Accounting Historians Journal

Volume 20
Issue 2 *December 1993*

Article 6

1993

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The Accounting Historians Journal
Vol. 20, No. 2
December 1993

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DR SCOTT'S CONCEPTUAL FRAMEWORK

Abstract: The objective of this study is to trace the influence of DR[1] Scott's writings on the development of accounting theory and standard setting. Scott's deductive approach to the development of a conceptual framework for financial accounting and reporting was adopted by accountants on a piecemeal basis from the 1930s to the 1970s. This study traces authoritative pronouncements from the 1930s to provide evidence on Scott's forward looking ability and the influence of his ideas on the subsequent development of accounting theory. The social, economic, and political environment of the 1930s is described to show why a change in accounting standard setting was needed. The authors show that Scott envisioned the function of accounting as extending beyond mere recordkeeping, to include control of organizations relative to their cultural environment. Further, Scott's broad educational background is presented to show the breadth of Scott's ability to see accounting issues beyond bookkeeping issues. The findings show that Scott [1941] was among the first to develop a theoretical, deductive, normative framework to serve as the basis for accounting principles.

"If we are going to be able to look ahead with assurance, we must be able to look back with accuracy" [DR Scott, 1931, p. 140].

The purpose of this study is to examine the role of DR[1] Scott as a catalyst in the development of a conceptual framework for accounting. Although accountants are often criticized as being overly conservative and defensive of the *status quo*, Scott was very perceptive and willing to adapt to his environment. Scott contributed to the development of accounting theory through his early recognition of several concepts not

[1]Scott had no given name. His parents named him DR, using the initials from his father's name, David Roland Scott. Scott used the two initials with no spacing or punctuation [Kvam, *et al.*, 1964].

generally understood in his time but widely accepted today. For example, he envisioned the need for a normative theoretical base to provide unity and coherence to accounting principles. He articulated the importance of a deductive approach to the successful development of a theoretical foundation. He also espoused the important role of accounting and financial reporting[2] in the economic control of organizations.

When Scott [1941] published his conceptual framework for accounting, there was wide recognition that a crisis existed in the social control of large industrial organizations. The speculative fever and unbridled optimism of the 1920s were gone as the nation struggled to deal with the aftermath of the stock market crash of 1929 and the financial devastation of the continuing depression. The accounting profession sought to convince financial statement users that a publication of generally accepted accounting principles, enforced via independent audits, could reduce future stock market abuses [Previts and Merino, 1979]. The Securities Act of 1933 and the Securities Exchange Act of 1934 required certification of financial statements of listed companies, which provided a powerful incentive for the profession to specify what constituted "generally accepted accounting principles."

Many practicing accountants and accounting theorists, as well as outside critics, recognized that the profession was in a period of upheaval. User needs were not clearly understood, practice was not standardized, and authoritative pronouncements tended to focus on individual issues in a piecemeal, often inconsistent, fashion. Dissatisfaction with the state of financial accounting resulted in users supporting a proposal that the Federal government control the profession directly through the creation of a national institute of accountancy with power to define theory and prescribe acceptable accounting and auditing practices [Schluter, 1933]. The accounting profession was further weakened by internal conflict, as the American Institute of Accountants and the American Society of Certified Public Accoun-

[2]Scott [1931] defined the term "accounts" broadly as including more than "the journal and the ledger" [p. 217]. For example, the term *accounts* included "differentiation of interests at stake in a business enterprise" [Scott, 1931, p. 218]. So too does the FASB [1978, par. 7] define financial reporting to include not only the financial statements but other information provided by the accounting system as well. Hence, the term "financial reporting" is all-inclusive just as Scott used the term "accounts" as all-inclusive.

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tants feuded bitterly (see Main [1923]), and practitioners and academics regarded each other with distrust and lack of respect.

The authors contend that despite widespread public criticism (see [Schluter, 1933]), few accounting practitioners or theorists understood either the causes or implications of the failure to develop a set of generally accepted principles. DR Scott was insightful both in recognizing the root of the problem, and in proposing a solution. In Scott's view [1931], the "invisible hand" of the competitive marketplace was no longer effective in regulating business activity. Scott foresaw that the role of accountants needed to be expanded to assume the control function previously presumed to be provided by the forces of the open market. Previts and Merino [1979, p. vii] recognize Scott's character as follows:

> Evidence suggests that the outcome foretold by DR Scott in 1931 — that American society would witness the use of accounting as a principal means of political and economic control seems to have come to pass in the contemporary "bottom-line" culture of the 1970s.

Scott recognized the potential of a theoretical framework to ameliorate the problem. By serving as the basis for an integrated, internally consistent set of accounting principles, such a framework could facilitate the social control of organizations. He envisioned a framework as interfacing with its environment and including a statement of the objectives of accounting and financial reporting, with a set of general principles to be used not only in reconciling inconsistencies in current standards, but also in evaluating the appropriateness of proposed future standards. He was an early proponent of the deductive approach to theory development, understanding fully the weakness of an *ad hoc* or inductive approach to the development of a body of authoritative standards.

