

**Book Review: W. A. Paton and A. C. Littleton: *An Introduction to
Corporate Accounting Standards***

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Introduction

This book has been viewed by many as the basis for modern accounting standard-setting. As the authors stated in the preface, they “have attempted to weave together the fundamental ideas of accounting rather than to state standards as such. The intention has been to build a framework within which a subsequent statement of corporate accounting standards could be erected.” (pp. ix) The book starts with general discussion of the need for and the characters of accounting standards (Chapter I, “Standards”). Then it turns to specific assumptions that underlie accounting standards and hence make them well-grounded (Chapter II, “Concepts”). The chapters that follow further elaborate the basic ideas by a closer look at the standards for cost (Chapter III), revenue (Chapter IV), income (Chapter V), and surplus (Chapter VI), respectively. Finally, the book addresses some questions related to the interpretation of accounting standards, e.g. revenue imputation, cost vs. value, etc.

The monograph was ground-breaking (Turner [2000]) in 1940, the year it was published, partly because it challenged the big problem faced by the profession at that time -- should standards follow practice, or should practice follow standards -- with a certain support for the latter:

... A formulated standard may not always conform with generally accepted practice. The latter is like a statistical mean in the midst of surrounding data; the former may often be a guide to the gradual improvement of corporation accounting practices and a gauge against which to measure variations. (pp. 6)

The Constructivism Nature

The authors' effort to develop a consistent framework of accounting standards is noteworthy in view of the contemporary practice that was "in conflict with itself at a hundred points" (pp. 4). However, such an attempt to design a unique business language inevitably falls into what Hayek calls "constructivism" and could be futile in some sense. After all, "language" was never the result of human design. Its survival and evolution are tied to the benefits it confers on those who use it. Our ancestors communicated with each other effectively well before they were able to write down a single grammar (we still could not for some dialects). And there was never an era when some Esperanto becomes the king.

In this light, a more plausible approach to set accounting standards would be to articulate and justify approximately what has long been observed in generally accepted practice in a systematic way (an approach Ijiri takes in his "Theory of Accounting Measurement" (1975)), rather than deliberately choosing a set of standards over others. And it may also be reasonable to leave those rules followed all along but very hard to express in words as they are. Indeed, if accounting is "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least, of a financial character", as commented by the committee of the American Institute of Accountants, then the meaning of reducing sundry practices is doubtful. -- It is likely to eliminate various great works by those who have a superior feeling for "language" in describing the business events to absentee financial statement users. Of course, by refuting the extreme of a unique set of standards (e.g. in this monograph, the historical costs basis), I am not proposing the opposite extreme where every firm could adopt completely different accounting standards. The optimal amount and content of standards sets

could only be determined by choices of financial reporting users over time, that is, by an “evolving” process. Such a process could be painfully slow, but I believe the outcome would overwhelm the limited complexity and optimality of those standards that are planned by people beforehand.

Entity Theory

I suppose that the one of the motivations of this monograph is aligned with that of the classic work of Berle and Means (1932): the separation of management and control poses great challenges on the survival and evolution of modern corporation and relative legal settings, of which accounting regulation is one important branch. Considering the historical context (e.g. the chaotic market, the decreasing prices) when the book was written, it is not surprising to find that the authors focus on the reaffirmation of the investors’ private property rights (in particular, via a strong adherence to the historical costs basis):

... Accounting exists primarily as a means of computing a residuum, a balance, the difference between costs (as efforts) and revenues (as accomplishment) for individual enterprises. This difference reflects managerial effectiveness and is of particular significance to those who furnish the capital and take the ultimate responsibility. (pp. 16)

... Corporation reports should rest upon the assumption that a fiduciary management is reporting to absentee investors who have no independent means of learning how their representatives are discharging their stewardship. (pp. 97)

