AN EXAMINATION OF THE ACCOUNTING DEBATE OVER THE
DETERMINATION OF BUSINESS INCOME: 1945-1952

DISSERTATION

Presented to the Graduate Council of the
University of North Texas in Partial
Fulfillment of the Requirements

For the Degree of

DOCTOR OF PHILOSOPHY

By

Diana Kay Pence, B.S.B.A., M.P.A.

Denton, Texas

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George O. May's (1952) prescient statement that "if accounting had not already become, it was well on its way to becoming a political phenomenon" provides the motivation for this study. Changing socioeconomic relationships in the post-World War II period make it an ideal period to examine the politicalization of accounting. Keynesian economic policies justified active government intervention in the economy to manage demand and ensure full employment. No longer could it be assumed that competitive market forces would ensure that corporations produced goods and services at a socially optimal level or that income would be distributed equitably. Claims that accounting profit provides a measure of managerial efficiency are based on these premises.

This dissertation examines the political dynamics of one particular accounting measurement debate--the debate over the determination of business income. Policies, such
as wage/price controls, the excess profits tax, and the undistributed profits tax, brought the accounting income determination debate to center stage. The perseverance of the historic cost allocation model in the face of significant economic changes presents a fascinating glimpse of the important role accounting played in justifying continued reliance on the private property rights paradigm.

I use retrodiction (reasoning from present to past) to examine why the historic cost allocation model has been so enduring. In my examination, I use personal correspondence, transcripts of Congressional hearings, published financial statements, and relevant journal articles. My analysis indicates that, while accountants empathized with managers who claimed that inflation distorted reported earnings and recognized that a serious measurement scale issue existed, they also recognized that abandonment of historic cost would not be politically feasible.

If accountants had adopted a strongly partisan position that favored management with respect to bargaining with labor, this could have undermined the profession's claim to neutrality and opened the standard-setting process to closer
political scrutiny. Accountants responded to management in a less visible way. Standard setters adopted techniques that gave managers maximum flexibility in managing income while retaining the aura of objectivity that attached to historic cost.
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CHAPTER I

INTRODUCTION

Accounting As a Political Phenomenon

George O. May's (1952b) prescient statement that, if accounting had not already become, it was well on its way to becoming a political phenomenon provides the motivation for this study. Changing socioeconomic relationships in the post-World War II period presented both challenges and opportunities for the accounting profession. Keynesian economic policies justified active government intervention to manage demand and ensure full employment, while large oligopolistic industries appeared to be administering prices, subverting market controls. Labor unions became a powerful force and demanded an equitable share of the profits of the emergent managed economy.

The fundamental tenets of neoclassical economic theory were under siege; no longer could it be assumed that competition would ensure that a free-market system would result in just prices and a socially optimal level of
production of goods and services. These assumptions were central to accountants' income determination model. From a neoclassical perspective, competitive markets adjudicated conflicts and ensured an equitable distribution of income among the factors of production. In a "managed" economy, this need not be the case. Not surprisingly, the post-World War II period was one of intense conflict with respect to distribution of income. Policies designed to foster an equitable distribution of income (e.g. wage/price controls, collective bargaining, the excess profits tax, and the undistributed profits tax) depended on accounting data and placed the accounting income determination debate at center stage. Scott (1933) predicted that, in a non-competitive economy, accounting data would replace competition as the arbiter of societal resources; and, in the post-World War II period, his prediction appeared accurate. But, accountants never accepted the role of arbiters; they continued to assume that the profession's primary function was to furnish information for use in capital markets.

Changing economic relationships brought accounting income determination into question and led to increased demand for accounting standards. Berle and Means (1933)
documented the fact that American industry was characterized by separation of ownership and control. They contended that passive investors had little influence over corporate managers and that an independent managerial class would use its power to promote its own interests. Some form of monitoring was needed, and financial reporting and external audits were the preferred monitoring mechanisms. Accounting standard setters had the responsibility for developing criteria to improve the credibility of financial reports. The standard setting debate, unlike the income determination debate, focused on direct corporate constituencies (i.e. investors, creditors, and managers). But, standards impacted reported income; and one of the objectives of this study is to compare the partisan nature of the accounting standard setting process with the position of impartiality that the profession took in the public debate related to income measurement. This places in stark contrast the difference between the profession's careful and skillful efforts to maintain the aura of objectivity and neutrality in the income determination debate with its actions in the standard setting arena.
Both income determination and standard setting became increasingly politicized during this period. It is the thesis of this study that, if accountants had adopted a strongly partisan position in the highly visible income determination debate, the profession would have come under harsh criticism. By steadfastly refusing to acknowledge the existence of non-competitive markets, the profession could maintain its preferred image as neutral reporters of fact. Accounting standard setting was less visible, allowing standard setters to use techniques, such as reserve accounting, in a partisan manner.

The Economic Basis of the Historic Cost Allocation Model

Adam Smith's (1776, rpt. 1937) classic work, *The Wealth of Nations*, provided the theoretical justification for a free-enterprise system. Smith argued that, while people engaged in economic activities to promote their own interests, they also, albeit unintentionally, promoted the public interest. The invisible hand, competition, translated the pursuit of individual self interest into a socially optimal economic system. Smith argued that competition ensured optimal industrial performance and
resulted in an equitable distribution of income to both capital and labor (Galbraith, 1987; Heilbroner, 1961). He warned that government intervention or collusion among powerful business interests posed the only threats to a socially beneficent economic system (Johnson, 1990).

Subsequent economic theorists refined Smith's model to provide a more systematic explanation of how and why market competition could be relied upon to promote the social good. Alfred Marshall (1920) developed a general equilibrium model based on marginal analysis. A downward-sloping demand curve reflected the law of diminishing returns (decreasing marginal utility of consumers) while an upward-sloping supply curve reflected rising marginal cost. Perfect competition would ensure that prices would be fixed at the intersection of supply and demand and that the economy would be in equilibrium. If prices were set at the margin, all production would be sold and full employment would be ensured (Galbraith, 1987).

In a competitive market system, prices are fixed for all products; all firms become price takers. But not all firms produce goods at the same cost, some are more efficient (produce at a lower cost) than others. If the
demand (price) side of the economic equation is considered fixed, accounting profit, which focuses on the supply (cost) side, can be regarded not only as a measure of technical efficiency (i.e. the lowest cost of production), but also as an indicator of social well-being.

Accounting theorists have generally disclaimed any interest in assessing the social desirability of profits; but, if one assumes competitive markets are operative and ensure a socially-optimal level of production, accounting profit has a social aspect. Paton and Littleton (1940, p. 3) made this assumption when they suggested that accounting is important from a "social point of view" because accountants provide dependable information about earning power (returns) which "can be an important aid to the flow of capital into capable hands." As long as accountants assumed that competitive markets functioned effectively, then their claim, that accounting profit could be used to allocate capital to its most productive use, was reasonable.

The rapid growth of large oligopolistic corporations, characterized by separation of ownership and control, and the Great Depression of the 1930s presented fundamental contradictions to the underlying assumptions of traditional
economic theory and accounting profit measurement. Economic theorists recognized that monopolies distorted the market mechanism—production would not be extended to where impersonally determined market prices covered marginal costs (Galbraith, 1987). Oligopolies result in similar distortions. In the case of either monopolies or oligopolies, profit maximization would not result in the socially optimal production of goods and services. DR Scott (1933) urged accountants to acknowledge the existence of non-competitive markets. Scott warned that, if they did not do so, accounting data would not only be useless, it would be dysfunctional—a warning accountants preferred to ignore.¹

**Separation of Ownership and Control**

Berle and Means' (1933) classic work documented the separation of ownership and control in the United States.

¹Scott (1933) reflected the influence of his mentor, Thorstein Veblen, an institutional economist. This study does not examine the institutional view; but it should be noted that, from the turn of the century to the present, institutionalists have regarded accounting profit as dysfunctional because it promotes pecuniary, rather than industrial interests. See, for example, Veblen (1911), Mitchell (1918), and Dugger (1989) for a reflection of the constancy of this view.
They pointed out that the law, based on private property rights, appeared inadequate to protect passive investors (stockholders). They argued that, if some mechanism were not put in place to provide adequate protection for owners, the moral justification for private property rights would be eroded. They reasoned that there was no moral justification for allowing managers (power holders) to appropriate corporate resources that did not belong to them (Berle and Means, 1933, p. 335). The crash of 1929 precipitated a crisis: Boards of Directors were perceived as "tools" of management, and independent audits did not seem to have curbed abuses by corporate insiders (Merino and Neimark, 1982). New Deal reforms (e.g. securities legislation in 1933 and 1934) were designed to restore investor confidence in the business sector.

Congress established a new regulatory agency, the Securities and Exchange Commission (SEC), that had the power to promulgate accounting principles. The SEC delegated that authority to the American Institute of Accountants (AIA), the national organization for Certified Public Accountants (CPAs). Throughout the 1930s, the need to restore investor confidence overshadowed reformers' concerns about the
adequacy of information provided to stockholders in financial reports. The AIA's Committee on Accounting Procedure (CAP) rejected the call, for "uniform" accounting standards, contained in the Securities Act of 1933. Instead, the CAP (Accounting Research Bulletin No. 1, 1939) focused on increasing consistency in the use of accounting methods and comparability of financial reports by reducing the number of acceptable accounting methods.

Although they knew that standards designed to "narrow differences" would allow corporate management wide latitude in preparing financial reports, SEC regulators did not object. While the SEC occasionally chided accountants for being "pleaders" for their clients and failing to constrain some of the more egregious financial reporting excesses, the agency did not want to undermine the credibility of the standard setting process. This might erode investor
confidence, which was still weak due to the longevity of the Great Depression.²

Accountants' attitudes did not change in the post-World War II period; they still exhibited no desire to become engaged in heated conflicts regarding income determination. They used the less visible standard-setting process to respond to managerial concerns about accounting income measurement, thus facilitating continued acceptance of the historic cost allocation model.

The Historic Cost Allocation Model

The threat of regulatory intervention by the SEC created the impetus for accountants to develop a conceptual framework for their discipline. Both the AIA and the American Association of Accountants (AAA), the national organization of accounting academics, joined in this

²See Healy (1939) and Landis (1935) for the types of financial reporting abuses that SEC commissioners found egregious and for warnings that, if the public accounting profession did not take a more proactive role, it might lose the authority to set accounting standards. The SEC, however, did not indicate that it wanted the responsibility. The only viable alternative suggested by the commissioners was that they might ask the American Accounting Association, the national organization of accounting academics, to assume responsibility for setting accounting standards.
endeavor. Arthur Carter of Haskins and Sells commissioned a study by two notable accountants, Thomas Sanders and Henry Rand Hatfield, and an attorney, William O. Douglas, to undertake a survey of existing practice. Upon being named an SEC commissioner, Douglas resigned from the project and recommended that his colleague, Underhill Moore, replace him (Douglas to Carter, Library of Congress, 1938). The Sanders, Hatfield and Moore Study, published by the AIA in 1939 at the urging of Carter, drew heated criticism from the academic community for its lack of theoretical basis; but it served a useful purpose by highlighting the wide diversity of acceptable accounting practices permitted in financial reporting.

