review steps which were forerunners to auditing procedures for ledger accounts. In fact the document was almost entirely a recapitulation of an

internal document of Price Waterhouse & Company, prepared by John C. Scobie.[13] Government-professional cooperation in establishing broad standards for financial statements and audits can be traced to this document.

In 1929 *Uniform Accounting* was revised and retitled *Verification of Financial Statements,* and while issued under the auspices of the Federal Reserve Board, it was acknowledged by the accounting professional community to be the "accountant's bible"—a document of authority, voluntarily heeded by the members of the CPA community.

These were not the only government agencies involved in the uniformity movement. The Federal Trade Commission also supported such steps as a means of standardizing cost and pricing practices in industry, perhaps reflecting the myriad of techniques encountered in war contracts, and of assessing competitive practice violations, which it sought to curtail as it combated trust and monopoly practices.

The 1920s and 1930s: Growth and More Structure

Alfred Chandler identifies the rise of the professional manager during the post World War I period as a critical episode in the development of the U.S. industrial economy. Chandler contends that the resource allocation decisions of professional corporate managers are in fact a "visible hand" superseding the invisible hand of Adam Smith's market place.[14] This visible hand of professional management was to be influenced by the conventions underlying accounting statements.

Writing in 1933 on a related phenomenon, the rise of the modern corporation, Berle and Means observed that the separation of owners and managers created a need for more structured reporting rules, to insure that owners received sufficient information to evaluate the performance of management. This concern reflected and amplified the concept of stewardship, which had been espoused as a principal objective of public statements.[15]

By 1920 a stage of maturation in the American industrial market economy had been achieved. The economy had been transformed from principally agrarian to manufacturing, and the related long run shift to an urban from a rural society was irreversibly under way. Correspondingly, the CPA's role was becoming institutionalized. But the dynamics of a changing investment community were to test the flexibility of this adolescent reporting system. The growing number of small, naive, investors transformed the basic network

of capital sources during the 1920s. Anxious for transactional gains, and relatively ignorant, if not uncaring, of reporting practices, small shareholders rode the crest of a speculative surge. Thousands of small investors speculated in the boom of the 1920s. Paper fortunes appeared and evaporated in the casino-like environment of Wall Street. The outcome was disastrous. The market led to a major catastrophe in 1929. Margin calls, bank system credit policies, and an inattention to rudimentary economic factors caused confusion and, as the market plunged, the economy entered a state of depression.

Leaders of the accounting profession demonstrated concerned leadership and formed a study group to encourage the New York Stock Exchange to require certain minimal disclosure and review procedures to remedy shortcomings. A voluntary reduction of accounting alternatives was identified as a means of resolving major reporting concerns. But when the Kreuger and Toll empire collapsed in the wake of a suicide and financial scandal in the early 1930s, the government decided to wait no longer for the stock market and the related professions to act. Senate Banking Committee hearings led to mandatory registration for traded securities in 1933, the establishment of the Securities and Exchange Commission (SEC) in 1934, and annual reporting requirements for listed companies.

Thus, a short lived tradition of government and professional "cooperation" was all but swept aside by the urgency of economic crises. It would take nearly 50 years to restore the prerogatives of the profession to set its own rules in this arena. Those 50 years would be characterized by every manner of criticism, several major setbacks, experiments and failures. The spark of professional control was kept alive as members of the accounting profession, such as Arthur Carter, were able to convince Congress that the independent public accountant was more likely to provide the long term solution to reporting problems than a corps of federal auditors.

Congress incorporated a role for the independent public accountant into the registration and annual reporting processes, but reserved the right to determine principles for the SEC when these related to statements of corporations filing with the Commission.

Substantial Authoritative Support—A Procedure and a Foundation

Carman Blough, the first Chief Accountant of the SEC had proposed, and the SEC endorsed in *Accounting Series Release (ASR)*

No. 4, the view that accounting principles which demonstrated substantial authoritative support would be viewed as acceptable by the SEC. With the formation of the American Institute of Accountants' Committee on Accounting Procedure in 1938, and through the subsequent period of the Accounting Principles Board (APB), groups of practicing CPAs worked to reestablish the profession's right to determine its own standards within the bounds of "substantial authoritative support."[a]

The Committee on Accounting Procedure (CAP)

The issuance of *ASR No. 4* and the establishment of the CAP began a long period of debate between the SEC and the practicing public accounting profession.[b] As the profession's first authoritative body, the CAP began by considering a broad conceptual statement.

