

APPENDICES

APPENDIX A

"THE BASIC POSTULATES OF ACCOUNTING"

The following list of proposed postulates is taken from MAURICE MOONITZ, THE BASIC POSTULATES OF ACCOUNTING 52-53 (AICPA Accounting Research Study No. 1, 1961):

Postulate A-1. Quantification. Quantitative data are helpful in making rational economic decisions, i.e., in making choices among alternatives so that actions are correctly related to consequences.

Postulate A-2. Exchange. Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers.

Postulate A-3. Entities (including identification of the entity). Economic activity is carried on through specific units or entities. Any report on the activity must identify clearly the particular unit or entity involved.

Postulate A-4. Time period (including specification of the time period). Economic activity is carried on during specifiable periods of time. Any report on that activity must identify clearly the period of time involved.

Postulate A-5. Unit of measure (including identification of the monetary unit). Money is the common denominator in terms of which goods and services, including labor, natural resources, and capital are measured. Any report must clearly indicate which money (e.g., dollars, francs, pounds) is being used.

Postulate B-1. Financial statements. (Related to A-1.) The results of the accounting process are expressed in a set of fundamentally related financial statements which articulate with each other and rest upon the same underlying data.

Postulate B-2. Market prices. (Related to A-2.) Accounting data are based on prices generated by past, present or future exchanges

which have actually taken place or are expected to.

Postulate B-3. Entities. (Related to A-3.) The results of the accounting process are expressed in terms of specific units or entities.

Postulate B-4. Tentativeness. (Related to A-4.) The results of operations for relatively short periods of time are tentative whenever allocations between past, present, and future periods are required.

Postulate C-1. Continuity (including the correlative concept of limited life). In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

Postulate C-2. Objectivity. Changes in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like, should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms.

Postulate C-3. Consistency. The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

Postulate C-4. Stable unit. Accounting reports should be based on a stable measuring unit.

Postulate C-5. Disclosure. Accounting reports should disclose that which is necessary to make them not misleading.

APPENDIX B

"A TENTATIVE SET OF BROAD ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES"

The following summary of proposed principles is taken from ROBERT T. SPROUSE & MAURICE MOONITZ, A TENTATIVE SET OF BROAD ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 55-59 (AICPA Accounting Research Study No. 3, 1962). It should

be noted that the principles listed are *recommended* only and do not purport to be those currently operative in accounting practice:

The principles summarized below are relevant primarily to formal financial statements made available to third parties as representations by the management of the business enterprise. The "basic postulates of accounting" developed in *Accounting Research Study No. 1* [Appendix A] are integral parts of this statement of principles.

Broad principles of accounting should not be formulated mainly for the purpose of validating policies (e.g., financial management, taxation, employee compensation) established in other fields, no matter how sound or desirable those policies may be in and of themselves. Accounting draws its real strength from its neutrality as among the demands of competing special interests. Its proper functions derive from the measurement of the resources of specific entities and of changes in those resources. Its principles should be aimed at the achievement of those functions.

The principles developed in this study are as follows:

A. Profit is attributable to the whole process of business activity. Any rule or procedure, therefore, which assigns profit to a portion of the whole process should be continuously re-examined to determine the extent to which it introduces bias into the reporting of the amount of profit assigned to specific periods of time.

B. Changes in resources should be classified among the amounts attributable to

1. Changes in the dollar (price-level changes) which lead to restatements of capital but not to revenues or expenses.

2. Changes in replacement costs (above or below the effect of price-level changes) which lead to elements of gain or of loss.

3. Sale or other transfer, or recognition of net realizable value, all of which lead to revenue or gain.

4. Other causes, such as accretion or the discovery of previously unknown natural resources.

C. All assets of the enterprise, whether obtained by investments of owners or of creditors, or by other means, should be recorded in the accounts and reported in the financial statements. The existence of an asset is independent of the means by which it was acquired.