Accounting academics rejected the focus on practice; the AAA commissioned two eminent accounting academics, William A. Paton and A. C. Littleton, who also served on the Committee on Accounting Procedure (CAP), to write a monograph that developed a theoretical basis for the historic cost allocation model used in practice. An Introduction to Corporate Accounting Standards (1940) filled the theoretical void brilliantly and became a classic in the field.
Paton and Littleton's entity theory attempted to address corporate relationships in a more realistic manner, explicitly acknowledging the separation of ownership and control. They depicted the nation's largest corporations as "quasi-public" corporations and suggested that corporate managers had a responsibility to a broad range of constituents, including investors, employees, consumers, and government. They concluded "that it is the imperative duty of management, therefore, to strive for decisions based on a balanced consideration of all the rights involved" (Paton and Littleton, 1940, p. 3).

Paton and Littleton's "quasi-public" corporation was a response to Berle and Means's 1932 monograph, rather than a response to the Keynesian revolution. Keynes (1935), reacting to the Great Depression of the 1930s, suggested that a laissez faire economic system would not work because the economic system was not self-correcting. He argued that a permanent equilibrium could be reached at less than full employment. Government should not sit idly by, he admonished; it should manage demand through public expenditures. To ensure the nation's economic well being, government must be an active participant in the private
sector. Keynes (1935) rejected the idea that high wages would limit production; he argued that high wages would increase consumption (demand) and thus result in increased, not decreased, employment. Active government participation in the economy, financed by taxpayer dollars, supported those who claimed corporations should be viewed as public, not private, institutions.

The Paton and Littleton monograph ignored Keynes's work. It was firmly rooted in neoclassical economics. Accountants focused on providing pertinent, quantitative information based on market exchange transactions; exchange transactions reflected the "measured consideration" of independent parties (Paton and Littleton, 1940, p. 22). Consistent with the assumption of competitive markets, Paton and Littleton (1940, p. 22) argued that "measured consideration implies that the cost of any factor acquired by an enterprise represents, at the outset, the true economic significance of the factor." Similarly, they reasoned that revenue, realized at time of sale, reflected the measured consideration or financial expression of the product of business enterprises (Paton and Littleton, 1940, p. 67).
They depicted the basic subject matter of accounting as "the measured consideration involved in exchange activities, especially those related to services acquired (cost, expense) and services rendered (revenue, income)" (Paton and Littleton, 1940, p. 11). Companies incurred costs to generate revenue; therefore, accountants' primary task was simply to (1) ascertain and record costs, (2) trace and reclassify costs in terms of operating activities, and (3) assign costs to revenues (Paton and Littleton, 1940, p. 69). The last task, they noted, was "crucial;" but they also warned that "recording the outflow of costs as embodied in revenue is essentially a matter of judgement and interpretation" (Paton and Littleton, 1940, p. 69).

Unfortunately, their warning went unheeded. This may have been due to their use of the term "matching" which communicated a degree of certitude that masked the inherent subjectivity of the cost allocation process. Their matching model received widespread acceptance because it portrayed "the accountant as a recorder, classifier and matcher of costs (with revenue)" that conveyed an aura of objectivity that appealed to the profession (Tinker, et al, 1982, p. 189).
The monograph also implied certitude by depicting accounting data, based on arms-length exchange transactions, as "verifiable and objective" with verifiable being defined as the truth (Paton and Littleton, 1940, pp. 18-19). The monograph positioned accountants as "unbiased" observers of fact who could, by a series of "test readings," provide a meaningful income figure that would enable all users to assess managerial efficiency in the use of resources.

The monograph emphasized the cardinal importance of "earning power." Paton and Littleton proposed that earning power could be best assessed by calculation of return on assets, but that point did not come across clearly because the authors assumed a stable dollar. This assumption allowed them to ignore asset valuation and to suggest that income was, by itself, an indicator of future earning power. The failure to stress that income would be a valid indicator of earning power only during periods of stable prices was unfortunate. In the post-World War II period, the failure to emphasize the importance of the stable dollar assumption in relation to interpretation of earning power would come to haunt the profession. Paton (1950a) would try to undo the damage, warning accountants that asset valuation was
critical to assessment of earning power and that historic
cost asset valuation was not useful during periods of
inflation. His mission would not be successful; accountants
liked the objectivity implied by the historic cost matching
model.

The Paton and Littleton (1940) monograph reflected the
accounting profession's response to the Keynesian
revolution--none.³ Accountants continued to view
corporations as "private" and to assume that profits should
accrue to the owners (stockholders) of the corporation.
Significant changes occurring in the socioeconomic
environment also had no impact on accounting income
determination.

The spirited debate, related to the concept of income
and income determination, following World War II provides an
excellent case study of how the accounting profession
skillfully balanced competing interests and why the

³Keynes (1933) did not believe that competitive markets
were operative so that a socially desirable level of
production occurred; he believed that the "peculiar"
calculus of accounting did not deserve the attention it
received, writing that under the "peculiar logic of
accountancy, men of the nineteenth century built slums
rather than model cities, because slums paid."
profession has successfully resisted efforts to reexamine the basic concepts underlying the historic cost allocation model. This study examines two investigations, the Congressional Hearings on Corporate Profits in 1948 and the Study Group on Business Income (1947-1952) sponsored by the American Institute of Accountants (AIA) and the Rockefeller Foundation, that raised important issues about the function of financial reporting in a corporate society.

Objectives of This Study

The post-World War II period from 1945 to 1952 provides an interesting case study of the essential role that accounting has played in reconciling changes in socioeconomic relationships with the nation's strong belief in a free-market system. The New Deal introduced an administrative logic that seemed to challenge the basic tenets of capitalism. The successful cooperative wartime effort of government, business and labor seemed to support Keynes' contention that government must be an active participant in the private sector to ensure the nation's economic well being. The success of this effort led to demands for economic planning that challenged the rationale
of efficiency inherent in traditional accounting profit measurement.

The post-World War II period could have raised significant questions about the relevance of accounting profit. First, a series of Congressional investigations (1947-1952), documenting that corporations in a wide variety of industries had administered prices, could have raised questions about the relevance of the assumptions underlying accounting income measurement. If prices were administered, then accounting profit would not necessarily provide a measure of managerial efficiency (i.e. it need not reflect effectiveness in the use of assets); accounting profit might instead reflect managerial power. Secondly, the rampant inflation of the post-World War II period made the stable dollar assumption tenuous. The claims made for accounting income become less persuasive when a variable measuring unit, the dollar unadjusted for inflation, is the basis of income determination.

Accountants willingly acknowledged the measurement scale problem (unstable dollar) and heatedly debated the question of which attribute (historic cost or replacement cost) to measure. But, the profession refused to
acknowledge that a non-competitive market system existed. This response is not surprising since recognition of a "managed" economy would have brought into question the relevance of traditional accounting profit measurement (Previts and Merino, forthcoming). While accountants did not generally empathize with labor's view that labor should be considered a factor of production (i.e. a partner in the productive process), the profession welcomed labor's demands for financial data. Those demands provided the profession with an opportunity to expand its social obligation and its power. They also played an important role in enabling the profession to justify retention of the historic cost allocation model.

Methodology

Carr (1962) defines the study of history as the study of causes. The historian is concerned with the explanation of the past as a model for action. Objectivity in historical enquiry is an unbiased examination of relationships rather than a mere recitation of "objective" facts. History acquires significance and objectivity only
when it succeeds in establishing logical relationships
between the past and future.

Previts, Parker, and Coffman (1990a) suggest that
accounting history is particularly useful as support for
contemporary research in policy-making and accounting
standard setting. History provides an overview of the
relationship between decisions on policy and the political
or economic consequences of those decisions. History
familiarizes accounting academics and practitioners with the
individuals, ideas, and theories that have been instrumental
in the evolution of the discipline. The methods employed by
the accounting historian must be appropriate "to the facts
being sought and the issues being investigated...the problem
determines the method" (Previts et al., 1990b, pp. 144-145).

I use retrodiction in my analysis of the post-World War
II income determination and standard setting debates.

Porter (1981, p. 14) states

(a)s a pattern of events emerges, the meaning of
any element in the pattern may change from what
was expected at an earlier stage, and cannot be
determined fully until the whole pattern has
developed. Understanding events in this way
requires a shift from prediction to retrodiction,
or reasoning from present to past.
The historian cannot know what was possible without examining initial conditions; the historian cannot determine the significance of an event without examining subsequent events.

I begin my study with an analysis of the post-World War II environment, demands by labor that they be recognized as legitimate users of corporate information, and accountants' response to those demands. This section highlights the contradictions between the profession's apparent willingness to recognize labor's right for information and its efforts to convince labor that traditional profit calculations would protect labor's interests. Next, I examine the 1948 Congressional Hearings on Corporate Profits and claims that corporations made "excess" profits; and I show how accountants responded positively to management's concerns without acknowledging any shortcoming in traditional profit measurement.

I then examine the technical debate on the measurement of business income. My analysis includes an examination of elements considered necessary for an ideal concept of business income and of the generally accepted postulates underlying accounting income. I use a case study of United
States Steel Corporation and Chrysler Corporation to show why corporate management demanded abandonment of historic cost for the calculation of business income. Next I examine the theoretical questions discussed in the Study Group on Business Income to gain an understanding of why accountants, although most closely aligned with management, continued to advocate the use of the historic cost allocation model. The analysis includes an examination of personal correspondence related to the debate on business income that illuminates some of the relationships and views held by individuals active in the debate.

**Data Sources**

This research uses both primary and secondary data sources. Primary data sources include correspondence related to the Study Group on Business Income from the extensive files of George O. May; the correspondence files of the Committee on Accounting Procedure; and transcripts of various Congressional hearings on corporate profits, monopoly power, and labor/management relations. Secondary data sources include published financial statements, journal articles relevant to the debate on the determination of
business income that have been identified through the
Accountants' Index for the period 1945-1952, and historical
accounts (both general and specific) for the period 1945-
1952.

Overview of the Dissertation

Chapter Two focuses on the conditioning (socioeconomic)
environment immediately following World War II to highlight
the changing socioeconomic relationships that impacted the
accounting profession. The chapter highlights the
increasingly important role that the federal government
played in guiding the economy. I then discuss how the
industrial strife of the period impacted accounting and the
profession's response to labor's demands to be treated as a
partner in the productive process with an equal interest in,
and right to receive, relevant financial data. The chapter
continues with a discussion of administered prices and an
examination of the testimony of economists, accountants,
labor leaders, and businessmen at hearings conducted by a
Congressional Subcommittee on Corporate Profits in 1948.
The testimony highlights the conflicts that existed among
various interest groups, with respect to what profit should
include, in order to position those parties most active in the income determination debate. The chapter concludes with an examination of the actions taken by the Committee on Accounting Procedures to show how use of a technique, "reserve" accounting, allowed accountants to respond to management's desire to decrease profits and lessen criticisms of "profiteering" without engendering the hostility of labor.

