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What are the basic accounting postulates?

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Financial statements are based on generally accepted accounting principles—but developing and applying these principles creates a variety of problems.

WHAT ARE THE BASIC

EVERY DAY CERTIFIED PUBLIC ACCOUNTANTS SIGN reports which state flatly that the accompanying financial statements are "fairly presented in accordance with generally accepted accounting principles." We CPA's have been making that representation for upwards of 25 years. During that time there must have been literally hundreds of thousands, if not millions, of discussions and arguments with clients, attorneys, bankers, investment bankers, other accountants, and government agencies as to whether a particular treatment was or was not in accordance with generally accepted accounting principles.

During the same period, ideas as to what principles are, in fact, "generally accepted" have changed. To cite but two examples: Purchased good will is not now, as such, to be written off against capital surplus, and LIFO has come to be an accepted method of stating inventories.

The SEC partially faced up to this problem in 1938 by issuing its

CCOUNTING POSTULATES?

by William W. Werntz
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Accounting Series Release #4. It did not try then to define "generally accepted principles" positively but, instead, took the position that it would reject a treatment as generally accepted if:

(a) there was no substantial authoritative support for such treatment, or

(b) the treatment was contrary to any rule, regulation, or opinion of the Commission or its Chief Accountant.

While this release was primarily directed to rejecting disclosure as a substitute for correction of financial statements, it did have the effect of narrowing the area that could be considered to be "generally accepted." It left unsolved the question of what constituted "substantial authoritative support"—words that are much more precise than the phrase they sought to amplify.

In practice, the outcome of arguments over whether something was

or was not generally accepted customarily turned on:

(a) References to rulings and decisions of the SEC;

(b) Since 1940 or thereabouts, citation of opinions issued by the Committee on Accounting Procedure of the AICPA and, occasionally, statements issued by committees of the American Accounting Association;

(c) Citation of procedures followed by other companies—unfortunately, often without precise knowledge of the underlying facts;

(d) Citation of articles, books, and occasionally court opinions;

(e) Long-continued practice by the company involved; and

(f) Logic, including reasoning by analogy.

Four things became clear quite early. First, mere long-continued practice or "counting of noses" did not always furnish a good basis for recognizing a practice as "generally accepted." Indeed, in some areas the SEC and the AICPA Committee felt it necessary and desirable to issue specific rules or bulletins which had the effect of banning a variety of long-followed practices. Secondly, the phrase "generally accepted" came to have overtones of "sound" as opposed to "generally followed" practices. Thirdly, as new situations developed from changing conditions, or new ideas appeared, the only usable tests were clearly those of logic and reasoning by analogy, since, by being new, the treatment proposed could not be "generally accepted." In many situations the procedures proposed had not even been discussed in the literature. Fourthly, many discussions were stymied because the participants could not agree on the criteria to be applied in testing a particular practice.

While this approach to the determination of "generally accepted accounting principles" worked reasonably well over the years it also, as time passed, emphasized the need for (1) an explicit statement or frame of reference within which to argue the acceptability of a particular practice and (2) a set of criteria by which to test proposed solutions. Without such bench marks, discussion very often came to an impasse, with neither participant being satisfied. Thereupon the outcome became dependent on such unscientific and illogical matters as the relative bargaining power of those involved, time pressures, materiality, and so on.

The American Accounting Association recognized the void that existed and sought to fill it by its efforts to develop an integrated statement of accounting principles as early as 1936. The American Institute as a practicing body took a different tack, seeking not to state an integrated set of principles but to narrow differences in approach by the issuance of Accounting Research Bulletins bearing on specific practices. Neither of these efforts was fully successful and, when the Special Committee of the Institute reviewed the Institute's research activities a year or two ago, the Committee came to the conclusion that what was needed first was a statement of basic postulates against which accounting practices could be tested.

Can you sell your list of basic accounting postulates?