D. The problem of measuring (pricing, valuing) an asset is the problem of measuring the future services, and involves at least three steps:

a. A determination if future services do in fact exist. For example, a building is capable of providing space for manufacturing activity.

b. An estimate of the quantity of services. For example, a building is estimated to be usable for twenty more years, or for half of its estimated total life.

c. The choice of a method or basis or formula for pricing (valuing) the quantity of services arrived at under b, above. In general, the choice of a pricing basis is made from the following three exchange prices:

(1) A past exchange price, e.g., acquisition cost or other initial basis. When this basis is used, profit or loss, if any, on the asset being priced will not be recognized until sale or other transfer out of the business entity.

(2) A current exchange price, e.g., replacement cost. When this basis is used, profit or loss on the asset being priced will be recognized in two stages. The first stage will recognize part of the gain or loss in the period or periods from time of acquisition to time of usage or other disposition; the second stage will recognize the remainder of the gain or loss at the time of sale or other transfer out of the entity, measured by the difference between sale (transfer) price and replacement cost. This method is still a cost method; an asset priced on this basis is being treated as a cost factor awaiting disposition.

(3) A future exchange price, e.g., anticipated selling price. When this basis is used, profit or loss, if any, has already been recognized in the accounts. Any asset priced on this basis is therefore being treated as though it were a receivable, in that sale or other transfer out of the business (including conversion into cash) will result in no gain or loss, except for any interest (discount) arising from the passage of time.

The proper pricing (valuation) of assets and the allocation of profit to accounting periods are dependent in large part upon estimates of the existence of future benefits, regardless of the bases used to price the assets. The need for estimates is unavoidable and cannot be eliminated by the adoption of any formula as to pricing.

1. All assets in form of money or claims to money should be shown at their discounted present value or the equivalent. The interest rate to be employed in the discounting process is the market (effective) rate at the date the asset was acquired.

The discounting process is not necessary in the case of short-term receivables where the force of interest is small. The carrying-value of receivables should be reduced by allowances for uncollectible elements; estimated collection costs should be recorded in the accounts.

If the claims to money are uncertain as to time or amount of receipt, they should be recorded at their current market value. If the current market value is so uncertain as to be unreliable, these assets should be shown at cost.

2. Inventories which are readily salable at known prices with readily predictable costs of disposal should be recorded at net realizable value, and the related revenue taken up at the same time. Other inventory items should be recorded at their current (replacement) cost, and the related gain or loss separately reported. Accounting for inventories on either basis will result in recording revenues, gains, or losses before they are validated by sale but they are nevertheless components of the net profit (loss) of the period in which they occur.

Acquisition costs may be used whenever they approximate current (replacement) costs, as would probably be the case when the unit prices of inventory components are reasonably stable and turnover is rapid. In all cases the basis of measurement actually employed should be "subject to verification by another competent investigator."

3. All items of plant and equipment in service, or held in stand-by status, should be recorded at cost of acquisition or construction, with appropriate modification for the effect of the changing dollar either in the primary statements or in supplementary statements. In the external reports, plant and equipment should be restated in terms of current replacement costs whenever some significant event occurs, such as a reorganization of the business entity or its merger with another entity or when it becomes a subsidiary of a parent company. Even in the absence of a significant event, the accounts could be restated at periodic intervals, perhaps every five years. The development of satisfactory indexes of construction costs and of machinery and equipment prices would assist materially in making the calculation of replacement costs feasible, practical, and objective.

4. The investment (cost or other basis) in plant and equipment should be amortized over the estimated service life. The basis for adopting a particular method of amortization for a given asset should be its ability to produce an allocation reasonably consistent

with the anticipated flow of benefits from the asset.

5. All "intangibles" such as patents, copyrights, research and development, and goodwill should be recorded at cost, with appropriate modification for the effect of the changing dollar either in the primary statements or in supplementary statements. Limited term items should be amortized as expenses over their estimated lives. Unlimited term items should continue to be carried as assets, without amortization.

If the amount of the investment (cost or other basis) in plant and equipment or in the "intangibles" has been increased or decreased as the result of appraisal or the use of index-numbers, depreciation or other amortization should be based on the changed amount.

E. All liabilities of the enterprise should be recorded in the accounts and reported in the financial statements. Those liabilities which call for settlement in cash should be measured by the present (discounted) value of the future payments or the equivalent. The yield (market, effective) rate of interest at date of incurrence of the liability is the pertinent rate to use in the discounting process and in the amortization of "discount" and "premium." "Discount" and "premium" are technical devices for relating the issue price to the principal amount and should therefore be closely associated with principal amount in financial statements.

