

4-1939

Uses of Theory

A. C. Littleton

Follow this and additional works at: <https://egrove.olemiss.edu/jofa>



Part of the [Accounting Commons](#)

Recommended Citation

Littleton, A. C. (1939) "Uses of Theory," *Journal of Accountancy*. Vol. 67: Iss. 4, Article 4.

Available at: <https://egrove.olemiss.edu/jofa/vol67/iss4/4>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

The Uses of Theory

BY A. C. LITTLETON

IN ORDER to lay a foundation for considering the service performed by accounting theory, it may be well first to look briefly at the history of theory.

A perspective of the beginning of accounting theory offers us no such dilemma as that posed by the conundrum: Which came first, the hen or the egg? Accounting methodology came before accounting theory. Bookkeeping had a long development as a records-method, serving the day-by-day needs of businessmen, before teachers of the art did any more than describe existing practices.

From description, teaching passed to the formulation of rules. It was presently observed that learners experienced difficulty in resolving transactions into debits and credits; therefore, rules were devised to fit every type of transaction. This approach was used for a long time. But some teachers came to realize that the process of memorizing a large number of rules and choosing the proper one to fit a given situation was a teaching method almost as ineffective as mere description. Consequently, the multitude of rules was compressed into one which was variously phrased but generally resolved itself into: Debit what comes in, credit what goes out.

But this simple rule did not make learning simple; although deciding what had come in or gone out was easy, difficulty was still met in deciding which account should receive the entries. Reasoning of some sort had to be taught. When reasoning entered, theory began.

The first attempt to rationalize transaction analysis took its clue from the words "debit" (he owes) and "credit" (he trusts) and proceeded to personify every account. Cash represented a cashier, merchandise stood for a store

attendant, etc. By this means, sometimes at the price of rather circuitous reasoning, most transactions were readily resolved into debits and credits.

But the method also had the effect of definitely pushing theory onward because it precipitated a violent debate about the classification of accounts into related groups. The recognition of classification as a fundamental characteristic of bookkeeping was a very important step. Attention was thereby directed to the purpose of bookkeeping, and to the content of separate accounts and the interrelation of accounts, which caused them to fall into groups with some element of similarity or into contrasting groups. This sounded the death knell of personification. Accounts have ever since been considered as mere categories of useful factual information. Transaction analysis now rests upon that foundation—the theory of accounts.

There is more to accounting theory, however, than the theory of accounts. But, in one way or another, accounting theory is still oriented primarily to the problems of the proper understanding of transactions and the proper classification of transaction facts. Although the distinction between balance-sheet items and income-statement items was inherent in double-entry bookkeeping from its beginning, that distinction played no important part in the development of accounting theory until the nineteenth century. Somewhat earlier the legal problems of trust estates had raised questions of conflicting rights as between life tenant and remainderman and with these appeared the need for carefully scrutinizing estate transactions to determine their effect upon corpus and income. Presently the economists were pointing out that fixed capital could not generate profit or loss by a mere change

in value and that profit or loss could arise only when circulating capital "changed masters." In another generation or two these doctrines were clearly reflected in the accounting practice of the English railroads and supported by English statutory law and judicial decisions.

The aspects of accounting theory that emerged from this background may be indicated by the following questions: (1) How shall transactions affecting assets (fixed capital) be distinguished from those affecting expense (circulating capital)? This poses the familiar problem of capital and revenue charges. (2) Shall the relation of fixed assets to net income be expressed by charging to revenue an annual depreciation allowance or only the repairs and replacements necessary to keep the property in its original condition? This poses the problem of maintaining physical property or a money total of investment. (3) Can fixed assets be lost or gained without affecting the calculation of current net income? This poses the problems of capital gains and losses, and the cancellation of deficits out of subsequent earnings.

Although theory, as here illustrated, is rooted in problems of classification its essence lies deeper than the separation of statistical categories. It reaches down to such basic elements as honesty and truth, considered in the light of the parties at interest and the purposes to be served by accounting.

Men in positions of trust are occasionally wilfully dishonest in their trust. At times self-interest may persuade them to choose from alternatives the one that best suits their own biased views. Perhaps lack of knowledge prevents realization that better policies exist or conceals the probable consequence of a blind choice. Distortion of the truth may thus derive from dishonest intent, shortsighted self-interest, or plain ignorance.

These conditions are not new; they

have been recognized for a long time. They may be said to underlie the development of professional auditing. Such considerations explain the growth of statutory recognition of the auditor in Great Britain.