Carman Blough recalled:

> At first it was thought that a comprehensive statement of accounting principles should be developed which would serve as a guide to the solution of the practical problems of day to day practice. It was recognized that for such a statement to be of much help to the practitioner it would have to be much more comprehensive and in far greater detail than the "Tentative Statement" of the American Accounting Association [1936 AAA Statement] issued two years previously.
>
> After extended discussion it was agreed that the preparation of such a statement might take as long as five years. In view of the need to begin to reduce the areas of differences in accounting procedures before the SEC lost patience and began to make its rules on such matters,

[a]Not, however until 1973 did this process come to a conclusion. With the establishment of Rule 203 in the AICPA's Code of Ethics (requiring observance of pronouncements by recognized bodies by members in good standing) and the simultaneous issuance of the SEC's *Accounting Series Release No. 150,* (recognizing the role of the FASB as the sole source of pronouncements with substantial authoritative support) the profession was in position to govern its standard-setting process for reporting.

[b]The McKesson Robbins case must be mentioned here to point out that it was the immediate cause for the initiation of a separate and specialized set of auditing standards within the profession, the first extended auditing procedures requiring confirmation of receivables and observation of inventory. The specification of a conceptual framework for accounting principles would be undertaken by the profession largely independently of a conceptual framework for auditing.

> it was concluded that the committee could not possibly wait for the development of such a broad statement of principles.[16]

Academic Efforts

By 1938 the academic community had twice broached the subject of a "framework." In 1936, an American Accounting Association group directed by Eric Kohler had published a brief 'normative' statement. Shortly thereafter, in 1938, under a commission by the Haskins & Sells Foundation, a 'positive' statement was completed by Professors Sanders, Hatfield, and Moore.

The fledgling American accounting academic community was now fully engaged in the quest for a set of concepts underlying principles, and in some sense was leading the investigation, perhaps to the discontent of a practicing community not entirely sure that its concerns about government takeover were resolved.

The appearance of the Paton and Littleton monograph, *Corporate Accounting Standards* (1940) added importantly to the academic framework for accounting. Written in support of the 1936 AAA tentative statement, the study was based on *the fundamental assumption that accounting was an allocation process, guided by a matching concept, and principally oriented to the historical cost valuation model.*[17]

Sterling, writing in 1975, suggests that the thought habits of accountants are responsible for whatever rate of development is experienced in addressing change. More simply put, we are reluctant to leave the old and the familiar, and convinced this reluctance is a good thing if the change also can be seen to risk our economic self-interest as investor or advisor to investors. It is possible to assert that many contemporary thought habits were nurtured in the cradle of these two academic works—the 1936 and 1940 statements.

Proprietary and Entity Theories

Accounting conceptual models may be distinguished according to the method of value measurement. Should historical cost be retained, or should some form of current valuation be supported? However, the inability to resolve a valuation issue may be a consequence of the lack of understanding of the irreconcilable proprietary and entity concepts as *orientation* guides to reporting issues.

In 1950 Newlove and Garner summarized this as follows:

> There are two possible approaches that one may take in the examination of basic accounting questions and propositions. One of these may be referred to as the *"proprietary theory,"* and the other is generally called the *"entity theory."* Each of these theories is well rooted in history and each has its several supporters. The differences between the two theories are based for the most part on (1) the nature of the business enterprise, (2) the view point to be taken of the fundamental accounting structure, and (3) relative emphasis to be placed on legal, economic, and accountancy concepts. Present day accountants should be particularly interested in these theories since they consciously or unconsciously select one or the other of them in deciding both major and minor questions which arise from time to time. In view of the fact that this process of selection is continually going on, there is small wonder that there are so many disputations in accounting matters. *The two theories mentioned do not offer a common meeting ground,* and if an accountant is not persistent in holding to one or the other, his conclusions as to matters of interest are likely to be inconsistent and unreconcilable.[18] (emphasis added)

Indeed if there is inadequate recognition of these differences, a consistent resolution of reporting issues cannot be expected.

