a. Determine the income under each of the following equity theories:
   - Proprietary theory
   - Entity theory (orthodox view)
   - Entity theory (unorthodox view)
   - Residual equity

b. Would any of your answers change if the preferred stock is convertible at any time at the ratio of 2 preferred shares for 1 share of common stock?

2. Critique A Statement of Basic Accounting Postulates and Principles by the referenced study group at the University of Illinois (it should be on reserve or otherwise made available to you). Your critique should cover, but not be restricted to, the following points:
   a. How do the definitions of postulates, concepts, and principles differ?
   b. Are the examples of postulates, principles, and concepts consistent with their definitions?
   c. Does this set of postulates, principles, and concepts provide a legislative body with a useful framework for deriving operating rules?

3. List and briefly discuss as many areas as you can in which an accepted method or technique is conservative, including why it is conservative.

4. A few years ago both Halliburton Corporation, a large construction company, and its auditor, Arthur Andersen, were chided for allowing Halliburton to book a percentage of cost overruns that Halliburton has attempted to collect from customers after projects are completed but before both agreed settlements with customers and, of course, collection thereof. The practice of trying to collect cost overruns in the construction industry is not uncommon. Until 1998 cost overrun collections were not booked until received. Since that time, Halliburton “began guessing how much of a disputed surcharge would ultimately get paid and crediting itself in advance.”

Required:
   a. Is there a case that can be made for allowing Halliburton to book these overruns? What arguments, if any, support Halliburton’s accounting methods?
   b. What situations should prevent Halliburton from booking these overruns prior to collection?

CRITICAL THINKING AND ANALYSIS

1. How permanent do you think the postulates and principles underlying historical costing will be?

2. If you could relate materiality, disclosure, and conservatism to types of measurements (nominal, ordinal, interval, and ratio scale), how would you do so?

Notes

2. Special Committee on Research Program (1958, pp. 62–63).
7. AAA (1957).
10. Ibid. (p. 86).
17. For a complete exposition, see Chambers (1966). For additional coverage, see Wright (1967) and Chambers (1970).
20. Canning (1929); Sweeney (1936); MacNeal (1939); Sanders, Hatfield, and Moore (1938); Gilman (1939); and Littleton (1953).
22. For example, Study Group at the University of Illinois (1964). In addition, Anthony has attempted to deductively derive a conceptual framework using premises and concepts: “Premises are descriptive [italics added] statements based on the best available evidence. They are subject to change as new evidence develops. In this framework, concepts are normative statements; they say what financial statement information should be [italics added]. Concepts are deduced from the premises and they must be consistent with the premises and with one another” [Anthony (1983, p. xi)]. While not labeling his system as postulates and principles per se, Anthony is certainly using a deductive–normative approach in terms of developing underlying rules to guide and support the FASB’s ongoing operating standards. Anthony states that his premises are “descriptive statements based on the best available evidence,” but many surely contain strong normative overtones. For example, Premise 15 (p. xiii) states that “users are primarily interested in the performance of an entity and secondarily in its status.” Premise 15-A then states that “between competing accounting practices, the one that provides users with more useful information about performance is preferable to the one that provides more useful information about status” (p. xiii).
23. Fremgen (1968) and Sterling (1968).
25. Ibid. (p. 407).
27. Ibid.
28. One reason for the overlap is that APB Statement 4 envisions a three-tiered approach to principles. The bottom level, detailed principles, is made up of the actual operating rules themselves, such as the opinions of the APB (AICPA, 1970, p. 9084).
29. Ibid.
30. For a classic statement of the idea, see Paton and Littleton (1940, pp. 48–49). Of course, this is also Principle A of ARS 3.
32. FASB (1984, p. 28).
33. Paton and Littleton (1940, p. 49).
34. FASB (1984, p. 28). Devine contends that the concept of realization “is concerned entirely and exclusively with liquidity.” Devine (1985a, p. 61).
37. Sterling (1967). Skinner (1988) found an important example of conservatism. He estimates that at the end of fiscal 1976–1977 in the United Kingdom fixed asset lives used for depreciation purposes were equal only to about half of the actual period. He attributes the short write-off periods to conservatism as opposed to factors such as inflation and the equalization of book lives and tax lives.
38. Basu’s (1997) findings were confirmed by Pae, Thornton, and Welker (2005). They also discuss two types of conservatism: (1) Ex ante conservatism stems from either GAAP rules (immediate research and development write-offs in SFAS No. 2, for example) or policies that reduce earnings, such as expensing stock option costs that are independent of current business and economic news, and (2) ex post conservatism, which is not independent of current economic news such as goodwill write-downs resulting from impairment testing. The separation between these two types of conservatism is not airtight because goodwill write-downs due to impairment result from current events but they are prescribed in SFAS No. 142. For more on these two types of conservatism, see Beaver and Ryan (2004).
40. Lobo and Zhous (2006) discuss several ways in which conservatism has increased after passage of the Sarbanes-Oxley Act. The operating definition of conservatism, given previously, is a working definition of conservatism for purposes of accounting practice, whereas the Basu and Bushman/Piotroski definition is geared more toward research.
43. For more on bond covenants and dividend constraints, see Ahmed, Billings, Morton, and Stanford-Harris (2002).
45. A number of authors have constructed and used disclosure indexes. These indexes provide ordinal measures only because problems of how to weight the components of disclosure indexes cannot be easily solved. The items in the index can only be a relatively small subset of all possible items to be disclosed. Marston and Shrives (1991) provide a good summary of disclosure indexes that have been presented in the literature. They also note (p. 205) that the larger the firm, the greater the likelihood of more disclosure. Of course, managers of larger firms are more likely to understand the importance of disclosure.
47. APB Opinion No. 22 (1972).
53. Pany and Wheeler (1989) applied a number of rule-of-thumb materiality measures to various industries and found sizable differences within and among industries that vary with the particular measure of materiality employed.
56. Ibid.
57. Ibid.
58. For a study of materiality in a European context, see Arnold, Bernardi, and Neidermeyer (2001).
59. Paton and Littleton (1940, pp. 18–21).
60. AICPA (1970, p. 9076). Vatter (1963, p. 190) was an early adherent of the view that objectivity is part of measurement methodology.
61. One example is Sprouse (1978, p. 71).
62. Revsine (1985) has conceived a formal model of comparability that is consistent with the output approach advocated here. Revsine’s model is based on concepts from the information economics literature. His hypothetical application of the model compares the quality of the information signals received by users in terms of (a) historical cost information systems and (b) current cost (value) information systems. He concludes that historical costing will have a timing difference problem; that is, different balance sheet valuations will arise because an older asset will almost never have the same valuation as an exactly similar asset (in terms of type and condition) acquired at the balance sheet date. Hence, historical costing is noncomparable across firms. However, current costing systems have a related problem called the estimation difference. It arises because actual current valuations for older assets cannot be directly measured and must therefore be indirectly measured. The difference in valuation between the estimated current valuation and the actual current valuation of exactly similar assets would be the estimation difference.

