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BOOK REVIEW

J. W. PATTILLO: THE FOUNDATION OF FINANCIAL ACCOUNTING A REVIEW ARTICLE

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The book was published in 1965 and subsequently reviewed in the April 1966 issue of the Accounting Review by Prof. Carl Nelson. Other than several citations in Hendriksen's "Accounting Theory" and a brief discussion in Yu's "Structure of Accounting Theory" Pattillo's work generally escaped notice. It was not widely quoted (not to say discussed) and even the review by Nelson was a rather neutral one. And if after 17 years, the work has not gained some semblance of recognition, then one wonders if the ideas expressed are logically faulty, if the issues raised were not relevant or pertinent to accounting, if the author strays too much away from the mainstream of accounting thought, or if Pattillo is too far ahead (or behind) his time. If the non-acceptance is due to the impracticality of the proposals then at least there ought to have been discussions relating to the conceptual framework, to test the validity of the various relationships. For surely, a work that attempts to examine the foundations of financial accounting deserves a greater degree of attention. It is not expected that each and every proposal relating to the theoretical foundation of accounting be accepted by the academics and the profession, but one would expect that it ought first be examined, discussed, and then may be rejected Accounting being as it is one of the few disciplines that is still to present to the world a sound conceptual framework explaining the basis of its existence and the interrelationships in the structure can ill-afford such a casual treatment of efforts to do so.

This review thus attempts to examine Pattillo's work thoroughly, and then to attempt an explanation as to why it is not accorded the recognition nor did it receive a following.

I - SUMMARY

The book can be divided into three parts: the first quarter discusses the justification of the study to its framework and its relation to earlier attempts at formulating a conceptual framework for accounting; the second quarter traces the origins of the "fairness" standard and discusses its appropriateness as the concept underlying all accounting, and the final half is concerned with testing and applying existing postulates of accounting (derived from existing literature and practice) against the fairness standard. The purpose of this final section is to demonstrate the extent to which existing postulates would fare in relation to his proposed framework, and thus to reinforce certain aspects of his foundations, especially regarding the need for an accounting court to decide on fairness, and the need for a lesser subservience to uniformity in accounting.

Pattillo began by establishing the relationship between the firm and the several segments of society and how the relationship is influenced by the tradition of accounting which drew upon and is influenced by developments in Law, Economics, and Statistics. An understanding of how and the manner in which law, economics, and statistics have influenced accounting is essential not only for us to appreciate the significance of accounting but more to demonstrate the extent to which principles already accepted in law, economics, and statistics are absorbed into accounting. Thus economics provides the data, statistics the methods, and law, the guidelines to explain present accounting practices. To all these Pattillo added the social and moral attitudes prevailing at any point of time as balancing the whole accounting process by providing the (society's) value perspective. Even though financial accounting deals only with the special case of micro-economics, the contribution of economics is nonetheless extensive. This is so especially when we look at the attempts of both disciplines to measure income. There has been some confusion as to what the income concept portrays and as to which is the more applicable concept to use. One of the main source of difference between the two can be explained via the accountant's realization principle. Pattillo points to a possible reconcilliation when he discussess the realization principle in the final half of the book.

The contributions of Law can be seen in the various statutes and regulations, and court rulings affecting accounting practice. In this, Pattillo gave a brief discussion of the influence of tax regulations, the SEC Act, and the Investment Act on accounting practices. He did not unfortunately discuss the key decisions in Smyth vs. Ames or the Hope Natural Gas decision, for we note that in these two cases can be found most of the argument for and against the use of historical cost in financial statements, and how one should deal with the effect of price level changes. Even though these two cases were concerned with rate-setting for railroads and utilities, the concept of "fair value" of Smyth vs. Ames encompassing as it did the various elements of costs – historical costs, replacement costs new, replacement costs less depreciation – would tie in well with Pattillo's standard of fairness.

The recognition of the existence of different segments in society, each interested in the performance of the business enterprise is related to how the development of accounting is linked to the development of the business enterprise. The development of the business enterprise from a sole proprietorship, to partnerships, joint-stock companies, and later diversified corporations, helps explain the deve lopment of concepts like proprietary accounting, fund accounting, and equity accounting. The fact that the development of accounting parallelled the development in business forms also explain the development of accounting from merely recording to stewardship reporting, and finally to income determination; and thus we can also see the development from mere recording and reporting, to verification and analysis. In a similar manner Pattillo traces the evolving influence of proprietors, to creditors, and then later the growing importance of groups like labor unions, management, consumers, and government. Pattillo needs to establish this growing and changing concern of the various groups in society in order to later establish the principle that the operation of the business enterprise affects these different segments, and that therefore the financial statements need to fairly present the affairs of the firm to these different groups.