Codification as a Remedy

In 1950 the SEC began to press the Committee on Accounting Procedure for a "comprehensive statement" (codification) of its output. With the threat of the government expanding Regulation S-X, (the compendium of SEC reporting requirements), the CAP agreed to codify its own pronouncements, thus producing *Accounting Research Bulletin No. 43* (1953).[19]

The pace of activity in these pre-1960 academic, professional, and government circles should be considered positive and remarkable. Herein established are precedents for both codification and theoretical investigation while the American culture and economy absorbed the pressure of a great depression, a global war, several minor wars, rapid expansion of the practice community, and increasing sophistication and diversification among user and preparer groups.

Furthermore, the academic community of the period was actively exploring alternatives to proprietary and entity orientations. New

"master" concepts were being proposed to reflect the increasing scope of accounting disclosure and the perplexing reporting problems related to corporate conglomerates. Writing in 1947 Vatter argued that the two traditional models of orientation were outmoded. He called for serious consideration of an alternative, a fund theory of accounting.[20] Moonitz identified both the corporate entity and consolidated reporting as focal points of concern and suggested more study of the implications of his "entity" theory.[21]

The fundamental preoccupation with proprietary and entity views however was not overcome, even though David Solomons, writing in 1961 observed: ". . . just as in the first half of this century we saw the income statement displace the balance sheet in importance, so we may now be de-emphasizing the income statement in favor of a statement of fund flows or cash flows . . . my own guess is that, so far as the history of accounting is concerned, the next twenty-five years may subsequently be seen to have been the twilight of income measurement."[22]

Developing a Research Basis

During the period, the CAP had seemed prepared to leave conceptual propositions to academics. But in 1958, the AICPA Special Committee on Research Programs recommended the formation of the APB and a research basis for the APB's deliberations. A substantial conceptual effort was then mounted under the sponsorship of the practice community, when as Moonitz tells:

> Two research projects were expressly called for in the special committee's report: the "basic postulates" research study did not evoke much reaction from the APB or the profession generally at the time of its publication. . . .
>
> The Sprouse-Moonitz (principles) research study appeared at the end of April 1962. Each copy of the research study contained a statement by the Accounting Principles Board (now referred to as APB Statement No. 1). The statement contained a key sentence "The Board believes, however, that while these studies (i.e., the first and third research studies) are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time. . . ."
>
> Research Studies Nos. 1 and 3 were rejected as too radical. Accounting Research Study (ARS) No. 7 (Grady,

An Inventory of Generally Accepted Accounting Principles, March 1965) however, was apparently what the APB wanted. . . . With one or two exceptions, it provided the kind of codification the Special Committee on Research Programs had in mind."[23]

In October 1970 *APB Statement No. 4,* identified as descriptive and not prescriptive, and binding on no one for any purpose whatsoever, was issued by the APB. Entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises"; it went over much the same ground as Grady's work. It failed however to satisfy the need for a comprehensive authoritative statement of Generally Accepted Accounting Principles (GAAP).

New Academic Proposals

A few years earlier (1966) academics had issued *A Statement of Basic Accounting Theory* (ASOBAT) under the auspices of the American Accounting Association. ASOBAT called for, among other things, both historical and current cost information. It seemed necessary that the practicing profession should respond to the academic position that more than historical cost measurement was called for in financial statements. Building on prior research *(Accounting Research Study No. 6,* 1963), the APB concluded in *Statement No. 3* (June 1969) that: "The Board believes that general price-level information is not required at this time for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles in the United States."[24]

The publication of *Accounting Research Studies Nos. 1* and *3* had challenged the comfortable thought habits of the times when they appeared in the early 1960s. Grady's *ARS No. 7* and the APB's *Statement No. 4* had a more comforting effect on the profession. The familiar and the practical triumphed over new and abstract proposals. Grady and the APB had credibility as they were identified with the practice community. The work of Moonitz, Sprouse, and ASOBAT were, perhaps "guilty" of being too novel, and too academic.

In late 1970 however, academics once again returned to address the issue. The AAA formed a study group, the Committee on Establishment of an Accounting Commission.[c] It was charged to consider the feasibility and desirability of establishing a Commis-

[c]One of the few places the charge and the list of the membership appears is in *The Accounting Review,* January, 1971, p. 174.

sion to study and recommend an organizational structure for (a) advancing the formulation and modification of generally accepted accounting principles and (b) the issuance of authoritative pronouncements concerning the application of such principles.