It was the auditor who gave accounting theory its modern significance. He found expenditures loosely supervised; thus the way was open for concealment or fraud, and scrutiny of details by an independent third party was made difficult, if not impossible. He therefore developed the theory that accounting facts should be supported by documentary evidence and validated by the authorizations of responsible parties. His examinations often revealed a misleading treatment of validated facts and he elaborated his ideas of proper treatment into accounting theory, much of which centered around such questions as those stated above. In this he probably was not altogether an independent innovator; the profession was new and the force of the management's views was strong. Not all of the growing body of theory was thoroughly rationalized out of basic principles; some of it no doubt was a justification of what seemed at the time the best practice. In any event much of the theory was before long embedded in custom and accepted in common law.

Later, and especially in the United States, it became clear that the true situation was difficult for absentee investors to read out of the customary financial reports because of the ease with which significant facts could be submerged. Hence theory is now in the process of further rationalizing accounting classifications, transaction analysis, and adequate disclosures in financial statements.

Accounting theory, since it has largely grown out of accounting practice, may seem to serve principally as a means of explaining and illuminating what is done in accounting. But theory has a further obligation, that of strengthening

The Uses of Theory

practice by subjecting customs to analysis and testing their justification by finding the relation of the ideas represented to basic concepts and purposes.

It may be too much to say that theory's analysis of accounting ideas is a guide to truth, for such a statement seems to imply that whatever is theoretical is true and much that is practical is not true. This is not an acceptable generalization, however. But theory can be helpful in the search for truth whether truth is concealed by dishonesty, bias, or ignorance. Because truth is relative, not absolute, any knowledge that is of assistance in judging degrees of truth will be useful knowledge. A knowledge of accounting theory falls in this category.

Public accountants have occasionally said that the search for accounting principles was largely fruitless because a single principle was all that was necessary to guide the professional accountant: See that the financial statements tell the truth. This "ever active impulse after truth" is further illustrated in the emphasis placed by accountants upon the clear disclosure of material facts and the consistent application of a method once adopted. Robert H. Montgomery expresses the thought in these words: "Accounting has but one purpose, to set forth the results of business operations accurately and truthfully."

The desire to make the revealing of truth a major objective marks the public accountant as a man who is striving for high professional ideals. But attainment of truth as an objective is not easy. The will to illuminate the truth may be defeated by an imperfect recognition of falsity, or it may be made ineffective by an inadequately developed technic of reporting. Or the will to truth may be rendered impotent by the lack of power to insist that technic be permitted to reveal the recognition of truth.

The ideal of making every financial statement tell the truth requires some-

thing more than a desire that it shall do so. The desire must be suitably implemented; it must have adequate backing. Behind the wish there must be: (1) *power*, that is, sufficient independence and courage to be able to insist upon truth in financial statements; (2) *skill*, that is, sufficient technical competence to be able to convey truth to another mind; (3) *knowledge*, that is, sufficiently well developed standards and principles to enable the auditor to separate business judgment from wishful thinking, and objectively determined facts from biased opinion. How the requisite power and skill may be attained need not be considered here. Although these two factors are no less important than the third, the ways of attaining them are easier to perceive than are the ways of recognizing truth.

Quid est veritas? We will search the dictionaries in vain for definitions of truth that will answer Pontius Pilate's question. Like all abstract terms, "truth" defies definition. If we say an assertion is true because it is exact, accurate, precise, correct, right, we merely find other words to be defined, and gain little insight into the essence of truth itself. It is not definitions we need, but standards by which to judge degrees of truth, and principles by which to perceive varying degrees of departure from truth.

But such hopeful generalizations still leave us full of questions. Where shall we seek standards? How can we distinguish principles from rules? What tests will enable us to recognize truth? What means have we of distinguishing the true from the false, knowledge from opinion?

Perhaps the test of truth lies in conformity with the pronouncements of authority.

But pronouncements of authority may derive their principal strength from the power that authority may possess to enforce its pronouncements, and the delegation or assertion of power does

not make pronouncements any less subject to human fallibility or individual bias.

Accounting principles can hardly derive from the authority of statutory law and judicial decisions. The one is concerned with rules of conduct which inflict punishments for the violation of stated maximums and minimums. The other is the result of the effort to see justice done under the specific circumstances involved. Neither is intent upon establishing general principles or desirable standards for accounting. In fact, law is upon occasion inclined to look to accounting knowledge for guidance.