The main hypothesis of this study is that the subsequent development of accounting theory has been influenced by, and is indebted to, Scott's progressive thinking. To demonstrate the significance of Scott's forward looking ability, this paper is organized as follows. The next section presents introductory information on the state of the accounting profession in the 1930s. Then a brief description of DR Scott's background and early work is provided. Next, a description of the conceptual framework developed by Scott is presented through the use of an illustration similar to that included in the Financial Accounting

Standards Board's (FASB) *Statement of Financial Accounting Concepts No. 2* (SFAC2 [FASB, 1980]). The following section details the significance of DR Scott's conceptual framework in the evolution of accounting theory. Finally, the study presents a summary and conclusions.

BACKGROUND

The advent of machine technology during the Industrial Revolution increased the scope and complexity of the industrial market as "large competitive units engaged in the production of goods tended to give the consumer a feeling of helplessness" [Scott, 1931, p. 67]. Scott saw the early twentieth century as a period of conflict and disorganization, as the growth of large scale competitive production led to distrust of market control, and instability of price and profits. Scott understood that the Industrial Revolution of the late nineteenth and early twentieth centuries was an example of the type of major cultural change which, in the view of the economist Thorstein Veblen, required total reexamination of the cultural infrastructure. As one element of the "institutional superstructure," accounting would be expected to change in response to major cultural shifts [Scott, 1931, p. 26].

Scott's recognition that the major cultural changes of the early twentieth century would lead to changes in governance structures (including those for accounting) was shared by others. Mitchell [1969, p. 626] describes the establishment of the Industrial Commission in 1898 as a response to widespread public concern about the presumed exploitation of consumers by the large industrial firms and trusts. Berle and Means [1933] called for improvements in financial reporting to facilitate social control of corporations characterized by separation of ownership and management. Recognizing that the effectiveness of market control had declined, most notably in the aftermath of the crash of 1929, Scott called for increasing use of "accounts" as a means of exerting social control of large organizations. He considered market forces to be an effective control mechanism for a developing society, in a "pioneer age," but ineffective in the complex highly industrialized economy of the early twentieth century.

Scott's understanding of the need for effective social control of organizations influenced his early recognition of the problems associated with inconsistent, poorly developed accounting principles. Governmental units and citizen's groups expected accountants to use their expertise and understanding of corporate activities to protect stockholder/creditor interests through the enforcement of accounting principles. However, there was little confidence in existing accounting principles. The inconsistencies in accounting principles were frequently cited by lawyers, engineers, consumer groups, government officials, and current and potential investors [Chatfield, 1977, p. 129-130].

Both the passing of the Securities Acts and the accounting profession's efforts to develop uniform accounting principles can be interpreted as efforts to develop appropriate control structures for organizations in the complex post-industrial society of the twentieth century. The SEC had responded to investor concerns by requiring that published financial statements carry certification by an independent accountant attesting to the appropriateness of the accounting practices. The SEC stopped short of issuing specific accounting standards, preferring instead to require adequate disclosure and to delegate to the accounting profession the establishment of detailed specifications of what constituted generally accepted accounting principles.

Accountants, mostly academics, responded by undertaking the development of a set of accounting principles, but as Gilman points out, accountants could not even agree on the definition of the term *principle*. Gilman [1939] sought to resolve the dilemma by first defining "principle" and then compiling all published accounting principles in one book. Accounting practitioners ignored these accounting principles espoused by academics. The profession's piecemeal approach to standard setting resulted in accounting pronouncements that lacked unity and clarity [Paton, 1938]. Although some accountants recognized these problems, few understood the full implications of the profession's credibility crisis [Scott, 1931].

Some feared that if the profession did not improve the quality of the standard setting process, rule-making authority might be re-appropriated by the SEC (see Previts and Merino [1979]). Scott saw beyond superficial issues to the root of accounting problems. He [1941] supported a conceptual framework oriented to its environment, to serve as the basis for an integrated, internally consistent set of accounting principles for the effective control of corporations in a complex industrialized society. His framework included 1) a statement on the relation between accounting and its socio-economic-political environment, and 2) a statement of the pervasive principle of accounting and financial reporting, with 3) a set of general principles derived deductively from the pervasive principle. The authors believe that Scott's framework, if adopted, could have enhanced the credibility and consistency of accounting standards.

Even today, Scott's framework still offers new elements and insights. First, unlike his contemporaries, Scott advocated a deductive approach[3] rather than a compilation of published accounting principles as Gilman [1939] had developed. Gilman collected existing documented accounting principles[4] inductively and placed these principles in one data source, *Accounting Concepts of Profit* [Gilman, 1939, Chapter 14]. The second innovative element of Scott's framework was his emphasis on the interface between accounting theory and the social, political, and economic environment, as expressed in his orientation postulate. This aspect of his thinking was well ahead of his time, not being incorporated into authoritative pronouncements until 1970. The Accounting Principles Board in *Statement No. 4 (APB4)* explicitly recognized the influence of the environment on accounting. For example, the Board [AICPA, 1970, p. 12] states that accounting needs to

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[3]While a deductive approach was advocated and supported in economics, this concept was new to accounting principle setting.