F. Those liabilities which call for settlement in goods or services (other than cash) should be measured by their agreed selling price. Profit accrues in these cases as the stipulated services are performed or the goods produced or delivered.

G. In a corporation, stockholders' equity should be classified into invested capital and retained earnings (earned surplus). Invested capital should, in turn, be classified according to source, that is, according to the underlying nature of the transactions giving rise to invested capital.

Retained earnings should include the cumulative amount of net profits and net losses, less dividend declarations, and less amounts transferred to invested capital.

In an unincorporated business, the same plan may be followed, but the acceptable alternative is more widely followed of reporting the total interest of each owner or group of owners at the balance sheet date.

H. A statement of the results of operations should reveal the components of profit in sufficient detail to permit comparisons and in-

interpretations to be made. To this end, the data should be classified at least into revenues, expenses, gains, and losses.

1. In general, the revenue of an enterprise during an accounting period represents a measurement of the exchange value of the products (goods and services) of that enterprise during that period. The preceding discussion, under D(2), is also pertinent here.

2. Broadly speaking, expenses measure the costs of the amount of revenue recognized. They may be directly associated with revenue-producing transactions themselves (e.g., so-called "product costs") or with the account-

ing period in which the revenues appear (e.g., so-called "period costs").

3. Gains include such items as the results of holding inventories through a price rise, the sale of assets (other than stock-in-trade) at more than book value, and the settlement of liabilities at less than book value. Losses include items such as the results of holding inventories through a price decline, the sale of assets (other than stock-in-trade) at less than book value or their retirement, the settlement of liabilities at more than book value, and the imposition of liabilities through a lawsuit.

APPENDIX C

"SUMMARY OF GENERALLY ACCEPTED PRINCIPLES OF ACCOUNTING FOR BUSINESS CORPORATIONS ON AN HISTORICAL BASIS"

The following summary of accounting principles is taken from PAUL GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 56-67 (AICPA Accounting Research Study No. 7, 1965). It should be noted that the principles listed purport to have been derived from current accounting practice.

Accounting serves many internal and external purposes in the broad fabric of corporate business. The most important external purpose is to supply the comprehensive and dependable information required so that management may fulfill its fiduciary accountabilities to stockholders, creditors, government and others having bona fide interests. The principles of financial accounting for corporate business enterprises logically and usefully may be classified in relation to these fiduciary accountabilities. Such principles are necessarily stated in broad terms of objectives and major criteria, and the complexities facing modern business make more definitive rules, such as the APB Opinions, necessary to implement the principles in relation to the pertinent circumstances of the time. In a changing world it naturally follows that detailed rules not only may but should be changed to meet changes in conditions or in the mode of thought of the business community, and that such changes do not necessarily affect the broader principles and concepts, all of which are comprehended in the term, generally accepted accounting principles. In this context, the principles of financial accounting for corporate business enterprise are summarized as follows:

Objective A. Account for sales, revenues, income, cost of sales, expenses, gains and

losses in such manner as to present fairly the results of operations for the period or periods of time covered.

Principle A-1. Sales, revenues and income should not be anticipated or materially overstated or understated. Accordingly, there must be proper cutoff accounting at the beginning and end of the period or periods.

Principle A-2. Costs of sales and expenses should be appropriately matched against the periodic sales and revenues. It follows that there must be proper cutoff accounting for inventories and liabilities for costs and expenses at the beginning and end of the period or periods.

Principle A-3. Appropriate charges should be made for depreciation and depletion of fixed assets and for amortization of other deferred costs.

Principle A-4. Proper distribution of costs should be made as between fixed assets, inventories, maintenance and expense. Direct costs are usually identifiable and common costs applicable to more than one activity should be distributed on appropriate cost incurrence bases such as time or use factors.

Principle A-5. Contingency provisions and reserves should not be misused as a means of arbitrarily reducing income or shifting income from one period to another.

Principle A-6. Nonrecurring and extraordi-