The task of developing basic postulates is fraught with many problems. At the very outset is the question of language. Is the word "postulate" the right word to describe the notions or fundamental propositions upon which our ideas about accounting rest? What do we mean by "basic postulates," anyway? Such questions may seem far away from the day-to-day problems that arise in the course of examining a set of financial statements, or from the broad questions that are being raised by our critics, such as whether leases should be capitalized, or full accruals made for pension plans. Yet it is often the lack of agreement on a starting point, or on criteria, that prevents the reaching of agreement on end results. If you doubt this lack of agreement, try discussing the matter with one of your associates; or try to list what you consider to be the "basic postulates," then try to sell your list to one of your associates. In most such discussions there is a tendency to start with a few propositions such as the going-concern concept, or the cost basis. Any such level of discussion, however, presupposes agreement on a whole bevy of underlying matters, such as that we live in a monetary, profit-making economy. Moreover, this "going concern" proposition, commonly regarded as a "basic postulate," is obviously not always so. Thus it may either not be a basic postulate, or may be an improper statement of the notion it seeks to convey. As you go ahead with the discussion of this or similar matters commonly called basic postulates, disagreements can often, if not always, be traced to differences in a number of unexpressed, underlying notions. It is thus important to all of us that the new Research Department of the American Institute and its advisers explore in detail

this underground area and seek to develop and state the propositions which underlie our thinking.

In the search for basic postulates, the question always arises as to whether such notions are always "so." Take the case of the going-concern notion just mentioned. As frequently phrased (that the life of an entity is assumed to be indefinitely long) it is obviously not so. Very few of the entities around us were here 100 or even 50 years ago. Nor are we entitled, from past experience, to expect that the average entity we now deal with will be here 100 or even 50 years from now. In some cases at least, it is obvious the particular company is headed for the rocks. If we change this statement to read that the life of the business entity is assumed, in the absence of clear evidence to the contrary, to be at least as long as needed to justify our policies as to depreciation, deferred taxes, and other matters that depend for fulfillment on future operations of the business, we have an assumption that is, indeed, in accord generally with current conditions. But do we have a basic postulate?

In a less immediate sense, one of our more basic postulates–that we live in a free, profit-making economy–need not necessarily be "so" forever in all countries, or even at all times in the same country–consider, for example, the modifications introduced in our country in war times. Here, then, is a special aspect of accounting postulates–they can be no more than creditable descriptions of the actual economy in which an accounting is to take place. As the economy changes in basic nature, so may some of our postulates have to change. The problem here is one of establishing criteria as to when a change in the economy calls for a change in a postulate and in the results reached by deductive reasoning based on the postulate.

Suppose the monetary unit is not stable

Perhaps the most current example is the question of the stability of the purchasing power of our monetary unit. If this is a basic postulate, when do we change, how do we change, and what changes in our collateral thinking are needed if the postulate of monetary stability is abandoned and we are forced by current conditions to adopt the position that the monetary unit is not stable? Those who advocate immediate transition to a "constant dollar" program have, in my opinion, by no means explored or answered all of these questions.

An equally interesting speculation might be the point at which the gradual march of a nation from free enterprise to a labor-oriented national socialism might require abandonment of the postulate of a free-enterprise profit-making economy. Would our operating statement then be more "useful" if the residuum were an item entitled "available for wages" rather than "net profit?" Would statements by industries in such conditions supersede in significance statements by entities?

Can there be conflicting postulates?

The next question that can be raised is whether there can be conflicting postulates or must they by definition be integrated and mutually exclusive? The answer to this question largely hinges on the level at which we define postulates. At the foundation of our thinking, the answer is that postulates must be integrated and mutually exclusive. If, however, we are thinking in terms of what are often loosely called postulates, but which are better described as rules or principles, conflicts are frequently apparent. For example, we generally talk about cost (i.e., value in an exchange) as being the amount at which a transaction is booked. But then we have another notion that says one cannot make a profit by dealing with himself. If a promoter sells property to his controlled company, which "rule" takes precedence? Suppose what he gets is stock rather than cash. And suppose, further, the property which he transfers to the corporation has a pretty readily and objectively ascertainable current value in excess of his cost.

