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Abstract: The paper presents a synopsis of the principles and theoretical dispositions of May and Paton on selected areas of accounting; in particular, income determination and valuation.

No study of the history of accountancy would be complete without consideration of the contributions made by George Oliver May and William Andrew Paton, two "giants" of U. S. accounting. Although both men had background connections with the United Kingdom, most of their contributions were made in the United States. Their influence, however, was felt far beyond U. S. borders. May was a native of England who came to the United States early in his professional career. His views on accounting thought were influenced, at least in part, by his British background. Paton's family originated in Scotland, but he was reared on a farm in northern Michigan where fierce individualism was necessary for survival. This individualistic trait became the backbone of his success in accounting. His writings still exhibit such rugged individualism of thought.

May gave, and Paton is still giving, a lifetime of service to accountancy and both were active during those critical years when the profession was in its formative stages. Although May was the older, they were contemporaries in the profession and the many contacts which they had with one another resulted, it is believed, in their becoming good friends and developing considerable respect for one another. The influence of these men continues to be felt and will, no doubt, continue to be felt for generations. The primary purpose of this paper is to present a digest or cross section and summary of the principles and theoretical dispositions of May and Paton on selected areas of accounting, in particular, income determination and valuation.

This is the revision of a paper presented at the Third International Congress of Accounting Historians in London on August 15-17, 1980.

Purpose of Accounting

May and Paton exhibit many similarities in their approach to the development of accounting thought. One finds evidence of both inductivism and deductivism, as well as a guiding force of ethical considerations, in their writings. Both were pragmatic in developing workable accounting practices.

May believed that accounting is not logical; it is fundamentally conventional and utilitarian.[1] The test of good accounting lies in whether it is useful, not to one particular group, but to society as a whole. He viewed corporation accounting as just one aspect of the corporate form of organization, which he considered to have been created to serve a useful social purpose.[2] In a 1928 memorandum concerned with the question of the usefulness of corporate financial statements to investors and others interested in corporation securities, he cautioned that one must recognize the limitations on their significance. He often stated that the individual items in financial statements are not statements of fact, but expressions of opinion after the application of judgment and accounting methods to the relevant facts. May believed that there was room for considerable improvement in the presentation of financial information of corporations. He reasoned that the primary purpose should be to satisfy the investor's need for knowledge, rather than the accountant's sense of form.[3]

May considered the fundamental postulates to be part of the framework of assumptions on which accounting rests. They are derived from experience and reason, and are those working hypotheses which have been proven useful. The three most fundamental postulates were realization, monetary unit, and indefinite life of the enterprise.[4] The task of the accounting profession was to reexamine them from time to time to ascertain whether or not changes in the social and economic system had invalidated them. The accounting profession should constantly strive to improve the basic hypotheses on which its framework rests.[5]

Paton describes his own approach as postulational. He, too, considers these underlying concepts, or assumptions, to be tentative. They are used as test-standards by which ideas and/or theories are to be evaluated continuously. Paton's postulates were included in his 1922 book, *Accounting Theory: With Special Reference to the Corporate Enterprise,* and were considered to be largely expedient assumptions.[6]

Whereas May refrained from elaboration on the definition and nature of accounting, Paton was somewhat more detailed. According to Paton, accounting is based on the presentation of economic information for business decisions, both inside and outside the entity. The purpose of accounting may be said to deal with the determination of values, that is, the values of specific items that have disappeared from the market and constitute a part of the capital of the particular enterprise.[7] Some years later in the process of relating the practical aspects of accounting to private enterprise, Paton sees accounting as a process involving systematic measuring, arraying, and interpreting of economic phenomena.[8] However, he is more specific in his text, *Essentials of Accounting.* Here he states the purpose of accounting as "compiling and interpreting the financial data . . . to provide a sound guide to action by management, investors and other interested parties."[9] In this manner, the accountant acts as a valuable advisor, or participant, in the decision process.

Throughout both May's and Paton's writings one finds a restlessness against accepting the *status quo.* They were constantly "building." As a prime example, their dissatisfaction with historical cost for income determination and valuation purposes was continuously expanded throughout their writings. This stand has been influential on numerous current developments in accounting practice throughout the world.

Income Determination

May believed that the emphasis placed on a single figure of net income was regrettable. The effort to simplify the information had resulted in the concealment of essential information and tended to deceive investors; therefore, it was necessary to educate the public as to the inadequacy of the information on which it based its conclusions.[10]

Paton saw accounting from the point of view of two parties: owners and management. His theoretical development of the entity concept in relation to accounting is well known. He saw the business as an economic entity and knowledge about the return on the entire fund of capital employed was essential for managerial decisions.