The customs and conventions of accounting are embodied in a literature prepared by men of maturity and experience. Their testimony carries weight; we honor authority based upon age and experience. But times and conditions change. The pronouncements in the literature may be only the expression of a familiar tradition or of experience that has not faced all the varied present-day problems or their equivalent.

Men speak of a consensus of authoritative opinion, of generally accepted practices. But they give little consideration to devising a means of selecting those whose opinions will be authoritative or of effectively canvassing those selected to obtain their opinions; and they offer no suggestions for striking an average or reconciling conflicting views. They seldom seem to realize that such a survey would have to be repeated periodically to be useful.

These are some of the weaknesses in an appeal to authority as a test of truth. But the method has an element of strength. An individual may be perfectly satisfied with his own opinion. But it is safer to seek the views of others before making an important decision. Though there may be disagreement in council, there is also wisdom.

Perhaps the test of truth lies in logical relationships.

Instead of looking for principles in pronouncements of what is customary or accepted, some may hold that a man's own rational good sense is the best guide. Or, if he hesitates to trust common sense too much, resort may be had to syllogistic analysis. This type of analysis will permit conclusions to be deduced from perceiving relationships between obviously true propositions and the question at issue, or it will put principles to the test of being logically linked to premises that are themselves clearly acceptable.

But this approach also has its weaknesses. It is often extremely difficult in a field like accounting to establish satisfactory relationships between the several ideas or classes under analysis. Too often one must rely upon intuitive insight; frequently significant distinctions are overlooked. And, in addition, the conclusion of a syllogism is not necessarily true; it can be a valid conclusion by the rules of logic and still be untrue because the antecedent premises are not true. Assumptions, postulates, and axioms may be useful starting points, but they do not necessarily represent truth.

Yet, here too, there is an element of strength. From an examination of the logic of various propositions we come to a realization that truth is not absolute, but relative. Thinking is likely to be much improved when it raises the question of what underlies a proposition or what must be previously assumed before a given statement may be accepted. Logic introduces into thinking a desirable element of caution, of looking beneath the surface. It also encourages the effort to arrange ideas into a single organization for their better understanding. The mere introduction of order into the ideas already possessed may easily lead directly to the perception of new ideas.

Perhaps the test of truth lies in agreement with natural laws.

Science has made rapid strides by

The Uses of Theory

discovering the laws that govern natural forces. Painstaking observations and countless controlled experiments have provided an ever-widening comprehension of the limits within which nature operates. Knowledge of these limits has established boundary lines beyond which the application of natural forces may not be pressed without a penalty accruing. It is of tremendous significance, for example, to the steamship designer that the resistance of water to the passage of a ship increases as the square of the speed; it is of additional significance, however, that the power necessary to overcome resistance increases as the cube of the speed. Truth is action within the natural limits; falsity is attempted action outside the limits.

Perhaps there are laws of economics and of business. Success may be explained as resulting from action within the limits set by those laws, failure as penalty for violations of those laws. As we study business successes and failures we think that we do catch glimpses of truth and falsity, of the limiting boundaries which confine our action. If those boundaries can be expressed as formulae or laws, those expressions become principles of business, and, indirectly, principles of accounting. However, but little success has attended the efforts to formulate those laws. We do not know how to predict business success or failure to an acceptable degree; the chain of causation is too complex and changing, the power of experimentation too weak. Human psychology is baffling; it is generally unpredictable, except in the mass and over the long run. But business cannot operate for the long run alone, and few enterprises contact sufficient masses to be able to place much reliance on averages and the statistical laws of large numbers.

Yet, here too, there is strength in the midst of weakness. We can learn much from science to help make accounting more useful in presenting the truth. We

learn that objectively determined facts are more likely to approach the truth than uncorroborated personal opinion, that it is better to bring our ideas into conformity with facts than to try to force the facts to agree with our ideas, that an impersonal attitude toward facts can only be achieved by consciously guarding against the unconscious pull of wish.

For example, we can conceive of the net profit of a period as an ideal which we are incapable of completely comprehending. We calculate the net profit as best we can, realizing that the results will inevitably be something other than complete truth. Yet the will to a closer approximation to truth leads us to strive to improve our technic. The same motive impels the scientist to try to improve his technic of measuring the speed of light. In accounting we have in the past measurably improved our technic of calculating net profit; further improvement is still possible. Calculated profit is now much less subject to the personal opinion of interested parties than it ever was. Profit is not "what I say it is"; already it is an impersonal calculation based largely upon objectively determined, verifiable facts. It rests upon knowledge, not opinion. The time may come when the word "largely" will be inappropriate in the above sentence. When it does, the calculation will be a closer approximation to truth than is now possible. That time can be hastened by increasing the proportion of objectively determined, verifiable facts made use of in accounting, and decreasing the reliance upon belief, wish, opinion.