Similarly, a fair share of the basic discussion as to the relative propriety of the LIFO and FIFO inventory methods derives from a conflict of assumptions—one side arguing that the cost of a sale is the amount paid for the physical article sold, as nearly as may be practicably determined; the other arguing that the more important fact is the relationship between current purchases and sales of like articles. In such problems, it is to be hoped that careful analysis and statement of our basic postulates, followed by sound deductive reasoning therefrom, may resolve the conflict.

The last question leads directly into another and very touchy one. We have all heard charges made that today's accounting permits too much leeway in the presentation of financial statements—that within the limits of what are called "generally accepted accounting principles" there may be, as to a given situation, two or more different but equally

acceptable methods in use. Some rather special but dramatic examples can be and have been developed. The relationship to the previous question is simple—is it to be inferred that with an agreed-upon set of integrated basic postulates there will necessarily emerge only one method of implementation that can logically be justified and, therefore, considered to be sound? This is a thorny question to which I do not have a ready answer.

It is certainly true that a variety of means of implementation is possible in certain areas without getting into what are generally talked about as "alternative" methods. For example, an estimate of bad debts may be made in several different ways—by an aging process, by reference to past experience, by analysis of individual debtors, by a percentage of sales coupled with a review of the situation at year end, or by using one of such methods and, in addition, giving weight to anticipated economic and business prospects. Certainly this type of "alternative" method is not subject to challenge, as a matter of theory, since each of them is designed to get the same answer—i.e., a reasonable allowance for possible losses in collection. Interestingly enough, most accountants do not have the same reaction to various means of implementing or applying the concept of depreciation; i.e., whether we should use straight-line, declining-balance, or sinking fund procedures. The reason for the different approach is clear—in the case of bad debts we are estimating the chance of a particular future event, payment; in the case of depreciation, on the contrary, we are selecting a systematic method of spreading a given cost over a reasonable period. Yet the available methods produce widely different results. The question is, can we by more rigid analysis and reference to "basic postulates" narrow these differences?

The method may depend on the facts of the case

It is also true that in at least some cases the method of implementation, chosen from among several possible methods, may depend on the facts of the case. Take, for instance, a dealer in real estate who buys and sells houses. It would seem most farfetched to suggest that he had any choice as to pricing his inventory of unsold homes. Or again in the case of bad debts, if there is only one receivable, then only the method of estimating bad debts by specific appraisal is available. On the other hand it remains to be seen whether by development of

basic postulates we can, by reasoning from them, conclude that we do or do not have a choice in valuing inventories as between, say, LIFO, FIFO and Average Cost. Interestingly enough, standard cost as a basis for valuing inventories has been generally rejected, except as it tends to approach one of the more usual methods. Yet standard costs, fairly determined, may well be a far more realistic basis than any of the other more commonly used bases. In the alternative we might conclude that while all of these methods are proper, certain conditions, if existing, would require the use of one method to the exclusion of the others.

In some areas agreement on basic postulates ought to enable us to resolve existing basic disagreements. As good an example as any would be the controversy over income tax allocation. Surely the important divergence in results which comes about by the use or non-use of income tax allocation must flow from differing basic assumptions–not from differences in facts or differences in methods of making estimates. The same is probably true of some of the other critical problems facing us today, such as whether to recognize price level adjustments, to capitalize leases, or to write off or capitalize intangible drilling costs, gross or net of taxes.

There is yet another aspect of the problem of developing and applying basic postulates. All accountants work in an environment in which such notions as materiality, conservatism, and fairness are in the air. The question is, how do such notions fit into the picture once we have agreed on our basic postulates and begun to apply them.

These notions are largely in the area of how an accountant goes about his work and how he reports what he finds. Obviously the development of basic postulates is not going to solve the question of when an item is "material." With or without basic postulates to guide us, we are still going to have some areas where good accounting is knowingly not followed because the effort needed to do so far outweighs any benefits thereby achieved, and in any case the dollar amounts involved cannot, on any rational basis, be termed material–e.g., failure to clear out all vouchers in all petty cash funds maintained by a multi-plant company, or writing off stationery at the time of purchase.