As contrasted with Paton's position, May believed that it was not the function of accounting to measure earning power. He took exception to the definition of "income" as stated in *Accounting Terminology Bulletin No. 2,* which he interpreted as including capital gains and losses. The use of the term "earnings," as synonymous to "net income," was considered confusing because net income may be more, or less, than net earnings. The proper use of the term "net earnings" was a description of the balance remaining after deducting from gross earnings the cost of securing them.[11] He believed that it was impossible to establish any universal rule as to whether capital gains and losses should enter into the computation of net income.[12]

In the opinion of May, the value of a business enterprise was dependent, in the main, on its earning capacity. The primary use of the income statement was to determine the capital value of the investment by applying a multiplier to the earnings shown. It was extremely important that this multiplier be applied only to the earnings produced in the ordinary course of business.[13]

May believed that a major need was to formulate a broad concept of business income.[14] He considered business income to be a rather indefinite concept which had not been clearly defined by anyone outside the accounting profession.[15] Paton's views were somewhat similar to those of May. He defined income over the entire life of the business without periodic matching of revenues and cost and expense, and also saw income as the return on capital after periodic cost of recovery of such capital costs. However, he accepted the view of the practicing accountant, that is, periodic matching of revenues and revenue deductions.[16]

In the opinion of May, there was no accounting method for determination of income of a complex business organization for a year which could properly be considered valid. The financial statements were based on conventions and were correct only in the sense that they conformed to some particular standard. He often said that "annual accounts . . . would be indefensible if they were not indispensable."[17]

For the accountant, the job of income determination is a complex one. As considered by both May and Paton, the source of such income depends not only on one's definition of income, but also on one's approach to valuation. Since many cost items are related to asset expiration, the valuation basis used in the financial statements is crucial.

Valuation

Many accounting theorists have expressed distrust for the historical basis. Few have been bold enough to agitate aggressively for alternatives. Both May and Paton came forth with sound denunciations of the accepted basis of historical cost. They were both vocal on this score from the beginning of their writings.

Departures from unadjusted historical cost are primarily twofold. First, "replacement cost" considers the current input equivalent cost rather than the actual cost assumed at acquisition. This method considers, then, the current cost of specifically identifiable items of assets. "Price level adjustment" accounting, on the other hand, is not related directly to specific items. Instead, the historical cost of the investment in assets (current nonmonetary, as well as plant and equipment items) is updated by price level indexes in order to reflect the price level changes. May and Paton were both very vocal in these two areas. Probably this innovation in the "stream of accounting thought" has identified both of them as "renegades" in the pre-1950 era. Thereafter, the tide slowly, but steadily, changed. Today they are both highly respected for their positive positions on the subject.

Paton was a staunch defender of both "replacement cost" and "price level adjustment" accounting. He saw the advantages and limitations of replacement cost clearly. Current economic value, he believed, influences the decision process more strongly than past recorded costs. However, in connection with plant and equipment accounting, he thought the method would be somewhat inexpedient to apply.[18] In addition,

> . . . the price system is not uniformly sensitive throughout, and that for considerable periods selling prices may not move in harmony with changing costs of production. Selling prices, moreover, are not fixed by costs to the particular concern—whatever the basis on which such cost may be computed.[19]

Since replacement cost bases are of major importance to business management, they should be considered in making decisions.

May had reservations about the replacement cost basis. Instead, he believed the monetary unit unsuitable for the purpose of serving as the accounting symbol; however he considered it to be virtually the only available one. He believed that, as a result of governmental policy directed at changes in the value of the monetary unit, rather than at maintaining its stability, its adaptability was impaired.[20]

With regard to asset valuation, Paton alluded to severe price movements and pleaded for consideration of economic values in his 1922 book mentioned earlier. To him this meant "current value."[21] He believed that the changing value of the monetary unit was a serious limitation to accounting data presented in financial statements. To him, the real basis of accounting is value.

Furthermore, "costs are important only because they are the most dependable measures of initial values of goods and services flowing into the enterprise through ordinary market transactions."[22] He indicates that assets which pass through the entity in a relatively short time span may be represented by original cost. But, in the case of assets possessing long lives, strict adherence to historical cost may result in "unreliable or even misleading"[23] information for management. Obviously, results of operation based on such distortion of values would misstate both the value of the entity and its earning power. He considers cost as an amount of economic sacrifice incurred, or "economic force expended or committed."[24]

May believed that changes in the value of the dollar had created problems for the accounting profession and had left it with two alternatives. The first was to adhere to established conventions and admit that financial statements had lost some of their former significance. The second was to seek to establish new principles which would make the reported amounts more significant. It was his opinion that the second alternative was followed, for example, in the case of inventories when the last-in, first-out method of valuation was employed. The first alternative was followed in respect to capital assets since charges for depreciation did not recognize changes in the price level. It was an inconsistency, and the profession faced the task of rectifying it.[25] He reasoned that two objectives should be kept in mind when considering this problem. These were:

1. Expressing revenues and charges against revenues as nearly as possible in units of equal purchasing power;
2. Placing the burden of decline in the value of the monetary unit as equally as possible on investments in monetary claims and investments in tangible capital assets.[26]

May regarded the LIFO inventory idea as being a compromise between accounting theory, accounting practicability, and convenience. Its significance lay in the recognition of the objective of relating cost to revenue more nearly on the same price level, rather than in the extent or manner of achievement of that objective.[27] Paton, on the other hand, had severe reservations regarding LIFO. He challenges the procedure in the following manner:

> The adoption of last-in, first-out is sometimes defended by reference to the view that in determining true profit the revenues of the period should be charged with costs

> measured by the level of prices obtaining at the end of the period. Is there any substantial merit in this line of argument? Answer in the negative seems to be called for. In the first place not very much of a case can be made for measuring profit in the manner indicated. In the revenues of the period are represented the prices of product in effect from day to day, and the costs to be charged to such revenues are the actual costs which have been incurred throughout the period and earlier which are reasonably assignable to the various batches of product sold. . . . In the second place the use of last-in, first-out does not result in charging revenues with costs based on year-end prices.
>
> . . . where there is a continuous pricing of goods issued under last-in, first-out procedure the total cost of issues for the period may not coincide with the cost of the most recent acquisitions in corresponding quantity. In the third place it may be urged that for managerial purposes it is more useful to apply the relatively recent costs to the goods on hand than to goods sold. Completed sales and the related costs are "water under the bridge," closed transactions. Utilization of the inventory, on the other hand, lies in the future and in planning such utilization the current level of costs is especially significant.[28]

May believed that whether a change in procedure should be made to bring the cost for depreciation into account at approximately the same price level as revenues depended in part on the importance of the amounts involved. He considered the problem to be of sufficient magnitude to warrant further study.[29]

May pointed out that the adoption of LIFO had brought with it acceptance of the view that a meaningless amount in the balance sheet for inventories was justified since it resulted in a more informative figure for income. The amount shown for inventories had no relation either to cost or current value. May reasoned that an amount for capital assets which could be described in a similar manner would be open to even less criticism since capital assets were not held for sale, and subsidiary records could be kept which would give all the pertinent information. He saw little difficulty in treating capital assets in a manner similar to inventories on the LIFO basis. The question in his mind was whether or not corporations would be willing to adhere to this policy in periods when prices were still high, but profits were low.[30]

In *Accounting Research Bulletin No. 5,* the Committee on Accounting Procedure considered the question of the proper accounting for depreciation on appreciation, and concluded that, where appreciation had in fact been recorded on the books, the charge against income for depreciation should be based on the newer and higher values.[31] May pointed to the decision to record appreciated values on the books as fraught with the difficulty of determining the value to be used. It was necessary to consider prospective earnings since the value of assets was dependent upon their earning capacity. A valuation based on prospective earnings would not necessarily form a suitable basis for the determination of the amount of depreciation charge required to maintain the enterprise.[32]

According to Paton, the businessman *must* think in terms of current cost equivalents, not past recorded costs in this connection. Therefore, the use of obsolete historical costs impairs the usefulness of accounting data. He stressed this belief, perhaps more strongly than before, when he stated:

> The plain fact is that *values*, not costs, constitute the basic raw material for accounting, and I submit that the profession will keep on floundering as long as economic reality is ignored by kowtowing to the "historical-cost" fetish. . . . cost data are truly significant and . . . afford the best evidence of *value* at the date of acquisition, as in ordinary purchases (including services) on the open market. Where the amount paid is materially at odds with initial value the so-called "cost" figure is an invalid economic measurement.[33]

Failure to recognize present value results in distortion of the earnings rate achieved on the value of employed capital. Past performance based on historical cost is "equivalent to courting operating disaster."[34]

In order to achieve more useful information, Paton would adjust the available cost data by a general price index to achieve a cost value. He argues that the cost principle has not been abandoned. These values are still based on costs, only undated to recognize price changes.[35]

May believed that every annual report should contain a statement of additions and deductions of fixed assets by years since 1940 both in terms of cost in money and cost in purchasing power. The index figure which was used should be disclosed.[36]

The problem of valuation caused May and Paton much anxiety. Early in their careers both saw severe limitations on the blind adherence to the use of historical cost. Both saw the wisdom of attempting to implement replacement cost and/or price level adjustments.

Impact

These two giants of U. S. accounting wrote extensively, one being involved in accounting practice, the other in academia.

They respected each other highly. The following quote is interesting in this regard.