Chapter Three begins with a examination of the United States Steel Corporation/Chrysler Corporation depreciation debate that escalated criticisms of the historic cost accounting model and placed the profession at the center of a bitter debate. I examine the theoretical issues involved in the replacement cost/historic cost debate, as well as the justifications provided for the differing positions adopted by individuals involved in the debate (e.g. May, Alexander, and Bailey). The chapter then focuses on the dialogue within the Study Group on Business Income and the acrimony that the debate raised within the accounting profession. I conclude with an examination of the response of the Securities and Exchange Commission to the heated postwar replacement cost/historic cost debate.
Chapter Four examines why the debate on business income was limited to a discussion of attribute measurement. I discuss why accountants refused to acknowledge the existence of administered prices, clinging tenaciously to the private property rights paradigm. The chapter examines the conflicts that existed in the 1947-1952 debate and how they were resolved. I conclude with a discussion of why the excellent theoretical debate became primarily a matter of academic interest by the end of the decade.

Contributions of the Current Research

One of the most significant contributions of the current research is to introduce correspondence of George O. May into the literature. May spent a total of sixty-five years as a professional accountant and was instrumental in the development of the thought, ethics, and practice of his profession (Grady, 1962). He was a prolific contributor to the accounting literature, with 181 articles published between 1906-1960 (American Institute of Accountants, 1921, 1924, 1928, 1932, 1936, 1940, 1944, 1948, 1950, 1951, 1953, 1955; American Institute of Certified Public Accountants, 1957, 1959, 1961), and served as Research Consultant for the
Study Group on Business Income. The use of both primary source documents (the correspondence of George O. May) and secondary source documents helped me gain a more complete understanding of the complex forces motivating May. Correspondence is directed to a specific select audience; thus the author can afford to be more candid in correspondence than in articles submitted for publication in national journals. I was particularly alert for any differences in the tone or content of the two very different types of communication.

This dissertation also introduces the transcripts of various Congressional committees, particularly the Congressional Hearings on Corporate Profits, into the literature and places into perspective the political aspects of the debate on business income that have previously been ignored. This should provide readers with a better understanding of why the current standard setting process has become so contentious and why it is likely to remain so. To the extent this enhances our appreciation of the political aspect of our discipline, it could result in development of a better process and more robust debate.
CHAPTER II

CONFLICT OVER THE DETERMINATION OF BUSINESS INCOME

The Political and Business Environment of the United States: 1945-1952

This chapter presents a general overview of the political and business environment of the postwar period to highlight changes in socioeconomic relationships (Boyer, 1995; Donovan, 1977 and 1982; Halberstam, 1994; Manchester, 1973; McCoy, 1984; McQuaid, 1994; and Schaller, Scharff and Schulziner, 1992). The political sector responded positively to the Keynesian call for active government intervention in the economy to "manage" demand and to break up the assumed underemployment equilibrium. This had profound implications for accountants. The basic justification for private property rights, a self-regulating competitive market, was called into question; and government intervention in the economy led to policies that relied upon accounting data to adjudicate conflicts of interest.

If markets were not competitive, then what did accounting profit measure? In a competitive-market
environment, it could be assumed that all firms were price takers and that market prices reflected the economic significance of the product acquired or sold. If market prices were fixed for all firms, accountants could focus on the supply side (the cost of production) to determine which producers were most efficient (i.e. produced goods at the lowest cost). A series of Congressional investigations documented that many of the nation's largest corporations had the power to administer prices; this raised questions about the relevance of accounting profit in the new cooperative economy.

Rampant inflation also raised significant questions about the adequacy of accounting profit measurement. Although accountants willingly examined the attribute measurement problem (historic cost or replacement cost) and the measurement scale issue (nominal dollar or constant dollar), they steadfastly refused to acknowledge the existence of administered prices. The profession's refusal to do so is not surprising; acknowledging the existence of administered prices would have raised questions about the objectivity and neutrality of accounting data, attributes prized by accountants.
This chapter begins with an overview of the conditioning environment of the period to highlight the increasing importance of accounting data in implementation of governmental policies and in adjudication of conflicts. Next, the study focuses on a Congressional investigation of corporate profits and demands by labor for more relevant accounting data. The analyses of the profession's responses should provide us with a better understanding of why the profession refused to abandon the historic cost allocation model and why the model withstood a heated attack. The chapter concludes with an examination of the strategies that accounting standard setters used to respond to management's concerns regarding traditional accounting profit measurement. The standard setting debate accentuates accountants' firm commitment to managerial interests.

The Changing of the Old Order: The New Deal and Its Aftermath

President Franklin D. Roosevelt organized the federal government to deal with many of the social and economic problems of the Great Depression. While historians differ as to whether New Deal reforms were revolutionary or pragmatic, the idea that active government intervention in
the marketplace afforded a means of economic recovery and progress challenged the core tenets of a free-market system (Richberg, 1937; Schlesinger, 1950; Means, 1962).

The reforms ushered in a significant change in attitudes toward business and government and resulted in what Means (1962) labeled the era of "collective capitalism." The enormous productivity, achieved by the cooperative efforts of government, business and labor to meet the demands of World War II, served to support those who favored Keynesian policies. The war led to a rapid growth in federal spending, a marked expansion of the federal bureaucracy, and escalation of the national debt. Wage and price controls, as well as rationing, were implemented to deal with inflation and a shortage of goods (Boyer, 1995; Schaller, Scharff, and Schulziner, 1992). The war united the citizenry in a common cause and silenced the critics of government intervention. But, after the war, Harry S. Truman, who had assumed the presidency upon the death of Roosevelt, had to reconcile the contradictions that existed between the dominant economic ideology (free enterprise) and New Deal reforms. The reforms suggested that the federal government should play an active role in
the private sector to stimulate economic growth and ensure the nation's social well-being.

The Employment Act of 1946

The remarkably successful wartime effort gave credence to those who suggested that economic cooperation, not competition, would serve the interests of the nation best. The Employment Act of 1946 reflected the belief that a coalition of government and business could direct and stabilize the economy. The act created a Council of Economic Advisers comprised of the chief executive officers (CEOs) of the nation's largest corporations. The Council was charged with developing, and recommending to the President, national economic policies to foster and promote free competitive enterprise, to avoid economic fluctuations or to diminish the effect thereof, and to maintain employment, production, and purchasing power (Vatter, 1963).

Galbraith (1987, p. 251) characterized the employment act as a concentrated effort to have "Keynesian prescription written into the law." The law reflected the belief that government should assume an underemployment equilibrium existed and take active measures to break that equilibrium.
This effort to write interventionist policies into law did not go unchallenged. The National Association of Manufacturers (NAM) led the opposition, claiming that government intervention would destroy the free enterprise system and lead to socialism. While not successful in preventing passage of the law, critics did get the language changed to make the law more consistent with traditional economic theory. Coordination would be used to "foster and promote free competitive enterprises and the general welfare" (Bailey, 1950, p. 238). The final passage also saw the word "full" dropped from the title of the act.

After 1946, there was a noticeable shift to the right in Congress; most proposals to extend "New Deal" type programs were destined for failure. Thus the passage of the Employment Act of 1946 was an anomaly for the period. The law required the federal government to follow a policy of maximum employment, production, and purchasing power. It also required the President to present an annual report to Congress and to recommend programs that would facilitate economic growth. Although the original drafts of the Act focused on attaining full employment through federal spending on health, education, public works, urban renewal,
etc., the business community successfully shifted that focus toward increasing incentives in the private sector. The final bill looked to measures such as tax cuts to stimulate investment and cooperation between business and government to achieve the goals of the Act (Boyer, 1995).

Although the Employment Act of 1946 may have been an anomaly, it gave added impetus to labor's demands that the nation's largest corporations should no longer be viewed as "private," but as quasi-public organizations, responsible to a broad set of social constituencies (Barkin, 1948). Keynesian theory supported this view. Keynes (1935) challenged the traditional wisdom that high wages caused high unemployment; he argued that lowering wages reduced effective demand, which in turn increased unemployment.4 This new image of labor had an impact on accounting; labor argued they had a right to share in profit, a right the accounting profession did not acknowledge.

Taxpayers also could be viewed as suppliers of capital to corporations in the private sector through (1) sale of

4See Johnson (1990) who discusses Smith's "trickle-up" theory; he interprets Smith to say that higher wages, not higher profits, lead to national well being.
wartime assets at bargain prices, (2) subsidization of industry through the Marshall Plan, and (3) financing of research and development for defense purposes. Critics questioned why the nation's largest corporations should not be considered public and the justification for allowing stockholders to reap profits generated by public funds (Berle, 1963). Labor leaders echoed that message and felt this further strengthened labor's claims to a share of corporate profits (Hedges, 1947).

The Post World War II "Fire Sale"

During the war, the government, not the private sector, provided most of the capital to build wartime production facilities. After the war, the government, in effect, donated capital to the private sector as it sold the plant and equipment to the private sector at what McQuaid (1994) called "fire sale" prices. The primary beneficiaries were the nation's largest 87 corporations who received two-thirds of the total value of all wartime plant and equipment at a
Donation of capital, financed by American taxpayers, to the private sector raised serious questions about private property rights (ownership claims). The question of to whom corporate profits should accrue became a focal point of labor's claims that it should share in corporate profits.

**The Marshall Plan**

While the government's donation of wartime property to the private sector raised questions about the legitimacy of viewing the nation's largest corporations as private, the government's visible subsidization of European recovery through the European Recovery Program (Marshall Plan) provided further support to those who claimed that corporations had become "quasi-public" institutions.

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5Houghton (1948, pp. 86-88) stated that, at the height of wartime production, the 250 largest U.S. manufacturing corporations controlled approximately 65 percent of total productive facilities usable for peacetime production. The capacity controlled by these firms during World War II almost equaled the total capacity of all U.S. manufacturing corporations in 1939. Houghton stressed that the distribution of the facilities following the war would be "a crucial factor in the future trend of concentration." U.S. Steel Corporation, Republic Steel Corporation and Bethlehem Steel fared particularly well in the postwar disposition of government facilities.
Although Congress was initially unreceptive when Secretary of State George Marshall presented a proposal in June 1947 for the economic reconstruction of Europe to be financed by American taxpayer dollars, Truman relied on big business to gain acceptance for the concept of foreign aid (Schaller, Scharff, and Schulziner, 1992).

Truman created a nineteen-member bipartisan advisory council, including nine businessmen, to draft a foreign aid plan. McQuaid (1994, pp. 44-45) reports that

(b)ipartisan definitely meant business-oriented. Moderate Republicans in Congress had told Truman that, without substantial corporate involvement in designing what was becoming known as the Marshall Plan, he could not obtain their support against obstructionist conservatives. Truman acceded. He faced congressional deadlock otherwise...business members--particularly [Averell] Harriman--set the agenda and the tone for the group's work.

Big business supported this plan as being in the self-interest of America, and indeed necessary for the very survival of the nation.

The corporate politicians were successful. Congress voted billions of dollars in foreign aid for the reconstruction of Western Europe; the funds would flow primarily to American corporations since the war had destroyed the productive capacity of most industrial nations
(Donovan, 1977). At the end of the war, the United States produced half of the world's goods with only 6 percent of the world's population (Schaller, Scharff and Schulziner, 1992). Given the lack of competition, many believed that the U. S. government had made the "down payment on the American century" with the Marshall Plan.  