[4]Gilman [1939] uses the following published accounting principles in developing his practical accounting framework:

Special Committee on Cooperation with Stock Exchanges of American Institute of Accountants, *Audits of Corporate Accounts*, New York: American Institute of Accountants (1934).

Executive Committee of the American Accounting Association, "A Tentative Statement of Accounting Principles Affecting Corporate Reports," *The Accounting Review* (June 1936).

Sanders, Hatfield and Moore, sponsored by the Haskins and Sells Foundation, *A Statement of Accounting Principles*, New York: American Institute of Accountants (1938).

Bryne, G. R., "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?", *The Journal of Accountancy* (November 1937).

Trouant, D. L., *Financial Audits*, New York: American Institute Publishing Co., Inc. (1937).

Littleton, A. C., "Tests for Principles," *The Accounting Review* (March 1938).

__________, "High Standards of Accounting," *The Journal of Accountancy* (August 1938).

Mason, P., "Principles of Public-Utility Depreciation," Chicago: American Accounting Association (1937).

Paton, W. A., "Comments on 'A Statement of Accounting Principles,'" *The Journal of Accountancy* (March 1938).

change in response to changes in economic and social conditions, to new knowledge and technology, and to demands by users for more serviceable financial information.

Finally, in 1978 and 1980, the FASB adopted a conceptual framework. The publication of the FASB's *Statements of Financial Accounting Concepts* (SFAC) *1* and *2* marked a major advance in the theoretical development of accounting. The FASB's *SFAC2* addressed the needs of the environment, and served as the basis for future accounting standards. The authors expect to find that DR Scott provides the antecedent thinking underlying the development of an accounting conceptual framework. To this end, the paper analyzes the conceptual framework which Scott developed and traces the influence of his thinking on the subsequent development of accounting theory.

SCOTT'S EARLY WORK

DR Scott had a broad background. His education included a bachelor of arts and science in journalism (1910) and a Ph.D. in economics from Harvard (1930). His professional experience included teaching political economy at the University of Michigan and working as a reporter for the *Detroit Times* newspaper. In 1918 and 1919, he was a statistician at U.S. Army Staff Headquarters in Tours, France [Kvam and Bauer, 1964]. With the exception of his brief Army experience, Scott taught at the University of Missouri from 1914 until his death in 1954. Although originally hired by the economics department, Scott became

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__________, *Accounting Theory*, New York: The Ronald Press Company (1922).

Broad, S. J., "Cooperation with the Securities and Exchange Commission," *The Journal of Accountancy* (August 1938).

__________, *Fiftieth Anniversary Celebration*, New York: American Institute of Accountants (1938).

Husband, G. R., "Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles," *The Accounting Review* (December 1937).

Stempf, V. H., "A Critique of the Tentative Statement of Accounting Principles," *The Accounting Review* (March 1938).

Montgomery, R. H., *Auditing Theory and Practice*, New York: The Ronald Press Company (1912).

Hosmer, W. A., "The Effect of Direct Charges to Surplus on the Measurement of Income," *The Accounting Review* (March 1938): 31-55.

Rorem, C. R., "Accounting Theory: A Critique of the Tentative Statement of Accounting Principles," *The Accounting Review* (June 1937).

chairman of the newly created department of accounting and statistics in 1930. His broad education (journalism, accounting, economics and statistics) and professional background provided the basis for his interdisciplinary and highly conceptual writings.

At the University of Missouri, Scott was a colleague of Thorstein Veblen, and Veblen's influence on Scott's early work is pervasive. The extent to which Veblen influenced Scott is evident in that Scott dedicated his book *The Cultural Significance of Accounts* to "those whose influence has contributed most to it: F. W. Taussig and to the memories of the late profs. H. J. Davenport and Thorstein Veblen". Both Scott and Veblen were to some extent outsiders in their professions — Veblen as a philosopher in the field of economics, and Scott as an economist in accounting — which enhanced their ability to view their professions objectively. Their status as outsiders may at least partially explain the iconoclastic tone of their writings. Scott [1931] and Veblen [1904] believed their colleagues were inordinately preoccupied with refining the details of existing theories, when what was needed was a reexamination of fundamental assumptions. Scott was disdainful of his contemporaries who concentrated on tinkering with existing theories. This attitude is reflected in the following quote from *Cultural Significance* [Scott, 1931, p. 15]:

> Men trained in the technique of making piecemeal revisions of theory are so nearly useless for purposes of a general revision that when they do accomplish anything looking in that direction it is ascribed to a mysterious quality called genius. Of course the use of the term genius here, as always, indicates merely that an explanation of the accomplishment to which it is applied lies beyond our present understanding.