Admittedly, Paton and Littleton notice “a public character” of corporations, especially great corporations, because of their duty to a public consisting of various parties such as investors, employees, customers, government, etc. As a result, accounting standards become responsible for furnishing guideposts to fair dealing in the midst of flexible rules and techniques and such guideposts eventually could lead the flow of

capital into “capable of hands and away from unneeded industries”. These arguments slightly bear an element of contract theory for firms. However, as the monograph goes on, the limitation that a firm is considered as if a distinct line could be drawn between internal and external persists. Hence, overall the authors’ view of entity is still rooted in the neoclassical economic paradigm where a firm is regarded as a monolithic profit-maximizer, as evident in the “business entity” assumption:

... the business enterprise is viewed as an organization designed to produce income. Few would question the propriety of this assumption. (pp. 23)

... accounting theory likewise is oriented first to the enterprise as a productive unit and only secondly to the investors as a legal claimant to assets.(pp. 11)

Characters of Accounting Standards

Paton and Littleton distinguish “accounting standard” from two terms: (i) “standardized accounting”, which suggest prescribed procedures and limited freedom, and (ii) “accounting principles”, which suggests certain degree of universality and permanence. I agree with them on the first point since accounting standards intend to facilitate the social coordination as long as it is not so coercive (as standardized accounting) as to completely ignoring information dispersion among individuals. However, I doubt the need for the latter distinction because essentially both inspire conformity to some extent and both evolve as time elapses.

The Historical Cost Basis

The major theme of the book is that accounting based on historical costs is more desirable than an accounting for current values (replacement costs). A closer look at the book reveals that the term “cost” in “historical costs basis” is actually a bit misleading. What the authors want to emphasis is the “price-aggregate”, i.e, *the*

*monetary results of an exchange which express the **mutual valuation** of the buyer and seller **as of the moment** of exchange.* For example, the price-aggregate of goods sold is called “revenue”; the price-aggregate of a service acquired is called “cost”, etc. And they assert that such price-aggregate, if recorded in a verifiable and objective way, is the best means available for representing varied transactions in homogeneous terms. I find the following two elements in definition of “price-aggregate” critical to all the later arguments against replacement costs accounting (or current value accounting): (i) Is “mutual valuation” generally achievable? (ii) Is the “moment” of replacement determinate?

Based on my reading, the authors develop their argument in a very consistent fashion. First and most importantly, competitive markets rarely exist for every asset, especially those non-liquid factors still in service yet having a relatively long career (e.g. a still-well-functioning machine used for two years). Hence, replacement cost accounting can hardly achieve measurement consistency in determining costs and matching costs with revenues. Second, even all those competitive markets exist and replacement values are used consistently in preparing statements, “the net effect would be nil so far as the units charged to revenue were concerned”. And the only net change in income statements would be “the amount of the write-up or write-down of the unexpired elements”, which are essentially not quite subject to management’s control. Third, because any price movements are “seldom reflected immediately and fully in the affairs of the particular business”, such resources reappraisal under replacement cost accounting is very hard to interpret and in some cases would unjustly attenuate shareholders’ residual claims. Finally, a complete reevaluation of all the resources period by period is very costly for the management, let alone the fact that it at the best yields some subjective figures “none too dependable”. Some of the above arguments

are discussed succinctly when the authors elucidate the fundamental concepts of accounting, namely, “business entity”, “continuity of activity”, “measured consideration”, “cost attach”, “effort and accomplishment” and “verifiable, objective evidence”. Then they, especially the first point, were raised repeatedly in the monograph in more details to support the authors’ acceptance of historical costs.

These arguments surely contain a lot of wisdom, especially when the primary is set to be the protection of property rights, an element essential to the establishment and development of free market. And it is worth mentioning that the authors are not against replacement cost information appearing in financial statements as some supplementary data. All they try to stress is that those current value data are “likely to be of little use unless reported in conjunction with the known “basing point”, cost”. However, I doubt that firms would be willing to incur costs of these supplementary data, mostly unaudited, once historical cost basis is set as the doctrine. And absent a leveling playing ground at the very beginning, the merits of replacement cost accounting would hardly emerge even if it fits environmental changes in certain cases.

Overall, the book impressed me with its clarity and consistency. Though I do not agree on every point, I still find the book inspiring for anyone who wants to go beyond glib analysis of accounting issues.

References:

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