Much the same thing is true of "conservatism," at least when that word is used in connection with necessary estimates and other judgment processes. Essentially, conservatism on the part of the accountant is little more than the description of his effort to get to good, sound answers not unduly influenced by either pessimism or optimism. As

such, it too is more of a way of working and thinking than it is a basic postulate.

Fairness, in contrast, is a notion that presumably characterizes the accounting that results from the basic postulates. If we conform to sound basic postulates, the resultant accounting can only be defined as fair—otherwise, we contradict our postulates. The term "fairness," however, is also used in a less fundamental significance, as a criterion for the extent of disclosure. Obviously, financial statements might be based on an accounting which gave full effect to all the basic postulates and their corollaries, yet be so condensed or fragmentary as not to be a fair presentation. Finally, there are some who argue that "fairness" itself is *a* or even *the* basic postulate of accounting. It would seem to me that "fairness" used in this way is a subjective matter and would then itself have to be defined in specific and objective terms if any degree of uniformity in application were to result. Otherwise "fairness" standing alone would be a most illusory concept.

Now let us suppose that agreement is reached, not only on the basic postulates of accounting, but also on the proper means of implementing such concepts through agreement on derived accounting principles and procedures in specific areas. Does this mean that we as accountants no longer have problems and, in effect, have worked ourselves out of a job? If we take at face value some of the claims of those who believe it possible to arrive at rigid uniformity in accounting matters, this might seem to be a logical conclusion. Actually this will not be so by any means.

To begin with, as accountants, public or private, we remain primarily responsible for the application of postulates and principles to the facts of each case and, more important perhaps, for arriving at sound solutions derived from postulates as new facts and new conditions develop. Basic postulates are not self-implementing and will not automatically solve an accounting problem any more than will the availability, through an electronic data processing system, of endless detail as to inventories solve the problem of whether the inventory should be shown at LIFO or FIFO cost.

In the second place, a very large area of accounting involves the application of informed and sophisticated judgment. Substantially all allowances, from depreciation to warranties, are determined by the exercise of judgment in greater or lesser degree. No set of postulates and no mechanical means can supplant this need for judgment.

Of equal importance is the presentation of financial statements and the number and language of footnotes to be given. These questions arise only after all matters of accounting principle have been resolved. The drafting of financial statements and their footnotes is a delicate art in itself, involving as it does not only what must be shown, but also what is best left out. This area will always involve a very high degree of expertise developed out of education, research and experience, but guided – and only guided, not settled – by any agreed-upon basic postulates.

Finally there is the role of accountants as auditors. A learned counsel once said in effect, "Let me write the statement of facts and I'll let you make the decision." In a way that is what we as auditors do. A major purpose of the examination process is to do just that–to find out what the facts are, determine which facts are relevant to the accounting decision at hand, array them in orderly fashion, weigh them, and arrive at or recommend the solution. As a matter of fact, a very large share of erroneous or questionable decisions in accounting matters is traceable to an incomplete knowledge or statement of the facts. How often have you had to ask your staff to go back and get more facts, or have undertaken that task yourselves? This work will never become unnecessary, however clear-cut our basic postulates and derived accounting principles and procedures may be.

To sum up, the work undertaken by the American Institute of Certified Public Accountants' Research Department, when brought to fruition, should immensely aid accountants and should improve accounting in our own eyes and those of our clients and our consumers. Yet it will not automatically settle problems nor dispense with the need for our accounting profession. Instead it will require a profession of increased stature. It will enable us as accountants to discuss a problem at a higher level from the vantage point of an agreed-upon set of starting points.

William W. Werntz, who has B.A. and LL.B. degrees from Yale, joined TRB&S in 1947 and is now partner in charge of the New York Office. His service on the AICPA Project Advisory Committee on Basic Accounting Postulates provided background for this article, which is from a talk given to the California State Society of CPAs at San Diego last June.