Scott and Veblen were perceptive in understanding that their fields were undergoing what Kuhn would later describe as a scientific revolution, that is, a period when "the profession can no longer evade anomalies that subvert the existing tradition of scientific practice" [Kuhn, 1970, p. 68]. Both Scott and Veblen were engaged in what Kuhn referred to as "extraordinary investigations that lead the profession at last to a new set of commitments, a new basis for the practice of science" [Kuhn, 1970, p. 68]. Scott perceived that for accounting to provide effective control of large industrial organizations, the traditional view of accounting as limited to mechanistic transaction recording would have to be expanded to include a broader role in protecting the interests of the various equity holders.

Both Veblen's work and Scott's have a distinctly Darwinian [1859] flavor, emphasizing the continuing evolution of economic systems, with the existing system representing simply one stage in an ongoing process of development. Mitchell [1969] contrasts Veblen's work with that of Marx, who understood the evolutionary nature of social change, but interpreted social change as progress toward the ideal of socialism. Veblen, on the other hand, viewed cultural change as an ongoing process of evolution, as changes in the daily activities of people were reflected in unconscious, but lasting changes in the prevailing habits of thought.

Like Veblen, Scott [1931] viewed the evolution of accounting theory not as a progression toward a static ideal, but rather as a continuing process of adaptation essential to maintain relevance in a continually evolving economic environment. This concept is presented in *Cultural Significance* where Scott describes two spheres of phenomena — concrete events and abstract generalizations, or ideals. As a new set of ideals gains dominance, its proponents become defendants of the *status quo*. Because events continue to change, however, the ideals need to be adjusted to be in harmony with the existing culture, and therefore maintain validity. Scott writes in *Cultural Significance* [Scott, 1931, p. 10]

> The point to be made here is that when the prevailing system of theory and the existing order of facts part company, it is primarily the system of theory which must suffer readjustment in order to re-establish harmony between them.

This concept would reappear in Scott's later work [1941], when he included adaptation as an important element of his conceptual framework.

Both Scott and Veblen used more of a sociological approach to their fields of study to explain how the world works, rather than limiting themselves to the established, formalized problems in their disciplines. Scott recognized the "significance of accounts in the larger field of economic relationships" [Scott, 1931, p. vii], and "the place of accounts in the existing scheme of human affairs among peoples" [Scott, 1931, p. 3]. The basic premise of *Cultural Significance* is that the "fundamental economic basis of any people's culture shapes the whole institutional superstructure of the society in question" [Scott, 1931, p. 26].

Scott [1931] described the historical development of a culture as moving through periods of harmony and disharmony. As cultural change occurs, there is a period of adjustment as the institutional superstructure adapts to the new "generally prevalent philosophical viewpoint." Once again, Scott's writings reflect Veblen's ideas. Veblen [1904] believed that men acquire habits of thought unconsciously, and the kind of thoughts that men get is shaped by their daily activities. Any major change in daily activities, such as that occasioned by the Industrial Revolution, would be expected to lead to a major shift in prevailing habits of thought.

Scott saw the scientific method as the new "habit of thought" coming to dominance, as evidenced by the following quote [Scott, 1931, p. 121].

> Speaking in figurative language, it is this momentum of the habit of thinking in objective terms which makes the scientific movement the dominant cultural trend of the current period.

Thus, while the growth of large, machine-process driven industrial operations rendered existing control mechanisms inadequate, it was the newly acquired habit of thinking in scientific, *objective* terms which led managers to look to quantitative methods (such as statistics and accounting) as a more effective tool for control of organizations.

The development of Scott's thinking can be traced through the 1930s, from *The Cultural Significance of Accounts* to the essay on "The Tentative Statement of Principles" [Scott, 1937]. *A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements*, published by the executive committee of the American Accounting Association [1936], indicates the academic community's recognition of the need for a conceptual framework to provide coherence and consistency to the body of accounting procedures. Scott's response to the *Tentative Statement* exhibits his ability to see beyond the immediate concerns and identify the more pervasive issue. He realized that the confusion about what constituted "generally accepted accounting principles" was a symptom of the underlying social and economic problem of redefining the role of accounting in organizations and society.

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Scott [1937, p. 296] perceived an important dual role for accounting, as an internal control mechanism among various levels of management within the firm, and as an external mechanism for "the protection of various economic interests." He criticized the *Tentative Statement* as having an inappropriately narrow view of the role of accounting, as it addressed accounting's transaction recording function only, and neglected the other important functions of managerial control and protection of the interests of various groups of equity holders. Scott's view is contrary to the more traditional view espoused by Littleton, who wrote [Littleton, 1938, p. 235]:

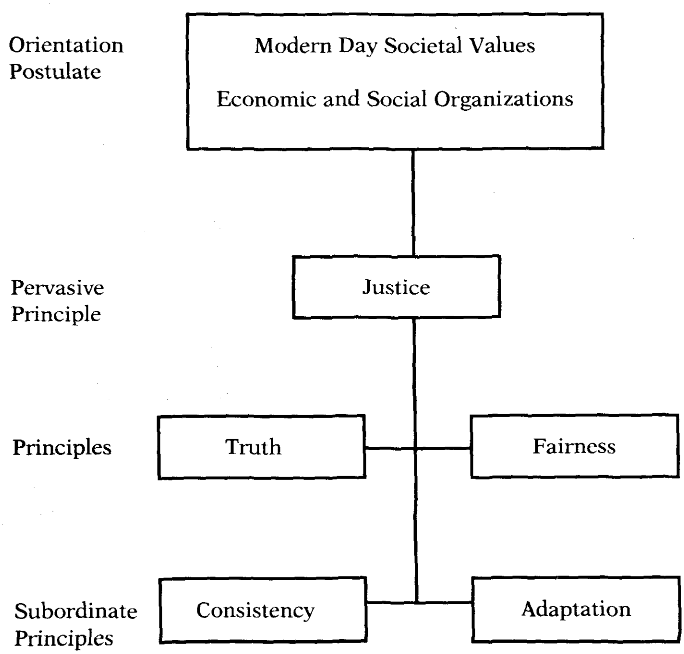
> It is confusing, therefore, to propose that accounting has at the same time a protection-of-equities function, a control function, and a records function . . . . Actually there are not three separate functions: protection, control, and record; nor are there two separate functions: calculation of net income and valuation for financial condition. I conceive of accounting as built about a single function: to supply dependable, relevant information about a business enterprise.

Although the *Tentative Statement*'s focus on the transaction recording function was typical of accounting thought in the 1930s, Scott understood that the changing nature of business organizations demanded a broadening of the role of accounting. He had the insight to understand that the strength of accounting comes from maintaining close contact with the environment in which accountants and accounting systems function. Scott [1931] predicted that continuing changes in the environmental context would require adaptive adjustments in accounting systems.

The next step in Scott's theory development appeared in "Responsibilities of Accountants in a Changing Economy" [Scott, 1939]. In this paper, he describes the impact of the Industrial Revolution, including the specialization of industries (e.g., manufacturing, finance, transportation), the development of joint-stock companies (continuity of life beyond the life of the proprietor), limited-liability corporations, and super-corporate organizations characterized by separation of ownership and control. The Industrial Revolution brought with it the need for improved financial reporting to meet the needs of resource providers (e.g., bondholders, equity holders, government), who were increasingly removed from the day to day operations of the firm. Scott recognized that without a sound conceptual foundation "doctrinaire or half-baked formulations of principles may be frozen into the rigid requirements of law" [Scott, 1939, p. 400].

In his 1939 article, Scott presents his concept of the enterprise as the subject of financial reporting, and statement users as the primary beneficiary. Scott's emphasis on (external) users of financial reporting stands in sharp contrast to the predominant view of the 1930s which held that accounting's primary beneficiary is the (internal) proprietor. As a first step in the development of a conceptual foundation, Scott included in his framework an accounting orientation postulate, designating the enterprise as the subject and the financial statement users as the beneficiary of financial accounting. Finally, in his 1941 article, "The Basis for Accounting Principles" [Scott, 1941], Scott presents his fully developed conceptual framework. Following is a description of Scott's conceptual framework and an illustration is provided in Figure 1.

FIGURE 1



Scott envisions his conceptual framework as an instrument for introducing coherence to the development of accounting procedures. (Figure 1 presents the author's interpretation of Scott's framework in a format parallel to that of the FASB's *SFAC2* [FASB, 1980]). Scott's framework includes a hierarchical structure of postulates and principles to be used in the development of accounting rules, methods and procedures. In Scott's [1941, p. 2] view, accounting principles are "statements relating accounting rules and procedures to underlying social principles." Scott defines accounting principles within the existing structure of society's beliefs and experiences, reflecting his emphasis on external constituencies.

Orientation Postulate

The first level of Scott's framework is an orientation postulate that articulates between the environment in which accounting operates and accounting principles (see Figure 1). While an orientation postulate as an essential element of a theoretical framework is widely accepted by accountants in the 1990s, the need for an orientation postulate was not widely recognized in the 1930s. Scott contended that unity in accounting comes from a broad consideration of the social, political, and economic environment in which accounting serves. Years later, DePree [1989], Stewart [1989] and Zeff [1961] make the similar argument that an essential element of a theoretical accounting framework is an orientation postulate. Stewart [1989] and Zeff [1961] argue that a conceptual framework must include the perspective from which accounting reports are to be prepared.

Scott believed accounting reports are to be prepared for society about the business enterprise. In this aspect of his theory, Scott was consistent with the entity theory proposed years earlier by William Paton [1922]. Accountants in the 1940s supported the pre-industrial view that the major beneficiary of accounting reports is the (internal) proprietor of the organization. The debate over whether the appropriate focus for financial statements was the individual proprietor (proprietary theory) or the business as a separate entity (entity theory), was unresolved as late as 1961 [Zeff, 1961]. Further, until the promulgation of *APB Statement 4* in 1970, an orientation postulate was not incorporated into an accounting framework for standard setting. Scott contended that a new orientation postulate was needed in response to the Industrial Revolution, and that an orientation postulate was an essential element for a conceptual framework of accounting.