The interaction between government and business was not unidirectional; as government became more active in the economic sector, business leaders became more active in the political sector. The National Association of Manufacturers (NAM), the United States Chamber of Commerce (USCC), the Business Council (BC), and the Committee for Economic Development (CED) represented the interests of business; all became powerful voices in Washington. This is not meant to imply that business interests were homogenous; they were

6See McQuaid (1994) who describes the Marshall Plan as a way to subsidize the largest U. S. corporations without generating public protest; see also Manchester (1973, p. 438) who offers an alternative view, concurring with Churchill's sentiment that the Marshall Plan was "the most unsordid act in history." Both authors agree that the plan greatly increased demand for American products, profitability of American corporations, and employment of American workers. They disagree about the degree to which all Americans shared in the wealth generated by this subsidization of industry.
not. The NAM and the USCC represented the interests of numerous large and small business organizations, while the BC and CED were composed primarily of CEOs of large corporations. Small business often shared labor's concern that the nation's largest corporations were not subject to competitive forces and had the power to administer prices or restrict supply in a manner that was disadvantageous to the small producer.

However, this potential conflict between large and small corporations did not impact the accounting literature. Business interests were viewed as homogeneous; they all were assumed to have a strong commitment to the private property rights paradigm. Small business interests might chafe at the inequalities that existed in the marketplace, but they shared the beliefs that all business enterprises should operate primarily for the benefit of their owners and that profits should be viewed as the return to ownership.

Labor did not view the emerging relationship between government and big business with equanimity. By 1945, 70% of all United States manufacturing workers were represented by unions; organized labor had sufficient strength to demand attention and did so. Although labor leaders insisted labor
had a right to share in corporate profits, accountants never accepted that argument.

Wage/price controls and collective bargaining created a need for accounting data for bargaining; the ongoing labor/management strife placed accountants in an interesting position. While accountants made it clear that they did not believe labor had a right to share in profits, they recognized that labor's need for information provided an opportunity to expand the profession. The profession actively courted labor leaders during the period, positioning themselves as independent professionals who could provide neutral data that could be used to resolve labor/management conflicts.

The Postwar Industrial Conflict

Strikes plagued postwar America. 1945 was a year of bitter conflict between business and labor unions. During the war, both strikes and lockouts were prohibited. After the war, both business and the unions wanted their share of the postwar pie. The unions wanted elimination of wage controls and the continuation of price controls; business
wanted an end to price controls and continuation of wage controls (McCoy, 1984; McQuaid, 1994).

Employers relied on economic pressure, lawsuits, public relations efforts, and federal intervention to break the strikes. When the Republican party assumed control of both the House and the Senate in 1947, containing the unions became a Congressional priority. Adoption of the Taft-Hartley Act in 1947 represented an effort by Congress to rectify perceived inequities in the National Labor Relations Act. The Taft-Hartley Act placed significant restraints on the actions of unions (McCoy, 1984; McQuaid, 1994).

Unions felt betrayed by Truman, and labor unrest continued. The demands of the Cold War and the Korean War mooted some of labor's harshest criticisms of the close government/corporate relationships, but they did not silence labor's demands to become a full participant in the fruits of American business. The accounting profession's response to these demands provides an interesting insight into how accountants reconciled their strong commitment to private property (ownership) interests with labor's demands that corporations be viewed as quasi-public enterprises, accountable to a broad range of corporate constituencies.
Abbott (1988) points out that, during periods of shifting power, professions have the ability to strengthen their power by extending their social obligations. Labor leaders contended that accountants failed to recognize that, in the new socioeconomic order, workers should be viewed as participants in the productive process, to whom corporate management had a moral obligation. Labor, they argued, should not be viewed as a financial commitment like repairs and maintenance and other ongoing expenses (Hedges, 1947).

Traditional accounting income measurement treated labor as a cost to be controlled. A reconceptualization of labor as a participant in the productive process would have entailed a radical change in accounting that accountants were not prepared to accept. Paton and Littleton's (1940) entity theory recognized corporate relationships had changed and recommended that accountants concentrate on calculating "entity" income and not income to owners. But their suggestions that the "affairs of the large corporation...are not solely the concern of the immediate management, or of the stockholders standing back of the management" and that managers should strive to balance the interests of a broad
range of constituents were not well received (Paton and Littleton, 1940, pp. 2-3).

Paton and Littleton (1940) suggested a slight modification in the calculation of income for both interest and dividends; either both should be considered expenses or both should be considered distributions of income. They reasoned that "to management the cost of operating the undertaking is not affected by the form of capital structure employed, nor by the particular kinds of instruments used in raising the necessary funds" (Paton and Littleton, 1940, p. 43). This entity aspect of entity theory was not accepted by the accounting profession. The rejection of Paton and Littleton's entity income concept foreshadowed the profession's reaction to labor's claims to share in profits.  

Accountants walked a narrow line in responding to labor's request for information. The profession wanted to

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'Tax laws allowed interest, but not dividends, to be deducted when determining taxable income, reinforcing the ownership focus. Reaction to the Paton and Littleton monograph suggested that, not only did accountants reject the idea that corporate managers should balance the interests of all parties, but also the fear that if interest became a distribution of income, it would no longer be tax deductible.
expand its social obligation to include labor, but most accountants remained firmly committed to the relationship between ownership and profit. T. Dwight Williams, President of the American Institute of Accountants (AIA), reflected the profession's attitudes. He warned against unquestioned acceptance of labor's right to share in profits, noting that "profit is the owner's share in the fruits of production after labor's share has been paid" (Editorial, "Labor's Share of Productivity," Journal of Accountancy, July 1946, p. 3).

The profession responded to labor in two ways. First, accountants suggested that, as independent professionals, they could provide objective data that could be used to resolve industrial strife. Second, accountants engaged in an educational effort to explain, to labor leaders, why reported profits were not excessive. Accountants seemed enthusiastic about their educational mission; they were strongly supported by corporate management in their effort to educate labor regarding the proper interpretation of profits.
Expansion of the Profession's Social Obligation

The period from 1945 to 1950 is remarkable in that it is the only period in this century when labor's concerns with respect to financial reporting have received widespread attention from the accounting profession. Numerous editorials in the *Journal of Accountancy* during the postwar period reflect the profession's acknowledgment that labor had become a powerful force in the new economic order.

Accountants realized that a new opportunity existed for expanding their services and depicted themselves as impartial judges in the ongoing industrial conflict. A 1946 editorial, entitled "Labor's Share in Productivity," in the *Journal of Accountancy* seemed to indicate that the profession was ready to acknowledge that labor/corporate relationships had changed. The editor wrote that

(t)he relation of organized labor to the American free-enterprise economy continues to hold top position on the agenda of domestic problems urgently in need of solution...Permanent industrial peace may be expected only when there is an understanding among ownership, management, and labor as to how the fruits of industrial production should be shared. At the present time labor is in revolt against the traditional concept that labor is a commodity and that wages should be determined in a free labor market--that is, by the available supply ("Labor's Share in Productivity," *Journal of Accountancy*, July 1946, p. 1).
The editor positioned accountants as independent professionals who could provide "objective" data to resolve industrial strife. While stressing the profession's objectivity, the editor also warned accountants to proceed cautiously in responding to labor's requests and not do anything to undermine the idea that profits belonged to ownership interests.

The editorial foreshadowed the position that the profession consistently would take. Labor should focus on productivity, not profit. The editorial accorded accountants a pivotal role in attainment of industrial peace by suggesting that the profession could develop "productivity" measures for labor negotiations. The editor concluded that:

(1) It is evident that full cooperation between employees and employers will not be attained without the aid of the accounting profession. Accountants must take the lead in devising techniques by which production and income may be measured...with a high degree of accuracy ("Labor's Share in Productivity," Journal of Accountancy, 1946, p. 4).

This editorial marked the beginning of a prolonged effort to convince labor that, as professionals, accountants could be relied upon as "neutral" and "objective" reporters of fact.
Subsequent editorials and articles depicted accountants as independent men, capable of taking a "disinterested" view in controversial areas.

Labor leaders welcomed the accounting profession's acknowledgment of changing labor/capital relationships. Marion H. Hedges, Director of Research of the International Brotherhood of Electrical Workers, commended the above editorial for its sensitive analysis of the labor problem. He hailed the editor's objectivity, suggesting that, if accountants accepted the role of mediator between labor and management "so that both sides can have confidence that what he says is true and not fiction," accountants might approach "a new professional status," comparable to that of scientists (Hedges, 1947, pp. 17-18).

But most labor leaders, like Solomon Barkin, Director of Research for the Textile Workers Union of America and a member of the Study Group on Business Income, remained skeptical about accountants willingness to abandon their pro business orientation. He warned that "accounting techniques" were shaped "solely to serve business judgments;" he saw little effort being made in colleges to sensitize future accountants to labor's needs (Barkin, 1947,
Barkin's skepticism was well founded. While the accounting literature stressed accountants broader social obligation to all corporate constituencies, including labor, the profession never abandoned its primary allegiance to business. Inglis (1947, p. 16), while discussing the need for reports to stockholders, management, and labor, reflected the dominant view of the profession when he wrote that "as accountants we must never forget that business is our business."

**Educating Labor**

There is an interesting omission in the accounting literature in that accountants refused to address the question of what accounting profit reflected in a non-competitive economy. Market prices were assumed to reflect value, objective representations of the economic significance of products. However, accountants willingly acknowledged that inflation eroded the purchasing power of the dollar, resulting in overstated profits. Labor, accountants suggested, should take that fact into consideration before claiming corporate profits were excessive. Labor was not receptive to this message.
Inflation also eroded the purchasing power of wages, and most labor leaders saw no reason why they should place labor in a disadvantageous position in wage negotiations by "properly" interpreting corporate profits (Barkin, 1951).

Business interests wholeheartedly supported accountants in their efforts to "educate" workers. Earl Bunting (1947, p. 91), President of NAM, lauded the profession, telling accounting practitioners that "no group in this country is more experienced in presenting unbiased fact." He suggested that accountants "owed it to their fellow citizens to clarify questions about the nature, amount and economic functions of business profits" (Bunting, 1947, p. 91). What, he suggested accountants do, is dispel myths about excess corporate profits to quell labor unrest. This educational effort had a salutary impact upon retention of the historic cost model. Labor leaders, while still questioning the relevance of accounting profit, became strong advocates of retention of the historic cost model since it was more advantageous for labor negotiations than inflation adjusted income.
Expanding the Educational Mission

Three policies (i.e. wage/price controls, the excess profits tax, and the undistributed profits tax) added urgency to the need to educate not only labor, but also the public and political leaders, as to the impact of inflation on reported corporate profits. These factors exacerbated conflicts among labor, management, and Congressional leaders; and financial reporting data played an important role in both creating and adjudicating conflicts.