> Opportunity doesn't knock on the door every day; only occasionally, in special combinations of circumstances, does it become possible to break the grip of longstanding attitudes and traditions, even when they are clearly carrying us in the wrong direction. And we have missed some good opportunities in the past to construct a consistent realistic framework of concepts and general principles as a basis on which to deal with specific problems as they arise. I vividly recall the first meeting of the Committee on Accounting Procedure back in 1939. At this initial session I proposed that we address ourselves first to the preparation of a groundwork statement, a foundation on which to proceed in our study of particular procedures and issues. But George O. May, our first chairman, did not take to this. Instead he urged that we make our first order of business the consideration of how bond redemptions made before maturity date, [were to be accounted for].
>
> . . . Since I have mentioned Mr. May I must add that he was a brilliant man, and that we were good friends for many years. I should also say that our basic points of view were not seriously at variance, and that he and I joined forces several times later in efforts to persuade the Committee to take a firm stand in support of current value, as an important measurement which should not be disregarded. But the combination of the natural preoccupation of practitioners (always a large majority on the Committee) with day-to-day difficulties, the timidity of our professional officialdom and pressure of government agencies dedicated to a policy of ignoring the impact of price ad-

vances on recorded dollars, prevented any decisive accomplishment in this direction.[37]

The significance of the use of replacement cost and price level adjustment financial information is demonstrated by its use in many countries of the world today. For example, in the U. S. the Securities and Exchange Commission, in 1976, issued *Accounting Series Release No. 190* which required the presentation, as supplementary information, of replacement cost data, for certain entities. This pronouncement has been withdrawn in favor of Financial Accounting Standards Board Statement No. 33, *Financial Reporting and Changing Prices,* which requires both current cost and general price level adjusted financial information for selected organizations.

This continuing emphasis on valuation clearly demonstrates the farsightedness of these two accounting pioneer giants, George Oliver May and William Andrew Paton, who were well ahead of their time in this aspect of accounting. Their influence will continue to be felt for generations.

FOOTNOTES

[1]May, "Truth and Usefulness in Accounting," p. 387.
[2]For a more extended discussion see Stabler, pp. 17-18.
[3]May, Unpublished Manuscript, A., p. 12.
[4]May, "Truth and Usefulness," p. 387.
[5]Lawler, "A Talk with George O. May," pp. 40-42.
[6]Paton, *Accounting Theory: With Special Reference to the Corporate Enterprise,* pp. 471-499.
[7]Paton, *Accounting Theory,* p. 10.
[8]Paton, "The Accountant and Private Enterprise," p. 44.
[9]Paton, *Essentials of Accounting,* p. 2.
[10]Study Group on Business Income, Unpublished Manuscript, G., pp. 13-14.
[11]May, Correspondence with Wilcox, Edward B.
[12]May, *Financial Accounting: A Distillation of Experience,* p. 224.
[13]May, Unpublished Manuscript, C., p. 1.
[14]May, Unpublished Manuscript, F., p. 5.
[15]May, "Income Accounting and Social Revolution," p. 36.
[16]Paton, "Costs and Profits in Present-Day Accounting," pp. 123-134.
[17]May, Unpublished Manuscript, B., pp. 14-15.
[18]Paton, *Advanced Accounting,* p. 324.
[19]Paton, *Advanced Accounting,* p. 324.
[20]May, *Business Income and Price Levels: An Accounting Study,* p. v.
[21]Paton, *Accounting Theory,* p. 12.
[22]Paton, "Accounting Procedures and Private Enterprise," p. 283.
[23]Paton, "Accounting Procedures," p. 283.
[24]Paton, "Measuring Profits Under Inflation Conditions: A Serious Problem for Accountants," p. 20.

[25]May, Unpublished Manuscript, D., p. 5. See also May, "Should the LIFO Principle Be Considered in Depreciation Accounting When Prices Vary Widely?" pp. 453-454.
[26]May, *Business Income and Price Levels,* p. 67.
[27]May, *Business Income and Price Levels,* p. 67.
[28]Paton, "Last-In, First-Out," pp. 355-356.
[29]May, *Business Income and Price Levels,* p. 67.
[30]May, Unpublished Manuscript, D., pp. 6-7. See also May, "Should the LIFO Principle," p. 456.
[31]American Institute of Accountants, *Accounting Research Bulletin No. 5: Depreciation on Appreciation,* pp. 37-38.
[32]May, *Business Income and Price Levels,* pp. 56-57.
[33]Paton, "An Opportunity for the Financial Accounting Standards Board," p. 27.
[34]Paton, "An Opportunity," p. 28.
[35]Paton, "An Opportunity," p. 39.
[36]May, Unpublished Manuscript, E., pp. 2-3.
[37]Paton, "An Opportunity," pp. 29-30.

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