In recognizing the needs of external financial statement users, Scott proposed an orientation postulate for financial accounting theory that would eventually gain dominance. By 1978, the FASB identified the first objective of financial reporting as the provision of "information that is useful to present and potential investors and creditors and other uses in making rational investment, credit, and similar decisions" [FASB, 1978, paragraph 34]. Although the focus on external users is universally recognized today, at the time Scott developed his framework, this represented a major departure from the prevailing point of view. More typical of accounting thought on an orientation postulate was the proprietary theory as presented by Charles Sprague [1912, p. 21], which describes the balance sheet equation as "What Belongs to me + what is Owing to me = what is Claimed from me + what is Unclaimed."

Pervasive Principle of Justice

After Scott defined the orientation postulate in his conceptual framework, he specified the next level of his hierarchical framework as a pervasive principle: justice. Justice requires that [Scott, 1941, p. 342]

> accounting procedures, rules and techniques . . . afford equitable treatment of all interests actually and potentially involved in the financial situations covered by accounts.

Society, as the beneficiary, demands principles that are not biased toward the interests of management, because such bias would preclude the equitable treatment of the interests of external financial statement users.

Justice is to pervade in the application of all subsequent principles (see Figure 1). For example, in applying the matching principle, accountants traditionally use statistics to estimate bad debt expense or depreciation expense. In some cases, however, accountants used these statistical methods to stabilize income rather than to present a fair depiction of operations in quantitative terms. The emphasis on justice reflects the widespread and intense public concern over misleading financial reporting and resulting business failures and scandals. In Scott's conceptual framework hierarchy, he sets justice above the principles of truth and fairness.

Principles of Truth and Fairness

The third level of the hierarchical structure of Scott's conceptual framework includes the principles of truth and fairness (see Figure 1). Truth is defined comparable to the FASB's [1980] "representational faithfulness." Truth ensures that financial reporting "presents a true and accurate statement of the information which they purport to record and present" [Scott, 1941, p. 342]. In accordance with justice, truth requires that the financial reports not be misleading to external users. Truth is subordinate to justice, as misrepresentation necessarily violates the principle of justice.

Scott warned accountants to avoid a narrow definition or application of truth, as truth should be interpreted as meaning faithfulness of total impression, not narrow meticulous accuracy. Truth must be implemented relative to the circumstances, and accountants must use professional judgment in application of this principle. Scott cautioned that a narrow concern with truth might not accurately convey the financial condition of the business enterprise to external financial statement users. As an example, Scott stated that if accountants are "eccentric with truth," they might require recording all contingent liabilities, regardless of their likelihood of occurrence, thus providing a distorted picture of the potential impact of contingencies on the firm's financial condition. Accordingly, accountants must exercise discretion in deciding which contingencies to disclose. A "true" representation of the firm's financial condition should be the goal when implementing the truth principle.

Another example of Scott's application of a truth principle was his rejection of the valuation of inventory at the lower of cost or market. Scott denounced the conservatism rationale for the lower of cost or market rule as inconsistent with the underlying objective of financial reporting — the presentation of a "true" or accurate portrayal of the financial position of the firm. He preferred to value inventories at market in all cases. Scott's presentation of this view in a paper entitled "Conservatism in Inventory Valuation" [Scott, 1926] provoked a heated discussion. However, the debate ended with William Paton [1938] supporting Scott's view and chiding his colleagues for their "unduly narrow view".

In Scott's framework, fairness is viewed as equal in importance to truth. Fairness is defined similar to the FASB's definition of neutrality [FASB, 1980]. This principle ensures that financial reports are "fair, unbiased, and impartial, . . . and do not serve a special interest" [Scott, 1941, p. 343]. Fairness follows from justice such that financial reports are to be objective, not biased, interpretations of a business's financial affairs.

Subordinate Principles of Adaptation and Consistency

The fourth level of Scott's [1941] hierarchy includes two subordinate principles: adaptation and consistency. In defining adaptation, Scott stated:

> [a]ccounting rules, procedures and techniques . . . must be continuously revised to allow for changing economic relations in order that they may continue to embody the principles of justice, fairness and truth [Scott, 1941, p. 343].

Because society and the economic environment change, accounting must change in order to adapt to the evolving social, political, and economic environment.

Scott understood that accounting, like other disciplines, is subject to revolutionary changes corresponding to changes in both social and physical phenomena. Scott [1941, p. 348] stated:

> The elevation of mere rules and conventions to the status of principles tends to bring rigidity into accounting practice and into the thinking of accountants about practical problems. It tends to destroy the open-minded tolerance and initiative with which rules, procedures and techniques should be adapted to meet the changing problems of business enterprise.