Financial reporting had a direct impact on wage/price controls. The assumption was made that, in non-competitive markets, prices and wages could stray from their socially desirable level and no self-regulating mechanism existed to "bring them back into the fold" (Heilbroner, 1961, p. 42). Barriers to entry prevented new competitors from entering an industry where "excess" profits accrued and made it possible for corporations to administer prices. The growth of labor unions also created significant barriers to the mobility of labor; therefore, wages could be kept at an artificially high level. Both business and labor railed against price controls that impacted them. Thus, business demanded an end to price controls, while labor wanted to end wage controls.
Each group claimed market regulation worked for them, making controls unnecessary, but was ineffective for the other group. With both big business and big labor united against wage/price controls, Congress repealed them in 1947. Despite their short duration during this period, these controls had an impact on accounting, in that they highlighted the important role accounting data played in a managed economy.

Although taxable income and financial reporting income need not be the same, financial reporting had a direct impact on administration of the excess profits tax and the undistributed profits tax. It also had an indirect impact when reported profits were large. The popular press and labor leaders brought excessive profits to the public's attention, thus increasing demands for controls.

The criteria for determining if profits were excessive came from data provided in annual reports. For example, the 1950 excess profits tax allowed for three methods for computing income not subject to the tax. One method used average profits for the 1946 to 1949 period to determine if profits were excessive (Casey and Lasser, 1951). Justification for an excess profits tax rested on the assumption that, in an oligopolistic market, corporations
administered prices and government intervention was needed to ensure a just distribution of income. Although the wartime excess profits tax was repealed in 1947 over President Truman's objections, a new excess profits tax was enacted in 1950 at the outset of the Korean War.

The undistributed profits tax had a different motivation; it reflected fears that managers would act to promote their own self-interests rather than stockholders' interests. The tax was consistent with Berle and Means (1933) assertion that corporate managers, freed from the salutary effects of market competition and with no fear of direct oversight by passive investors, would abuse their power. The underlying assumption appeared to be that managers' power was related to corporate size and that managers would seek to maximize growth, rather than profitability, through retention of earnings (Galbraith, 1987). This would have two inimical effects. First, it

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"In classical economic theory, prices could not be administered because consumers reigned supreme; if a corporation attempted to charge excessive prices or to increase profit by limiting supply, competitors would enter the market and force prices back to their socially ordered level. See Heilbroner (1961) for succinct discussion of the dual regulation of prices and income to ensure each is at a socially optimal level."
would deprive stockholders of their rightful profits; and second, it would lead to further concentration of industry. Financial reporting data, the amount of retained earnings (or earned surplus) that a company reported, had a direct impact on whether the tax was imposed.

Collective bargaining, price stabilization, and tax policies increased the political visibility of accounting. Accountants welcomed the opportunity to expand their social obligation; to do so, it became imperative that the profession be perceived as independent. Managers argued that inflation eroded the purchasing power of the dollar and that historic cost accounting created "illusory" profits, resulting in unjust taxation and unfair labor demands. Accountants agreed. However, abandonment of historic cost might be viewed as a partisan maneuver, calling into question the profession's neutrality. The theoretical debate over attribute measurement (historic cost or replacement cost) and measurement scale (nominal dollar or

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9The correspondence files of the CAP indicate that accounting standard setters were aware that abandonment of historic cost measurement would call into question the profession's neutrality and undermine its claims to independence. See Stans (1947) and Tilly (1947) for examples of the strength of this feeling.
constant dollar), discussed in the next chapter, was a highly visible debate. Accountants held fast to historic cost in the debate. That is not to suggest that accountants did not empathize with management or respond to their concerns; they used the standard setting process as the mechanism to redress management's concerns in a less visible manner.

While accountants could not ignore the impact of inflation on historic cost income measurement, they could and did ignore those who claimed that accounting profit was dysfunctional in a period of administered prices. The accounting literature continued to reflect classical economic theory. Consumers were sovereign, market competition regulated both price and quantity of goods provided, and profitability reflected the ability of producers to provide a level of goods and services that was socially desirable. Accountants refusal to acknowledge that prices could be administered is understandable; acknowledging the possibility of administered prices would have undermined the profession's claims that accounting

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10See Bond (1946), who states this position clearly, in his dispute with Bonbright over rate regulation.
profit could be used to channel resources to their most productive use in a socially optimal manner. Similarly, if firms were price setters, not price takers, then profitability would not necessarily provide a measure of managerial efficiency (i.e. production of goods at the lowest cost). Dr. Scott's warning that, if the "profession did not recognize the non-competitive nature of the corporate economy, accounting would become a useless vestigial appendage of society" proved to be untrue (Tinker et al, 1982, p. 190).

The Specter of Administered Prices

Acceptance of Keynesian policies suggested that the nation no longer believed that market regulation would ensure the nation's well being. The war had shown that demand, fueled by government expenditures, would result in economic recovery. Pent-up consumer demand and the need to rebuild the ravaged European industrial system fueled post-war demand.11 Personal savings had grown to a total of nearly $140 billion during the war due to a high rate of

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11See Galbraith (1987) for a discussion of how the war served as a laboratory for Keynesian policies and seemed to prove them right.
employment and a shortage of consumer goods. Defense expenditures continued to be high due to the Cold War and then the onset of the Korean War. Fears of inflation kept price controls in effect for a short time, but a conservative Congress repealed wage/price controls in the latter part of 1946. Prices skyrocketed in 1947; and labor leaders were livid, demanding that Congress conduct an investigation of corporate profits to curb corporate excesses. The 1948 Congressional Hearings on Corporate Profits, a response to public outrage, provide a fertile ground for examining accountants' commitment to neoclassical economic tenets and to understand their reluctance to abandon the historic cost allocation model.

**Congressional Subcommittee on Corporate Profits**

The Joint Committee on the Economic Report of the U.S. Congress was established to study the periodic economic reports made by the President of the United States to Congress and to make recommendations to Congress regarding information contained within those reports. The Committee also was given the responsibility for making policy recommendations to Congress to maintain employment and
production and to improve the standard of living within the United States. In his January 1948 Economic Report to Congress, President Truman directed attention to the size of business profits which were, in the aggregate, of unparalleled size. The magnitude of business profits led to an assumption by organized labor and the public that some of those profits should be passed on to labor and consumers through lower prices, higher wages, or a combination of both (U.S. Cong., 1949, p. 1).

Under the auspices of the Joint Committee on the Economic Report, a Subcommittee on Profits held hearings in December 1948 to examine the size, source, and distribution of business profits. The Subcommittee was specifically charged with the task of examining the profit situation within the framework of the major economic problem, controlling inflation without engendering mass unemployment (U.S. Cong., 1949, p. 1). The Subcommittee on Profits heard the testimony of numerous individuals, including Sumner H. Slichter and Seymour E. Harris, Harvard University economists; William A. Paton, an accounting academician instrumental in formulating accounting theory; George D. Bailey, a well-known professional accountant and accounting
standard setter; Nelson H. Cruikshank, Stanley H. Ruttenberg, and Donald Montgomery, labor leaders; and representatives of private industry. The conflicting testimony was often caustic and intense.

This chapter examines in some detail the testimony of the above men to highlight the stark contrasts among them. The two economists, Slichter and Harris, took polar views with respect to large corporate entities. Slichter adopted a private property rights perspective (i.e. corporations should be run for the benefit of their owners). The two accountants, Paton and Bailey, shared this belief. All three criticized the government for taxing "illusory" profits by refusing to acknowledge that inflation decreased the purchasing power of the dollar. Corporate profits were not excessive; taxes were confiscatory.

Slichter (1949) and Paton (1949) suggested that financial reporting should be changed to reflect the changing value of the dollar. Bailey (1949), an accounting practitioner and a member of CAP, while agreeing that "illusory" profits should not be taxed, was not willing to say that fluctuations in the purchasing power of the dollar undermined the usefulness of historic cost for financial
reporting purposes. He argued that replacement of assets should be viewed as a managerial decision and have no impact on reported profits. Bailey (1949) characterized historic cost as objective and value free, reflecting the profession's steadfast position that competitive markets remained operative and that prices could be assumed to be just.

Harris (1949), an economist, joined the labor leaders in depicting the nation's large corporations as quasi-public institutions. He, like the labor leaders, urged Congress to prevent these corporations from exacting a tribute by increasing taxes so that they would not benefit unduly from their ability to control prices. Cruikshank (1949), Ruttenberg (1949), and Montgomery (1949) all testified that corporate profits were not understated, but excessive; unlike the accountants, they assumed prices were administered and that government should intervene through tax policies to rectify an unjust distribution of national income. The labor leaders argued that administered prices resulted in a suboptimal production of goods and services and an inequitable distribution of income (Heilbroner, 1961, p. 46).
Accounting profit measurement became the focal point of debate. Those who viewed the economy from a neoclassical perspective argued that inflation eroded the usefulness of historic cost data and that accounting income grossly overstated corporate well-being. This resulted in confiscatory tax policies. Labor leaders, adopting a Keynesian perspective, argued that the ability to administer prices enabled corporations to insulate themselves from inflation. Tax policy should be used to redress inequities in the distribution of wealth. A heated and provocative debate, regarding the reasonableness of the premises underlying traditional accounting profit calculation and the interpretation of accounting profit, ensued.

Four concepts/principles/assumptions figured prominently in the testimony before the Subcommittee. They were the: (1) capital maintenance concept, (2) historic cost principle, (3) stable measuring unit assumption, and (4) continuity or going concern assumption. The testimony reflected widespread disagreement among witnesses with respect to each issue. The positions taken appear to have been primarily shaped by witnesses' views with respect to private property rights and their perceptions of the
adequacy of market regulation in the emerging corporate economy.

The concept of capital maintenance requires that capital used up during a period must be replaced before any profit can be recognized. The concept can be traced back as far as 1776 to Adam Smith in *The Wealth of Nations*:

> Though the whole annual produce of the land and labour of every country, is, no doubt, ultimately destined for supplying the consumption of its inhabitants, and for procuring a revenue to them; yet when it first comes either from the ground, or from the hands of the productive labourers, it naturally divides itself into two parts. One of them, and frequently the largest, is, in the first place, destined for replacing a capital, or for renewing the provisions, materials, and finished work, which had been withdrawn from a capital; the other for constituting a revenue either to the owner of this capital, as the profit of his stock; or to some other person, as the rent of his land (*The Wealth of Nations*, rpt. 1937, pp. 316-317).

Before the concept of capital maintenance can be applied to the determination of business income or profit, the capital to be maintained must be defined—either in terms of financial capital or physical capital. Under the financial capital view, the capital to be maintained is the dollar investment of the owners; under the physical capital view, the capital to be maintained is the physical productive capacity of the firm. The debate centered on
these two concepts, although labor leaders tried, but failed, to add another dimension. Labor questioned whose capital was being maintained. They argued that government provided significant amounts of capital to the private sector. Thus, corporate capital should not be viewed as private and debates over maintenance of stockholders' investment were irrelevant. Business oriented witnesses, including accountants, viewed labor's question as a diversion. They assumed that owners provided corporate capital and proceeded accordingly.

If one assumes a competitive-market system, then accountants can focus on the supply (cost of production) side of the economic equation. While the question of when to recognize revenue is an issue, once criteria have been set for revenue recognition, recording the market price at the appropriate time does not require accountants to

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12See McQuaid (1994, p. 24) for a discussion of the post-World War II "fire sale" of wartime production facilities to the 87 large firms that had run the plants during the war.
exercise judgment as to the "fairness" of the price.\textsuperscript{13} The same can be said when accountants record the acquisition cost of a factor of production. Paton and Littleton (1940, p. 24) defined cost as "the amount of bargained-price of goods or services received or of securities issued in transactions between independent parties." It is the subsequent allocation of cost among artificial time periods that requires exercise of judgment. One interesting aspect of the Congressional hearings debate was that, while witnesses argued about the objectivity and fairness of market prices, there was little debate about the inherent subjectivity of subsequent cost allocations needed to determine annual profits.