The determination of accounting standards and the formulation of accounting knowledge into coördinated principles has an important part to play in this evolution. Its part is important because principles and standards are important aids in the recognition of truth and the separation of nontruth.

Each of the tests for truth discussed

above has seemed inadequate in some respect. The customs and conventions of accounting may not have kept pace with the requirements imposed by new conditions, and a consensus with regard to accepted practices is very difficult to obtain. Logic is helpful to clear thinking but it tests validity, not truth. Science reveals the laws of nature and describes the limits within which natural forces operate. But similar laws and measurable limits have not yet been found that govern business. We may still hold to the basic idea that accounting statements should express the truth. But in these tests we have not yet found much guidance to the recognition of truth.

There is another avenue of approach, however. Perhaps the philosophical view of the nature of truth will give the sought-for test of recognition.

In science, it is the function of thinking and research to collect experience and give it organization and unification. Organization and unification alone give experience a meaning, for a new object, or idea, acquires meaning to the extent that it fits into our previous organization of objects or ideas. J. A. Nicholson (*An Introductory Course in Philosophy*) illustrates this thought with an example. A peasant who saw a steam engine for the first time had difficulty in fitting the new object into his mental organization of objects; he was sure there must be a horse inside to make it work.

The advancement of science has been founded upon two factors: (1) the close, detailed examination of experience in clearly marked areas, (2) the constant striving to perfect an increasingly complex organization of that experience. Yet that organization of knowledge always seems imperfect to the scientist; absolute truth still escapes. But the more complete, the more accurate, the more subdivided into categories that the organization of an area of knowledge becomes, the closer we are to truth in that area.

Truth then is an ideal, as goodness

and beauty are ideals. It is the striving for the ideal, not the attainment, that generates understanding and progress; every closer approximation is a source of satisfaction and a reward.

Professor Nicholson asks: "If truth is an ideal, what do we mean when we say that a particular judgment is true?" He answers:

"It can only mean that the judgment fits into the organization of facts that we have already accomplished. A statement is false, on the other hand, when it cannot be fitted into such an organization. If I say, for example, that a particular tree is a maple, it is because the various facts that I see fit into the organization of facts that I call a maple tree. If a botanist informs me that I am mistaken and the tree is an oak, it is because he sees facts that do not fit into a more complete organization of facts than mine which he calls a maple and do fit into the organization that he calls an oak tree. On this view of truth, knowledge and opinion differ only in degree. The scientist is said to have knowledge only because he has organized the facts of his particular field far more comprehensively: he has moved a stage nearer the ideal than the laymen. But no knowledge is absolute. There are degrees of truth; and the degree is to be determined by the comprehensiveness of the organization into which a particular judgment enters as an organic element."

If we carry this conception over to the field of accounting, the basis by which to judge various accounting situations or propositions should be a close-knit organization of our present stock of accounting ideas. We have a large enough stock to start with; it has been accumulating for a long time, but the organization has never been very thorough.

An improved organization of accounting ideas into an integrated whole can be accomplished. It will never be perfect; it must be free to grow as change comes and as understanding deepens. No body of knowledge was well organ-

The Uses of Theory

ized in its early stages. Yet merely trying to improve the organization reveals blank spots that need filling and debatable areas that are not sufficiently analyzed.

But of this we can be sure: "An idea that forms part of a logically coherent system . . . is more likely to be true than an idea that has not yet entered into such a system."

What Nicholson calls "a logically coherent system," might also be called "a coherent body of doctrine," "a consistent system of theory," "a group of interrelated concepts and principles," "a set of standards by which to judge variations."

The approach to such a body of doctrine must give weight to the meaning

inherent in "logical," "coherent," "consistent," "interrelated." Such a body of accounting theory may in some part seem unpractical and unrealistic, but it need not be without usefulness, nevertheless. A coherent body of accounting theory can still afford a basis for distinguishing necessary or useful variations and unnecessary or deceptive variations. It can help to free the public accountant for really important critical appraisals of the practices he meets. It can help him to guide management toward well considered judgments, toward suspended judgment until the facts are fully examined, toward impartial weighing of factors and responsibilities — in a word, toward a scientific attitude.