As an example of the need for adaptability in accounting techniques, Scott advocated the introduction of statistical techniques into accounting in response to the increasing complexity of business organizations following the Industrial Revolution. In the simpler organizations of earlier time periods, there was probably no need for either the statistical estimation of bad debt expense or depreciation of fixed assets. Bad debts were written off individually when they were deemed to be uncollectible, and depreciation expense was recorded when assets were sold. As organizations became larger with continuous lives, and the number of transactions increased, statistical tech-

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niques provided a way to record transactions collectively, and accomplish the appropriate matching of costs with revenues.

In Scott's view, disputes about the appropriateness of accounting techniques should not be resolved by appeal to practice or tradition. Rather, accounting practice should adapt and evolve, developing in parallel with the organizations it serves. The evolution of stockholder-owned corporations, with continued existence beyond the completion of a single venture/voyage or the life of a single proprietor, necessitated periodic income reporting. This development should be accompanied by a similar evolution in accounting practices, such as the statistical estimation of bad debt and depreciation expenses or the timely recognition of gains and losses from fluctuations in inventory value.

Scott advocated that the validity of new methods or procedures should be determined, not by the extent to which they conform with convention, but by the extent that they are logically derived from a conceptual framework. In turn, the appropriateness of the conceptual framework should be determined by the extent to which it is in harmony with the basic philosophies of its social, political, and economic environment. Scott perceived accounting theory as an abstraction of social processes continually open to change as the underlying social structures and processes change. Adaptation requires that accountants periodically reexamine their conceptual framework and related techniques/procedures, to allow adjustment to contemporary experiences, technologies, and beliefs.

Scott realized that the need to adapt and remain current must be balanced with the principle of consistency. In his framework, consistency is a subordinate principle that initially appears to contradict the equally important principle of adaptation. Scott discussed consistency as follows [Scott, 1941, p. 344]:

> Accounting rules, procedures, and techniques should be consistently applied. They should never be changed arbitrarily to serve the temporary purposes of management. When changes are necessary, they should be controlled by the principles of justice, fairness and truth.

Consistency does not preclude adaptation, and the conflict is more apparent than real. While some adaptation is necessary, the adaptation principle must not be applied arbitrarily or capriciously. An appropriate balance of consistency and adaptation will result in accounting reports that meet financial statement users' needs in a fair, just, and truthful manner.

In his understanding of accounting's evolving role in the social control of organizations, Scott foresaw that accounting is not a purely technical control measure. Rather, an accounting system is an integral part of its social context, simultaneously shaping and being shaped by its organizational, economic, and political environment. His writing, very much in the tradition of Thorstein Veblen [1904], focused on the changing status of organizations within a dynamic society. Covaleski, *et al.* [1991] concur that Scott saw beyond the first order concerns of dealing with practice anomalies, which preoccupied most accountants at the time. Scott recognized the importance of a major shift within the field. Scott was perceptive in his understanding of the ongoing cultural change in the 1930s, the shifts in economic and political power which required accompanying adjustments in the institutional control structures, and the role of accountants in facilitating this change.

SIGNIFICANCE OF SCOTT'S FRAMEWORK

Writing nearly thirty years after Scott published his framework, Chambers noted that accountants still had not developed a clear statement of the underlying theoretical constructs, essential prerequisites to the development of a coherent set of "generally accepted" accounting principles. Chambers [1966, p. 443] stated:

> Many must have long wished for an inventory of generally accepted accounting principles; for whether one wishes to adopt, to rebut, or even simply to think about these principles, it would be useful to know what they are.

Paul Grady's "Inventory of Generally Accepted Accounting Principles for Business Enterprises" *(ARS No. 7)* [1965] was viewed as a "catalogue of generalizations from current practice" (see Chatfield, [1977, p. 299]). Scott's framework is uniquely forward-looking both in the definition of an orientation postulate to serve as the starting point in the development of accounting principles (providing the benchmark against which current or proposed procedures should be judged) and in shifting the emphasis of accounting standards from a narrow focus on individual accounting procedures to a broader focus on consistency

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of accounting rules within the needs of the economic environment. In this respect, Scott's work went beyond the syntactical[5] level of theory prevalent in his era, and represents an early example of the semantical[6] level of accounting theory [Hendricksen, 1970].

The problems Scott identified in the 1930s have continued to command the attention of accountants. *Accounting Research Study 1* (*ARS1* [Moonitz, 1961]) and *Accounting Research Study 3* (*ARS3* [Sprouse and Moonitz, 1962]) impound several of the ideas Scott had espoused years earlier, including the concept of adaptation and the external focus for financial reports. These two research studies were considered revolutionary, even in the 1960s. The AICPA [1962] issued a disclaimer with every copy of *ARS3*, stating that the conclusions of the report were "too radically different from present generally accepted accounting principles for acceptance at this time".