Although labor leaders raised questions about the fairness of market data, the debate quickly shifted to the reliability of historic cost during periods of inflation. Historic cost accounting income assumes a stable measuring unit; many witnesses argued that its usefulness was lessened during periods of dramatically fluctuating prices. Much of

\textsuperscript{13}This statement is made with the caveat that market transactions are assumed to be arms-length transactions between independent parties; related-party transactions must be more carefully scrutinized.
the testimony before the Subcommittee centered on what attribute should be measured to determine income--historic cost or replacement cost--and what measurement scale should be used--nominal dollars or constant dollars. No closure was reached, but the testimony indicated that labor leaders would not support abandonment of historic cost, however irrelevant, if the alternative was to use a method that would reduce reported profits (Montgomery, U.S. Cong., 1949).

The "going-concern" concept also played an important part in the testimony at the hearings. Accountants assume that continuity of activity, not liquidation, is the normal expectation for a firm. The going-concern concept provides the foundation for any attempt to measure profit for a period of time less than the entire life of the firm (Paton and Littleton, 1940, pp. 9-11). Continuity is also central to retention of historic cost, justifying recording of an asset at value in use, not value in exchange. The historic cost allocation model requires the expectation that assets will continue to be used by the firm. If the assumption of continuity cannot be made, then resources must be valued at their exit value in an orderly liquidation.
Professor Sumner H. Slichter (1949), a Harvard University economist, testified that the profits reported by American corporations were overstated due to some inaccuracies in reporting practices for inventories and depreciation. Most corporations included increases in the cost of replacing inventories and increases in the cost of replacing plant and equipment as part of profits. Slichter argued that, if a firm is to continue in existence, it must replace inventories, as well as plant and equipment. He predicated his argument on a physical capital maintenance approach.

Dr. Seymour E. Harris (1949), another Harvard University economist, criticized both national monetary policy and national fiscal policy for not restraining inflation. Under direct questioning regarding whether profits were excessive, Harris stated that it depends on how you measure profits. He proposed that too much emphasis is placed on profits after taxes rather than the more relevant variable--profits before taxes. Harris incorporated a discussion of the problem of equity (what seems to be justice to the average individual regarding profits) into his testimony. He suggested that excess profits could lead
to collapse of the American economic system and recommended an attack on prices as a solution to the problem of excess profits. This would include taxing corporations at the 60 percent level, as well as increasing the personal income tax.

William A. Paton (1949) disagreed with Harris on the subject of taxation; he suggested that the individual should be taxed rather than the corporation. Paton agreed with Slichter that corporate net earnings were significantly overstated and suggested that the common stockholder is a forgotten man in terms of what he receives from dividends after deducting personal income taxes. He stated that one of the limitations of accounting is that it is based on the assumption of a stable monetary unit—an assumption not valid in periods of high inflation. He further suggested that costs (as a measure of economic sacrifice) should be revised to bring them into line with present prices. Paton predicated his argument on maintaining productive capacity (physical capital maintenance). He concluded that the problem of overstated earnings is amplified when applied to understated book values of shareholders' equity in calculating a rate of earnings.
George D. Bailey (1949), immediate past president of the American Institute of Accountants (AIA) and a partner in Touche, Niven, Bailey & Smart, reminded the Subcommittee that corporate profits are not the same thing as money in the bank or distributable profits. Using a physical capital maintenance approach, he argued that, during periods of inflation, corporations must retain dollars reported as profits to invest in more inventory, as well as to replace machinery and facilities. He further stated that taxation of corporate profits makes it difficult to retain and reinvest enough income to preserve the productive level of plants and facilities. Bailey did not suggest developing new reporting procedures, instead he recommended that corporate financial statements be interpreted within the framework of current economic conditions. Restrictions on profit could be presented in an addition or addendum to the financial statements.

When Representative Huber (1949) asked Bailey to clarify his position regarding the current tax structure, Bailey (1949) stated that current methods of accounting resulted in excessive taxation. He stressed that taxes on corporations should be reasonable and fair and recommended a
small corporate income tax and a higher tax on individual income. Senator Flanders (1949) asked whether there would be any loss of revenue to the government over the life of an asset if a firm used an accelerated method of depreciation rather than the straight-line method. Bailey (1949) replied that there would be no loss. Bailey not only failed to consider the implications of present value calculations in his testimony, he also failed to mention that, if a firm continues to replace its assets and has a 6 percent inflation and/or growth rate, there could be a permanent deferral of taxes.

Nelson H. Cruikshank (1949), Director, Social Insurance Activities, American Federation of Labor (AFL), stated that labor was extremely interested in business profits, particularly as those profits relate to the distribution of national income. He called for equity (fairness to all groups) in the "distribution of the rewards of production" among workers and investors and for wage increases that could be granted without corresponding price increases (Cruikshank, 1949, pp. 108, 128). Cruikshank pointed out that, although the rate of return on stockholders' equity had doubled over the prior two decades, American businesses
were currently retaining approximately 70 percent of
profits. He suggested that American businesses were
extracting new capital from consumers (frequently low-income
consumers) through high prices rather than obtaining new
capital from willing investors. The profits retained by the
firms were then used, not only for replenishing plant and
equipment, but also for the more sinister purpose of
acquiring smaller corporations, thus lessening competition.

Stanley H. Ruttenberg (1949, p. 130), Director of the
Department of Education and Research, Congress of Industrial
Organizations (CIO), portrayed American industry as self-
interested, short-sighted, and indulging in depression-
producing thinking. He claimed that industry was
reinvesting soaring profits in expanding operations, thus
eliminating new competition. The labor leader further
stated that

...American industry shows little regard for the
general public, while it shows a major concern for
itself...the practice of industry to raise prices
and thus its profits will do more to bring on a
depression and reduce production than any other
single decision of industry. If, on the other
hand, industry would moderate its avaricious
appetite for profits by moderating its pricing
policies, it would go a long way toward
stabilizing our economy and thus postponing, maybe
indefinitely, the inevitable depression which they seem desirous of protecting themselves against (Ruttenberg, 1949, pp. 130-131).

Ruttenberg called for an all-out attack on what he characterized as the monopolistic, self-interested practices of American industry, advocating enactment of both an excess profits tax and an undistributed profits tax. The desired outcome of the two taxes would be to discourage price increases while encouraging the distribution of profits to shareholders. Ruttenberg (1949, p. 135) claimed he wanted an economy operated on a fair and equitable basis: an economy where the average American could afford to purchase the goods produced by American industry.

Donald Montgomery (1949), Chief of the Washington office of the United Auto Workers-Congress of Industrial Organizations (UAW-CIO) and a former member of the Securities and Exchange Commission (SEC), joined Cruikshank in asking for wage increases without price increases. He described present profits as far too high and proposed that "present profits will destroy the purchasing power base which is essential to maintenance of prosperity and full employment" (Montgomery, 1949, p. 420).
The request for wage increases without corresponding price increases was consistent with Adam Smith's conclusion in *The Wealth of Nations* that, in a progressive society, the distributive share that goes to profits should decrease and the revenue going to labor should increase (Johnson, 1990, p. 263). Smith's "trickle-up" theory has not had an impact on the accounting literature; and accountants, testifying at the hearings, rejected the idea that inequitable distribution of excessive profits would destroy the nation. Montgomery (1949) suggested that corporations, embarrassed by the public attention directed to the size of their profits, were inventing methods to minimize those profits on paper (e.g. setting up special inventory reserves and deductions for additional depreciation and obsolescence).

He stated that

(t)he staggering profit totals reported by the Department of Commerce hardly result from "overstatement" by the corporations, Professor Slichter to the contrary notwithstanding. Indeed, in the face of the varied and ingenious devices used by industry to conceal profits, there can be little doubt that the Department of Commerce seriously understates the profit total. The personnel of the Office of Business Economics would probably have to be multiplied several times over if it undertook to ferret out all profits
from their multifarious hiding places in financial reports which are designed more to mislead than to inform (Montgomery, 1949, p. 427).

Montgomery (1949, p. 427) further declared that "logical consistency is thrown to the winds" by some firms in their effort to reduce profits. The firms concurrently set up inventory reserves (assuming a decrease in prices) while computing depreciation using current replacement costs (assuming prices will remain at the current level or increase). Montgomery (1949, p. 430) suggested that (t)he replacement-cost fad is directly related to the "new look" in current profit rates. What I mean is that the legs have gotten so fat they want longer dresses to cover them up.

The UAW-CIO representative was the first witness to suggest that corporations might be depreciating some assets more than once. He stated that assets, fully depreciated during the war under certificates of necessity, had been placed back on the books at original cost less normal depreciation; the public was paying for the cost of the assets twice--once as taxpayers and again as consumers. Although Senator Flanders (1949) requested documentation on firms depreciating assets more than once, Montgomery was
unable to produce the documentation at the time the testimony presented at the hearings was published.

Montgomery pointed out that depreciation charges were never intended to provide for replacement of an asset. He characterized the case for replacement cost depreciation as a case for placing the responsibility for supplying the capital needs of industry on taxpayers and consumers. He continued that

\[(t)o\ distinguish this from the equity capital obtained from investors, we may call it inequity capital, since consumers (1) do not invest it willingly, but have it taken from them; and (2), having invested it, they retain no equity in the corporation to which they have donated it (Montgomery, 1949, p. 431).^{14}\]

Montgomery (1949) concluded by calling for an undistributed profits tax that would encourage corporations to distribute larger dividends, which he argued would lead to a more dynamic investment market.

^{14} Sanders (1952) used the concept of equity in support of the steel industry. He suggested that any relief from inflation should be "furnished equally to all sufferers from it. But the essential injustice of inflation is that it afflicts different economic groups very unequally" (p. 57). Sanders proposed that the owners of corporations had already been discriminated against through double taxation. Any relief obtained by the owners through higher allowances for depreciation would merely serve to mitigate this discrimination.
Enders M. Voorhees (1949), Chairman of the Finance Committee, United States Steel Corporation (USS), emphatically declared that USS had charged much less for its product than customers would have willingly paid and denied that profits for the corporation were record breaking when compared with prior periods. He proposed that the committee should use income as a percentage of sales to judge whether profits are excessive. Senator Joseph C. O'Mahoney (1949) suggested that USS wanted to depreciate facilities that had previously been depreciated under five-year amortization certificates during World War II, an allegation that Voorhees vigorously denied. Voorhees expressed concern that a lack of understanding of costs could trigger a hidden erosion of the tools of production.\(^{15}\) He further argued that

\[\text{(i)f a business is to continue, it is necessary to recover the purchasing power of sums originally}\]

\(^{15}\text{Jones (1949, p. 14) combined the financial statements of nine steel companies for 1941-1947 and then adjusted the combined statements for changes in the purchasing power of the dollar. The published financial statements of the steel companies indicated that } \$543,000,000 \text{ of income had been retained by the firms between 1941 and 1947, while the adjusted financial statements revealed that no earnings had been retained by the firms and that } \$409,000,000 \text{ of dividends had been paid out of capital.}\]
invested in tools of production so that the tools may be replaced as they wear out...I can understand the committee's very serious interest in proper accounting for the cost of the tools of production consumed, for the present nonrecognition of part of that cost in computing taxable income means that the Federal Government itself is participating in, and even forcing, the erosion of the Nation's tools of production (Voorhees, 1949, pp. 597-598).