Thus Pattillo posits that his definition of accounting and the objectives of enterprise accounting is different from and represents an improvement upon earlier definitions (eg. of AICPA, Moonitz, etc.). He criticizes earlier definitions of accounting for ignoring the communications and decision-making aspect, for vaguely defining measurement and for being restrictive in limiting the basis to the dollar. He felt that we should use economic units instead of the dollar; and that the word measurement is wrongly used – instead we should use allocation. His definition thus represents an improvement over earlier definition in that it makes some of the earlier concepts more explicit. Similarly he quibbles with the definition of the objectives of accounting as given by Littleton, Scott, Kerrigan, or the AAA 1957 statement. He rejects these earlier statements as inadequate and thus proposes his own. He agrees with Edwards and Bell in that accounting is concerned with the evaluation of past management decisions and thus to serve as a tool for the present and the future. He disagrees with

Littleton's emphasis on income as the fundamental concept in accounting and thus reject the notion that the balance sheet is inferior to the income statement. He felt that the statements are complementary. The key to Pattillo's thinking on accounting can be seen in the following quote from his book:

> "the objective should be to present enterprise information which is a financial representation of the relative economic rights and interests of shareholders, management, labor, creditors, customers, government, and general public. Accounting does not seek to **determine** (internally decide) these rights and interests, but rather to **ascertain** (externally observe) them as they already exist. The interdependent rights and interests in enterprises are determined by laws and the social, moral, economic, and political attitudes of the time."

And the basis to all these ought to be "fairness".

Having outlined his framework, Pattillo next sought to defend fairness as the key and the foundation to financial accounting. He first began by discussing (and then rejecting) the traditional 'usefulness' concept. Pattillo reject this pragmatic approach for he felt that for one thing usefulness is not really definable nor controllable; and for another the basis of usefulness would mean the preparation of different reports for different users. Consideration of different users would lead to ranking of importance and thus resulting in financial statements being prepared only for the more important users. He next discussed in great length the concept of justice, truth, and fairness, earlier propounded by Scott. We note that both Scott and Pattillo adopt the ethical approach to formulating accounting theoretical framework. They differ though in the ethical consideration that each thought to be more important. Scott for example felt justice to be the overriding principle, stating that accounting theory and practice should afford **"equitable** treatment of all interests actually and potentially involved in the enterprises." Scott further incorporated the concepts of truths and fairness, adding that "accounting records and statements should present a true and accurate statement of the information which they purport to represent". Pattillo agrees with Scott that the principle of Truth be added in but disagreed with Scott in according justice the pole position. He felt that justice implies that not only must one be right and proper, but that treatment accorded all parties should be equal. This tend to preclude the possibility of weighting and the fact that "one could be fair to all parties without giving each a strictly equal treatment".

To Pattillo, **fairness** is the more acceptable central concept because not only does it connote impartiality and objectivity, but also it implies ethical consideration. Accounting should, according to Pattillo, be fair to all segments of society having an interest in the affairs and results of operations of the enterprise. The standard of fairness would be the prevailing concept of fairness as defined by an impartial accounting court. The individual can experiment with and argue for changes in methods, rules, and procedures, to one that is considered **fairer** provided he can convince the court that the innovation is for the better (in terms of greater fairness). **Fairness** here then is not within the generally understood term of **fair** as used in the auditor's short-form statement where fair means conformity with generally accepted accounting principles. He noted that the diversity of segments may necessitate the preparation of special-purpose statements, but on the whole, general purpose statements could still be prepared based on principles that have met the test of fairness to all parties.

Pattillo foresees three steps essential to formulating a financial accounting structure that would be fair to all parties. We need first to "examine current practice to see if the principles, rules and procedures would meet the test of fairness", next, test proposed principle against the fairness concept, and finally, to formulate principles that would meet the fairness concept. Pattillo spent the next half of the book in a meticulous examination of current practice to see if they are fair or otherwise. He examined a total of 14 principles and disussed 3 applications. The principles which he felt met the fairness test are:

(1) Concept of business entity;
(2) Periodicity;
(3) Materiality;
(4) Consistency;
(5) Full disclosure;
(6) Objectivity;
(7) Matching;
(8) Separation of ordinary from unusual items;
(9) Recognition of actual and contingent liabilities.

Those which he rejected are:

(1) Conservatism;
(2) Stable dollar;
(3) Realization;
(4) Historical costs.