The timing difference is closely related to representational faithfulness (see Chapter 7), and the estimation difference correlates closely to the principle (concept) of verifiability or objectivity discussed here and in Chapter 1.
63. For example, see Peloubet (1961, pp. 35–41) and Kemp (1963, pp. 126–132).
64. Merino (1993).
65. Merino (1993, p. 171) states that proprietary theorists were disingenuous about the centrality of absentee owners because conservatism was also an important tool of these same proprietary theorists, which would have minimized the profit available for dividends to these same absentee owners. Hence, proprietary theorists, while attempting to stress the importance of absentee owners, also attempted to develop accounting rules that would focus on curbing their greed by minimizing income.
66. For example, Lorig (1964, p. 572).
68. Paton (1922, pp. 50–84).
69. The duality between the firm itself and its owners can lead to some strange interpretations. Husband (1938) has pointed out that a stock dividend under the conventional entity theory approach would be income to the shareholder because a transfer is made from the firm’s account (retained earnings) to the owners’ account (capital stock). To get around this problem, Husband viewed the corporation as an association of individuals with the affairs of the corporation largely being carried out by management. This association view—which has overtones of proprietary theory—is contrasted with the older entity view, which sees the firm as an artificial person separate and apart from its owners. We do not believe that stock dividends can be interpreted as being income to shareholders under any equity theory.
70. Li (1960).
73. An interesting sidelight to Anthony’s interest on equity capital proposal is that Merino (1993, pp. 176–177) noted that proprietary theorists at the end of the nineteenth century were afraid that if interest were capitalized on owners’ equities, amounts of owners’ equities in excess of the capitalized interest might be claimed by labor, consumers, and government.
AAA (1957, p. 5) discusses enterprise net income in which interest, taxes, and dividends are excluded from the determination of net income; hence, a broad entity theory approach is advocated. Enterprise net income, however, is contrasted with income to shareholders, which coincides with proprietary theory.

77. Vatter (1947).
78. Goldberg (1965, p. 149) believes that totally depersonalizing the firm is much too restrictive because enterprise functions and endeavors are carried out by people. He also states that criteria for determining what funds should be established are not clearly set out by Vatter.
79. Ibid. (p. 169).
80. Ibid. (p. 173).
81. Rosenfield (2005) rejects both the entity and proprietary theories in favor of putting the “focus of attention” on the reporting entity itself. He appears to arrive at his own modification of the entity theory.
82. A European view of entity and proprietary theories sees a renewal of interest in these theories. See Zambon and Zan (2000).
83. Paton and Littleton noted that the word standards has less of a flavor of permanence than does the word principles. Paton and Littleton (1940, p. 4).

References


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