In response to Voorhees' proposal that replacement of facilities should be a part of the cost of the product produced, Senator O'Mahoney (1949, p. 630) stated that

...the Soviet Government proceeds upon the same theory. It pushes private capital out of the picture and gets whatever capital it needs out of prices which it levies upon the consumers...we are confronted face to face with a problem of whether or not little business can continue to survive in an economy where a few giant corporations actually call the turn.

O'Mahoney clearly believed that corporations administered prices and that they had done so to the disadvantage of other societal interests.\(^{16}\)

This investigation highlighted the strategy that the accounting profession would take. They would openly debate

\(^{16}\)See Burnham (1952), *The Managerial Revolution*, who reached a similar conclusion, writing that the professional managers of neocapitalism resemble the professional managers of the Russian commissariats and the Nazi combines, quoted in Heilbroner, 1961, p. 261.
the limitations of the historic cost model in an inflationary era, but they would consistently maintain that the input data, exchange prices, should not be questioned. The market determined value; accountants dealt with costs.

Accountants were loathe to abandon their image as objective, neutral reporters of fact by forsaking historic cost. They empathized with management's claims that taxes were excessive and that labor did not understand that inflation resulted in reporting overstated accounting profits. Use of prices of actual market transactions as the input data not only seemed to make accounting data appear objective, it had the added benefit of reinforcing the perception that regulation by competition remained feasible. The idea that the primary responsibility of financial reporting is to furnish information to capital market participants remains the dominant idea today.\(^{17}\)

Accounting standard setters, who operated in virtual obscurity at this time, could be more responsive to

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\(^{17}\)Agency theory provided the most popular current justification for accounting to be limited solely to an economic function; see Watts and Zimmermann (1979) who argue that bargaining and competitive market forces protect societal interests.
management's demands. In 1947, corporate management forced the accounting profession to give some attention to the inflation issue by using methods such as replacement cost depreciation in their annual reports. This tactic drew a storm of protest from labor leaders and the public who charged that corporations sought to hide profits. Government officials were also unhappy; they understood that one objective of gaining acceptance for replacement cost for financial reporting was to strengthen arguments for its acceptance for tax purposes. The result would be a loss of tax revenues. Although the excess profits tax had been repealed, it continued to loom overhead; replacement cost income would still some of the criticism about excessive profits.

Labor leaders were equally outraged; the Taft-Hartley Act had made labor negotiations more difficult, and the concept of collective bargaining came under repeated attack. The SEC reflected the strong partisan interests involved in this issue and made it clear that it would be politically unacceptable to depart from historic cost at this time; a conclusion which most accountants welcomed. But, it would be erroneous to assume that because accounting standard
setters did not abandon historic cost, they remained neutral in the inflation debate. They simply used less visible means of responding to management's concerns.

Reserve accounting and surplus adjustments provided management with greater flexibility than replacement cost would have in managing reported earnings. Use of these two techniques had two major benefits. Accountants could continue to depict themselves as neutral and objective reporters of fact, and it reaffirmed the belief that competitive market forces made it possible for accounting profit to be used to channel resources to their most productive use.

The Accounting Standard Setting Debate

Immediately after World War II, the Committee on Accounting Procedure (CAP) began to address criticism of financial reporting, and especially accounting profit measurement. While standard setters indicated a great deal of empathy for management and rejected charges that corporations were profiteers, they did not wish to tamper with a proven product—the historic cost allocation model.
Although numerous accounting articles, published during this period, questioned the relevance of historic cost during periods of inflation, the correspondence files of CAP indicate that there was little likelihood that the SEC would support abandonment of historic cost. In the immediate postwar years, the SEC's primary concern appeared to be retaining investor confidence in the new economic system. To do so, the agency felt that it had to limit management's ability to manipulate earnings by charging items to surplus (Werntz, 1945).

The debate during this period focused on the all inclusive concept of income vs. the current operating concept of income. William Werntz (1945), SEC Chief Accountant, left no doubt that he felt that users were being misled by the lack of adequate criteria for determination of income. He alleged that management had a "free hand" in manipulating income and that accountants showed little desire to curb abuses.

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Advocates of the all inclusive concept of income wanted all accounting events to be reported in income, while advocates of the current operating concept argued that only those events related to "normal operations" should be reflected in income.
Citing an SEC study of 165 representative companies, Werntz (1945, pp. 36-37) reached the following conclusions:

(1) There are no existing criteria as to when an item should be excluded from income...but that the effective considerations do not seem to have been accounting principles.

(2) Accountants have accepted the situation and have been willing to certify statements.

(3) By a choice as to between income and surplus, it is possible to report earnings within very wide limits.

He was especially incensed at the AIA Subcommittee's statement that the SEC study does not indicate that "the investing public is being misled" (AIA, 1945, p. 205). He argued that, while the study could not prove anyone was misled, it did show that the lack of any unifying principle made financial reports susceptible to misuse or misunderstanding (Werntz, 1945, p. 37).

The focus of the all inclusive/current operating debate was on where to report various items of income; it did not open up the question of how to measure income. The standard setters simply never questioned that markets remained competitive and that market data, based on arms-length transactions, remained relevant to assess corporate performance. Although the standard setters probably would
have preferred to avoid the measurement scale issue, in 1947 several major corporations forced CAP's hand by using replacement cost depreciation in their annual reports.

The profession's reluctance to depart from the nominal dollar, historic cost measurement model can be attributed primarily to two factors. First, labor leaders would be incensed if corporations, whom they contended already enjoyed excess profits through administering prices, were allowed to depress income further to reflect the decreased purchasing power of the dollar. Second, politicians would not view favorably a method that would reduce tax inflows from the corporate sector. Corporate managers' motivation for advocating replacement cost for financial reporting was clear; they hoped that, once replacement cost was accepted for financial reporting, tax authorities also would view it as a legitimate method to calculate taxable income. If accounting standard setters had recommended a highly visible

While outside the scope of this study, it became clear, after 1954 when accelerated depreciation (based on cost) was accepted for tax purposes, that tax and not "correct" income measurement had been the primary motivating factor for many managers. As wage and price controls were lifted, companies like USS, who had been ardent proponents of depreciation based on replacement cost, switched to straight-line depreciation for financial reporting.
method of reducing corporate profits, through the use of either replacement cost or general price level adjustments, they may have run afoul of both labor and political reformers.

Carmen Blough (1947), AIA research director and former Chief SEC accountant, recognized that the debate was over distribution of income. Clearly sympathetic to business, he outlined the reasons he felt that business people had for advocating a method that would reduce corporate profits, writing that

(stockholders are hard to convince that increased profits should not be distributed as dividends, labor increases its claims for compensation, political demagogues harangue on the excessiveness of corporate income, and enemies of our political order use it to stir up prejudices against private enterprises (Blough, 1947, p. 3).

But, he also suggested that business management take a realistic look at the current environment. He noted that, when accountants had failed to meet investors' needs in the 1920s, "the pendulum had swung sharply and we got the SEC."

He warned that, if accountants and businessmen did not appear responsive to labor's interests and did not provide information voluntarily, it might not be long before "some major event again precipitates legislation far more drastic
than necessary" (Blough 1947, p. 5). His message was clear --labor would not stand for any "overt" effort to depress reported corporate earnings.

Although the SEC's primary focal point was investors, it also reflected Congressional concerns about labor's position. The SEC did not mince words; the commission would not look favorably upon any attempt to abandon historic cost. The SEC's rejection of USS's 1947 replacement cost financial reports, discussed in the next chapter, effectively silenced replacement cost advocates within CAP. It was not politically feasible for CAP to abandon historic cost despite general agreement among CAP members that inflation might make reported profit misleading to investors (See, for example, Paton, 1948, and Spacek, 1950).

That is not to say the profession would have abandoned historic cost if there had been no political pressure. That remains problematic. The profession wanted to retain its image as independent; historic cost data was perceived as objective because it reflected actual market transactions. Replacement cost placed the profession in the realm of speculation, recording hypothetical events (Stans, 1947).
While CAP members recognized that cost allocation required many subjective judgments, that fact was not well understood by non-accountants. Proponents of traditional profit measurement argued that accountants could best serve their role if they remained "historical," reporters of past fact. Maintenance of the appearance of objectivity seemed especially important to accountants who worked for smaller firms. V. O. Tilly, a partner in W. O. Ligon of Oklahoma City and a member of CAP, reflected the view of many accountants in a letter to Carmen Blough, writing "we as professional accountants should stand firm against any philosophy that seeks to commingle accountability for the past with expectations of the future, and thereby destroy the integrity of our statements, which are literally historical reports" (Tilly, 1947, p. 6).  

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20Tilly was one of the few accountants on CAP who rejected even accelerated depreciation based on cost. His concern was that, if adopted for financial reporting, it might be accepted for tax purposes, which he, unlike most accountants, felt would be objectionable. His argument was that, if the government allowed a tax deduction for accelerated depreciation, then it became a partner in corporate business by financing part of future undertakings for present owners (Tilly, 1947, p. 2).
This position had two benefits. First, accountants need not become embroiled in the administered price debate; they simply reported market transactions, whether prices were "fair" or administered was not the profession's concern. Secondly, accountants could disclaim any responsibility for reporting economic income. Samuel Broad, an influential member of CAP, spoke for most practitioners when he said

(e)conomic income arises from the creation of wealth. In contrast, accounting income emphasizes realization; it is founded on cost, not because cost is a truer measure but because income cannot be spent till it is realized and because recognition of wealth created through real appreciation would create problems so great as to make objective measurement impossible (Broad, 1948a, p. 2).