The deliberation of this Committee, chaired by Solomons, coincided with parallel formative actions being explored by an *ad hoc* professional group. The AAA group concluded its 'catalytic' efforts, and Solomons became a principal draftsman of the AICPA's Wheat Committee report. This Wheat (Solomons) Committee called for the creation of a Financial Accounting Standards Board, and for broader representation in determining GAAP in that practicing public accountants were joined by representatives from other constituencies of the financial community. Simultaneously with the formation of the Wheat (Solomons) Committee, the Trueblood Study Group on "Objectives of Financial Statements" began its work. George Sorter, another academic, served as its Research Director. He had also been one of the members of the short-lived Solomons AAA Committee.

The results of the Trueblood (Sorter) study group were to assert these "normative" propositions:

- — The basic objective of financial statements is to aid in economic decision making.
- — Financial statements should:
  - — Assist in predicting, comparing and evaluating the earning power of enterprises.
  - — Report both historical cost and current values which differ significantly.
  - — Separate information which is factual from information which is interpreted.[25]

Conclusion

This excursion into the evolution of the intellectual architecture of American accountancy has attempted to establish a point of reference for contemporary consideration of the FASB's conceptual framework project. It suggests that we recognize the continuing philosophical differences of view between government, academe, the practicing profession, and investor groups in seeking what some would suggest is the "negotiated truth" of accounting standards. A summary point, and an important one, is that a dynamic tension has existed almost continuously between academic and practice elements as to the composition of a comprehensive conceptual model. These tensions have provoked activity which has

brought us to a threshold of an important event—the measurement component of a financial reporting framework of the Financial Accounting Standards Board.

Nearly a decade ago, Sprouse, keeping in perspective his role as co-author of *ARS No. 3* ten years previously, remarked:

> The assertion is frequently made that in accounting's house the income statement is our most important product. To the extent that this is intended to mean the attention of most users of financial statements tends to focus on the income statement, the assertion is acceptable. To the extent that the assertion refers to the most important elements of accounting theory, the assertion is delusory. **This paper is written in support of an alternative proposition;** (emphasis added) the balance sheet embodies the most fundamental propositions of accounting theory, from which the essential elements contained in the income statement can properly be described as merely a summary of one class of transactions resulting in changes in one balance-sheet account.[26]

Sprouse is now a member of the Financial Accounting Standards Board. How much of this view represents Sprouse's thoughts today? How much of it will underlie the measurement component of the conceptual framework of the Board?

American accountancy has evolved without an exclusive/comprehensive framework for financial accounting thought. We have negotiated and then legislated, in some fashion, our truths for at least as long as we have been an organized profession. The potential for an FASB sponsored single comprehensive theoretical framework for financial reporting, therefore is limited by the historical view of such conceptual undertakings. But the transitory quality of the past can change if constituent groups begin to recognize the inherent limitations of general purpose reports, and embrace the usefulness of *multi-valuation* disclosure.

FOOTNOTES

[1]Lee, 1972, p. 28.
[2]Pacioli (Crivelli), 1924, p. 32.
[3]Scott, 1931, p. 7.
[4]Elam, p. 39.
[5]Chatfield, 1977, p. 55.
[6]Chatfield, 1977, p. 222.
[7]Most, 1982, pp. 44-45.
[8]Sprague, 1880.

[9]Sprague, 1907, p. 23.
[10]AI[CP]A, 1937, pp. 2 and 6.
[11]Dickinson, 1904, p. 196.
[12]Federal Reserve Board, 1918, title page.
[13]Previts and Merino, 1979, p. 189 and DeMond, p. 125.
[14]See Chandler, 1977.
[15]See Berle and Means, 1933.
[16]Shenkir, 1979, p. 175.
[17]Moonitz, 1974, p. 16.
[18]Newlove and Garner, 1951, pp. 20-25.
[19]Kohler, 1951, p. 51.
[20]Vatter, 1947, Ch. I.
[21]Moonitz, 1951, p. v.
[22]Solomons, 1961, p. 383.
[23]Moonitz, 1974, p. 28.
[24]*APB Statement No. 3,* par. 25.
[25]American Institute of Certified Public Accountants, *Objectives of Financial Statements,* 1973, p. 71.
[26]Sprouse, 1970, p. 91.

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