He rejected the going concern assumption not because it is not fair, but because it is felt to be not necessary. According to him it is felt that we are accounting for a going concern and as such an assumption to that effect is mere redundance. I do not propose to go into his deliberations in arriving at an accept (fair) or reject (unfair) decision for each of the principle. What he does basically is to (a) define the traditional meaning of the principle, (b) discuss the implication of each principle for the different segments in the society, and thus (c) decide if the inclusion of the principle would be fair to all parties. As an example take his discussion of the historical cost principle. He begins by stating that if prices were stable, then the use of historical costs is fair because financial statements so based will correctly (and fairly) reflect the rights of individuals and their claims upon the corporation. Each of these statements can then use the financial statements in decision making. But as it is, prices are not stable, and as such financial statements prepared based on historical costs would not correctly reflect the current costs of doing business. The income figure would be of ambiguous value. It would jeopardize the position of current shareholders because historical costs financial statements would overstate income, causing an unnecessarily high tax burden. It would affect the capital maintenance ability of the enterprise. Management would be unfairly judged on performances that are due to factors beyond their control. As such the historical cost principle is not fair.

The final part of this half discusses the development of rules and procedures from the principles included in his structure for three situations: accounting for leases, inventory valuation, and fixed asset depreciation.

In accounting for leases, Pattillo began by first discussing several alternatives emanating from Myer's work. He concluded that his principles would suggest the use of the present value method of accounting for leases where the lease agreement is considered as "a financial transaction in which an asset is acquired and an obligation is created." This will ensure that (a) a record of the asset and liability is made in the firm's books, (b) the rights and lease liability would be amortized over the lease life, (c) there will be a periodic charge to income for the amortization of asset and payment of interest. This particular treatment is considered fair because it will correctly (and fairly) reflect the true asset-liability position, the adequacy and utilization of capital assets, and thus the respective claims and rights of the various interested groups.

For inventory valuation and fixed asset depreciation, the governing principle would be cost, matching, and the realization principle. In the case of inventory valuation, a fair rule or procedure would be one based on LIFO. A "fairer" rule would be to use FIFO for ending inventories, and LIFO for cost of goods sold. In the case of asset depreciation, the traditional historical cost amortization over asset life is rejected. A "fairer" rule would be through use of current replacement cost.

He concluded his book by repeating his call for an accounting court that would sit to judge on the fairness of a principle, considering as it should, the rights and claims of all parties. He felt that there ought to be experimentation to find new rules and procedures that would be "fairer" in line with changing social values. The GAAP is thus not something sacred. Rather the GAAP should change to reflect the change in moral standard of society.

II-EVALUATION

As earlier noted, Pattillo's main thesis is that the basic foundation of the accounting framework should be fainess. This is a most appealing concept and one that merits serious considerations. A concept that reflects fairness could gain support for despite the crass world that we live in today with the tendency to apply the zero-sum principle to everything that we do, each individual would like to have everything to be fair. The one difficulty would be to operationalize the fairness concept. This would entail two things: (1) an understanding of what fairness is (the definition problem) and (2) applying the principle to judge if the methods, rules, and procedures, are fair (the implementation problem). We note that Pattillo is not too clear as to what he means by fairness. At one point he says that fairness is "definable and objective" and at another he posits that "the usefulness of the fairness concept lies precisely in the fact that it cannot be **strictly defined"**. Also he states that its meaning will therefore vary over the range of possibilities within the limits of observed and interpreted attitudes and as applied to specific situations." As Nelson noted, possibly what Pattillo wants us to understand from his fairness concept is that fair financial statements are fair "because they are fair". The concept thus is based on and appeals more to intuition than to reason. Each segment of society is asked to develop a 'gut feel' for what is fair. Pattillo rejects the pragmatist's approach of usefulness because it is not definable, thus implying that the fairness concept **is** definable. We can only wonder how this could be so.

Possibly the "fairness" concept would be made much clearer if we try to implement it via the accounting court as he suggests. The question here is who would be the people sitting on the bench acting as judges of fairness. Would it be an omnibus bench, consisting of representatives of the creditor group, shareholders, investors, consumers, government, management, labor, and all other groups having an interest in the operations of the enterprise. Who would the creditor group representative be – banks, insurance companies, trusts, or what? Who would the consumer representative be – citizen's coalition, Nader representative, conggressmen? Who would the labor representative be – Meany, the plant foreman, or John Doe? In fact similar ambiguities apply to the other user groups. The question of who would sit on the bench is not addressed to at all. Neither is the issue of standard to go by. The criteria "based upon the economic and political environment and the customs and modes of thought of all segments of society" is as ambiguous as one can get. Is there such a thing as the custom and mode of thought of **All** segments of society. Where would we find such a homogenous populace. How would one for example reconcile the mode of thought of members of the John Birch Society with that of the Communist Party. Or how would one go about reconciling the sense of fairness of Senator Tunney and that of Senator-elect Hayakawa.