The American Accounting Association's *Statement of Basic Accounting Theory (ASOBAT)* recognized the continuing difficulties in developing a conceptual framework and suggests that it was premature to suggest a detailed framework for a theoretical structure of future accounting as late as 1966 [AAA, 1966, p. 68]. However, *ASOBAT* clearly reflected the influence of several of Scott's ideas, including the orientation postulate, the "protection of equities" function of accounting, and the need for theory development to reflect the social, political, and economic environment. Scott's deductive, normative approach is reflected in the introduction to *ASOBAT* which states [AAA, 1966, p. 6]:

> The absence of an accepted theory of accounting has led many accountants to equate "accounting theory" with the sum total of accounting practices currently in use. They thus lack logical criteria for accepting or rejecting various practices.

Scott's influence is also reflected in *Accounting Principles Board's Statement 4 (ABP4)* [AICPA, 1970]. *APB4* proposed a framework similar in structure to Scott's, with a set of pervasive principles which serve as the basis for subordinate levels of

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[5]Hendricksen describes syntactical theories as those which "relate to the structure of the data collection process and financial reporting" [1970, p. 2].

[6]Hendricksen describes semantical theories as those which "concentrate on the relationship between a phenomenon (object or event) and the term or symbol representing it" [1970, p. 2].

more detailed principles. *APB4* included both Scott's adaptation principle and his emphasis on the relationship between financial accounting information and the underlying economic environment. However, the APB did not refer to its framework in promulgating principles as Scott had recommended. The deductive approach advocated by Scott belatedly gained dominance, and is reflected in the FASB's *SFAC 1* and *2* published in 1978 and 1980, respectively. *SFAC 2* describes the conceptual framework as [FASB, 1980, ¶ 4040]:

> a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting.

The influence of Scott's ideas is readily apparent in several of the desirable qualitative characteristics enumerated in the FASB's hierarchy of accounting qualities illustrated in Figure 1 of *SFAC2*. The definition of representational faithfulness as "correspondence or agreement between a measure or description and the phenomenon it purports to represent" [FASB, 1980, p. 4053] obviously ties to Scott's truth principle, and also to his hope to raise accounting theory from the syntactical level (where "truth" is defined by internal consistency) to the semantical (where "truth" is defined by reference to an external reality).

Neutrality, described in *SFAC2* as one aspect of reliability, impounds the principles of truth and fairness from Scott's framework. Scott's understanding of the need to balance consistency with adaptation is also reflected in *SFAC2*. Although consistency is listed as an important secondary quality interacting with relevance and reliability in the *SFAC2* framework, the statement later cautioned that "No change to a preferred accounting method can be made without sacrificing consistency, yet there is no way that accounting can develop without change" [FASB, 1980, p. 4062].

Given that Scott was proposing a theoretical framework and an orientation postulate as early as the 1930s, it is interesting to speculate on the reasons such concepts did not gain authoritative support until 1980. The process by which such a framework gains legitimacy can only be understood in the context of the interaction of the people and institutions involved, including standard setting bodies, owners and managers of corporations, and accounting organizations both professional and

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academic. It is important to understand the institutional changes which occurred in the standard setting environment between the 1930s and the 1970s to permit the acceptance of the FASB's framework, published in 1980, while Scott's framework, published forty years earlier, received little support. One important factor impeding the development of a framework was the rivalry between the two professional organizations — the American Institute of Accountants (AIA) and the American Society of Certified Public Accountants (ASCPA). During the period of rivalry between the AIA and ASCPA, there was little hope of achieving general agreement on a single conceptual foundation.

In addition, Scott's position as an academic and a non-accountant probably limited his ability to influence practitioners. As Previts points out [Previts, 1984, p. 13]:

> . . . a dynamic tension had existed almost continuously between academic and practice elements as to the composition of a comprehensive conceptual model.

Although the profession has been slow to accept Scott's ideas, contemporary accounting theory reflects many of his ideas, thus ensuring him an important place in the history of accounting theory.

SUMMARY AND CONCLUSION

Financial accounting and reporting have frequently been criticized as providing incohesive and irrelevant accounting principles in a piecemeal reaction to economic phenomena. DR Scott, writing in the 1930s, envisioned the need for the accounting profession to develop a normative, deductive theoretical framework that reflected its culture and would serve as a basis for the standard setting process. In 1941, Scott proposed a conceptual accounting framework which included an orientation postulate defining the subject and beneficiary of financial reports. He also defined principles in his framework which reflected the social, political, and economic environment and was intended to provide cohesiveness to accounting principle promulgations. In addition, Scott provided examples of how such a conceptual framework should be applied in the standard setting process. Clearly, Scott's emphasis on the critical intertwining of the accounting profession and its socio-economic environment is as important today in understanding the conceptual roots of the profession as it was to the accountants of his day in attempting to define their role in a complex industrial society.

Scott's early writings about the need for a conceptual framework continually adapting to the evolving social, political, and economic environment are as relevant in the 1990s as they were fifty years ago. His ideas can provide guidance in a continuing reevaluation of the existing frameworks.

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