One may, I suppose, as a matter of hindsight be able to say what the general custom and modes for the previous period was, but still, even in this case, it is not possible to say that it is applicable to all segments of society. And thus that financial statements prepared on this criteria be fair to **ALL**. Possibly in a police state, where the people cannot but be subservient to the mores and norms dictated by the politburo, we can get this homogenizing atmosphere; and thus fairness to one is fairness to all. But is it really? Fairness as Pattillo himself admits is a relative concept, and in this lies its greatest weakness, and not as he posits, its greatest strength.

We note that Pattillo is not the sole proponent of the fairness approach. Leonard Spacek of Arthur Andersen in his many writings and speeches proposed that fairness be the key concept. In fact Pattillo acknowledges his academic debt to the writings of Spacek and several other partners of AA. Prior to this, Scott, though according "justice" the central role, also discussed fairness. Other than these though there has not been much written on nor were there acceptance of fairness as the underlying foundation. McNeal emphasized "Truth" much more than fairness.

The ethical approach does not seem to be too popular with accounting theorists. Hendriksen for example notes that the approach "fails to provide sound basis for the development of accounting principles". We note that the rather ambiguous nature of the fairness concept tends to set it apart from the mainstream of accounting thinking.

There has not been any semblance of acceptance either by the academics or the profession to Pattillo's work. Professional accounting bodies are more interested in the pragmatic approach to formulating accounting theory framework. Buckley, et. al in a review article on accounting methodology did not even include Pattillo's work in the suggested alternatives of accounting postulates. The ommission is not that serious for we note that Spacek's contribution was included. This could be due to the fact that Pattillo's works is too similar to Spacek's and therefore was excluded on the fear that it might be redundant. Nonetheless, we note from Buckley's table that the approach taken by Pattillo is very much different from that of the more frequently quoted writings. Usefulness seems to be the approach favoured over fairness. The profession seems to assume that there is a body of GAAP floating around and that all reports are fair since they conform to the GAAP. The overriding consideration then is the utility of the financial statement. There is also the feeling that the group most affected by financial statements are the investor groups and as such financial statements should be tailored to meet their needs. The needs of other groups, say the IRS or the regulatory commissions, though important can be satisfied by preparing special-purpose reports. The lack of acceptance for Pattillo's work can also be due to the fact that works dealing with accounting theory formulation are less understood and much less cared for. There seems to be a tacit acceptance that accounting is but a tool and to accord more to it would be expecting too much. The urgent task seems to be to help accounting meet the problems caused by economic events such as the changing price levels. It is these specific short-run problems that seem to merit attention and not the long run job of theory formulation. The existing framework, whatever be its weaknesses, is well understood and well-embedded in practice. Accountants being the conservative creature that they are, would not be easily persuaded to change over to something as nebulous as fairness.

We note that Pattillo's concern is not with any specific problem such as income determination or trying to mitigate the effect of price-level changes. His concern is more fundamental, representing a serious attempt at questioning traditional thinking as to what constitutes the basis of accounting theory and practice, and at the same time proposing a conceptual framework. His is a philosophical work and should be evaluated as such. To ignore it because it does not solve any of the current accounting problem posed by the economic situation is, without overly using the word, not fair to him.

This is not to say that his work in itself is not at fault. Pattillo did not discuss the possible costs that would be incurred to switch over to his system. He attempts to do too much. He attempts to build a theory which, according to him, would solve all problems relating to accounting. Buckley, et. al for example point out that this is not possible and not the best way to approach the task of building a theory of accounting. To quote Buckley, "if there is a sign of the continuing immaturity of accounting as an intellectual discipline, it is the persistent search for a panacea in the form of a body of wisdom which will provide the answer to all problems". Thus what Buckley, et. al are proposing is that we should try develop **operational theories** in certain critical areas such as income determination, asset valuation, communication of accounting data, or multivalue reporting.

In conclusion, one thus note that the reason for the non-acceptance of Pattillo's work is due to the fact that it does not really contribute anything new. Spacek and the other partners of AA have been more vocal spokesmen for the fairness idea. AA being one of the Big Eight Accounting firm is in a much better position to canvass for the setting up of an accounting court and thus ultimately the adoption of the fairness idea. One cannot agree more with Buckley et. al that the key to accounting theory formulation lies not in the formulation of one general theory, but rather in the construction of piecemeal theories which would, after having been proven as to its structural and conceptual soundness, later be incorporated into one single theory.

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