While this position seems inconsistent with CAP's ongoing message that accounting income provided a measure of managerial efficiency, this lack of concern is not surprising if one examines the techniques adopted by CAP during this period. Reserve accounting and surplus adjustments became the primary mechanisms for management of income.
"Dirty" Surplus or Managed Income

Due to the uncertainty about the usefulness of productive assets after the war, management had been given great latitude in providing reserves to handle the transition to a peacetime economy. Maurice Stans, a member of CAP, was one of the most vocal critics of reserve accounting. He noted that "we are now confronted with reserves for excess replacement value over cost, reserves for excessive construction costs, reserves for future inventory declines, reserves for future payments to employees, reserves for future expenses in revisions of manufacturing programs, reserves for rehabilitation of foreign business, and many others" (Stans, 1947, p. 1). What, he asked, do these reserves have in common? His answer was that "they all aim to absorb currently in costs some part of a charge which belongs in the future. There can never be truth in corporate reports, or public trust in them, if such prestidigitation is permitted" (Stans, 1947, p. 1). Stans position was unusual, most of the members of CAP had no objection to reserve accounting; prudence dictated management establish reserves.
While large corporations could use reserve accounting to reduce reported income, avoiding the excess profits tax and strengthening their bargaining position with labor, smaller corporations had less desire to depress reported earnings. CAP responded to their concerns by allowing direct write-offs to surplus, which allowed maximization of income and had the added benefit of enabling some companies to avoid the undistributed profits tax. Current operating performance advocates argued that any non-recurring item should be charged off to surplus, rather than to income so that income would provide a better indicator of future earning power. Despite the SEC's support of the "all inclusive" concept of income, current operating performance advocates appeared to have won the battle at CAP. A series of Accounting Research Bulletins (ARBs) appeared that allowed corporations to write off directly to surplus (1) material charges or credits of prior years, (2) material gains or losses for sale of assets not acquired for resale (fixed assets), (3) material gains or losses for natural disasters, (4) material amounts of intangibles or deferred charges (elimination of goodwill; write off of debt discount upon retirement or refunding), and (5) all other material
gains or losses not attributable to current operations.

Bailey, Chair of CAP, believed that ARB No. 32 settled the issue once and for all. He believed CAP had rejected the all inclusive concept of income, and the committee began to examine other issues such as Depreciation on High Costs (December 1947). The committee faced conflicting expectations with respect to inflation. Some people argued that current costs of construction were excessive (assuming lower prices in the future) and that they should be directly written off. Others argued for replacement cost reserves (assuming higher prices in future years) to provide for replacement of assets.

The committee, under pressure from the SEC, rejected both proposals, suggesting that companies signal the inadequacy of historic cost depreciation by "appropriations for replacement cost." ARB No. 33, Depreciation and High Costs (1947, p. 268), concluded that "accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level." In short, the issue would be settled when there was no inflation problem.
CAP initially did not expect reserves and appropriations to be charged or credited to income. The ARBs recommended that such charges be made to earned surplus, but they clearly stated this as a recommendation and did not say companies must do so. This opened the door. Many companies, rebuffed in efforts to use replacement cost depreciation or to adjust for price level changes, simply started writing off both "reserves" and "appropriations" to income. Managers had maximum flexibility in "determining income;" and, despite the SEC's protests under its new chief accountant, Earle King, accounting techniques proved to be an effective means of reducing reported income.

Blough (1950) posited that the objectives that business had for replacement cost were achieved in a manner that did not attract a great deal of attention. By 1950, when the SEC sought to issue a new SX, the accounting profession seemed firmly in control of the standard setting process, even challenging the SEC's right to set accounting principles, addressing the major concern of management with techniques to manage income while retaining their claims to
being "objective" and "impartial" reporters of fact. The reason that the reports of the Study Group on Business Income (SGBI) had little impact on the profession may be that accounting techniques proved to be a more effective way to forestall criticisms. Accountants avoided conflict with management by allowing management maximum flexibility in determining income and avoided conflict with labor and government by not giving in to management's demands for replacement cost.

Summary

Economic conditions in the post-World War II period raised significant challenges for the accounting profession. New Deal reforms, combined with the close cooperation between business and government to meet the defense demands of both hot and cold wars, blurred the distinctions between the private and the public sector. The emerging

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21 See correspondence file between Broad and King (1948) for discussion of the SEC's anger at the use of reserves in income and between CAP and King (1950) for the profession's reaction to the new SX and the SEC's response.
administrative logic of a mixed economy challenged the rationale of efficiency, the basis of the financial calculus of accounting.

In addition, the growing role that the federal government played in providing capital to and subsidizing industry, brought into question the appropriateness of depicting the nation's largest business organizations as "private." Labor demanded recognition as a "factor" of production, a partner that had a "right" to share in the profits of corporate America. Acceptance of labor as a participant in the productive process would have required rejection of the central tenet of private property rights, namely that profits accrue to ownership.

Accountants ignored any implication of administered prices. The accounting literature continued to reflect the belief that market competition worked and that accounting profits reflected management success in producing goods and services at the lowest cost (i.e. technical efficiency). The investor could use the data to allocate capital to its most productive and socially beneficial use. Profits accrued to owners, and labor remained a cost to be controlled. The basic premises of Keynesian economics
simply did not impact the accounting income determination or standard setting debate.

While retaining a neutral position by adherence to historic cost income determination, accounting standard setters used less visible techniques to respond to management's concerns. There is little question that, by the end of the period, corporate management had all the tools it needed to manage income. Standard setting would become the primary means by which accountants responded to management's demands and is the arena in which the affinity of the profession to business interests came through most clearly. Standard setters labored in relative obscurity during this period, but it marked the beginning of the politicalization of the standard setting process.
CHAPTER III

THE ACCOUNTING DILEMMA

Measurement of Business Income: The Technical Debate

This chapter focuses on the technical debate over the measurement of business income. One objective is to show why corporate management demanded abandonment of historic cost for the calculation of business income; a case study of United States Steel Corporation (USS) and Chrysler Corporation highlights the issues of this debate. A second objective is to examine the actual theoretical questions raised by the Study Group on Business Income (SGBI) and to gain an understanding of why accountants ignored the theoretical debate. Throughout the debate, accountants continued to support the idea that they should measure income to owners and never challenged the private property rights paradigm. While they would probably have preferred not to have engaged in the highly visible debate over the meaning of accounting income, the corporate sector forced their hand.
Corporate America was concerned about inflation in the immediate post-World War II years. Almost $140 billion that had accumulated in savings during the war helped to ease the passage to a peacetime economy while fueling inflation. The consumer price index jumped from 2.2 in 1945 to 18.1 in 1946, and corporate profits were of unprecedented size. Organized labor and consumers proposed that business should pass on some of their "excess" profits to labor and consumers through higher wages, lower prices, or a combination of both. Although corporate management argued that profits were not excessive in light of the costs required to replace facilities and maintain productive capacity at current high price levels, they also sought acceptance of accounting measurement techniques that would reduce reported income.

One method of decreasing profit (without a corresponding decrease in cash flow) is to increase the
depreciation expense for the current period. Both USS and Chrysler Corporation adopted new depreciation policies during 1947 that increased depreciation expense for the year. Since the steel and automobile industries were targeted for Congressional investigation for administering prices, the two companies sought to decrease recorded profits.

The Federal Government and the Steel Industry: 1945-1952

There was considerable tension between the steel industry and the federal government following World War II. Between 1945 and 1952, the White House, as well as many public agencies and Congressional committees, became

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22As accountants attempted to devise a measure of managerial performance (i.e. accounting income), some means of allocating the cost of fixed assets became imperative. The concept of depreciation was introduced first in railroad accounting in the 1890s (Previts and Merino, 1979), and then the Revenue Act of 1913 made it acceptable for all businesses (Witte, 1985).
embroiled in the steel/government controversy. During this period, there was a continuing cycle of strikes or threatened strikes for higher wages and/or increased benefits, followed by price hikes and Congressional hearings (Tiffany, 1988).

The first post-World War II steel strike occurred in January 1946. The steel industry had requested a price hike from the Office of Price Administration (OPA) in late 1945. This price increase was ultimately rejected by the OPA; and Benjamin Fairless, president of USS, stated that the firm would be unable to grant wage increases without compensating price increases. The stabilization policies advocated by the Truman administration required a separation of wage and price issues, thus Tiffany (1988) suggests that the refusal of USS to consider wage increases without compensating price increases.

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23 This included the Council of Economic Advisors, the Federal Trade Commission, the House Subcommittee to Investigate Questionable Trade Practices of the Committee on Public Works, the House Subcommittee on Study of Monopoly Power of the Committee on the Judiciary, the Joint Committee of the Economic Report, the Joint Committee on Labor-Management Relations, the Steel Subcommittee of the Special Committee to Study Problems of Small Business, the Office of Price Administration, the Wage Stabilization Board, the Steel Industry Board, the Department of Defense, and the United States Supreme Court.
increases could be construed as a blatant disregard for administration policies. Truman appeared indecisive in his handling of the steel/labor dispute (his first significant domestic test as president). The strike ended in February 1946 after the president allowed the OPA to approve an increase in steel prices and industry and labor reached agreement on a wage increase. Price controls ended in November 1946.

In March and April 1947, Truman urged large corporations (particularly those in the steel industry) to cut prices to stem inflation. However, USS, acting in concert with other integrated steel producers, raised its prices on finished steel in August 1947. In that same month, the Federal Trade Commission (FTC) filed suit against the American Iron and Steel Institute and 101 individual
steel firms to force them to abandon the basing-point system of steel distribution.\textsuperscript{24}

USS pricing policies in 1948 were inconsistent. While the firm announced an increase in semi-finished steel prices in February, it reduced prices on finished steel in May. Tiffany (1988) suggests that USS had attempted (unsuccessfully) to eliminate competition from smaller unintegrated firms. An FTC study concluded that

(i)t is apparent that by raising prices of semifinished steel in February [1948] and by cutting the prices on the products made therefrom in May [1948], U. S. Steel Corporation applied a double squeeze on the smaller semi-integrated and nonintegrated mills. The leadership of U. S. Steel was followed by the other large integrated companies in both instances, though apparently somewhat more reluctantly on the second occasion.

\textsuperscript{24}Under the basing-point system, precalculated freight charges were assigned to steel deliveries; thus equalizing freight charges. In April 1948, the Supreme Court upheld FTC rejection of the basing-point system used in the cement industry; and USS subsequently announced that it would no longer use the traditional basing-point system. Representatives of industries, forced to abandon the basing-point system due to the Supreme Court decision, joined together and gained Congressional approval for a modified basing-point system. Truman was incensed and suggested that the Republican Congress had been reduced to following the "marching orders" of USS. Truman vetoed the bill, and the steel makers adopted a universal FOB method of delivery which increased the importance of mill location for competition (Tiffany, 1988, p. 58).
These companies were themselves caught in the squeeze when the prices of finished steel products were cut (Federal Trade Commission, 1952, pp. 553-54).

In his January 1948 Economic Report to Congress, President Truman directed national attention to the size of business profits. A Subcommittee on Corporate Profits of the Joint Committee on the Economic Report held hearings in December 1948 to examine the size, source, and distribution of those profits. The Subcommittee heard testimony from economists; an academician; a professional accountant and standard setter; labor leaders; and representatives of industry, including the President, the Chairman of the Finance Committee, and the General Solicitor for USS.

Many small firms in the United States had difficulty obtaining adequate supplies of steel in the immediate postwar years. Following his unexpected election in 1948, President Truman (1949, p. 75) told Congress that business should "plan for steady, vigorous expansion, seeking always

\[25\]A Steel Subcommittee of the Special Committee to Study Problems of American Small Business heard testimony from representatives of businesses that "were either being priced out of a market or were having to get out of a market altogether because of their inability to secure steel at a price they could afford to pay" (U.S. Senate, 1947, p. 1315).
to increase its output, lower its prices and avoid the vices of monopoly and restriction." He further proposed that Congress should authorize a study of the adequacy of production facilities for materials deemed to be in short supply (e.g. steel). If existing facilities were inadequate to meet current needs, the president encouraged Congress to authorize Government loans for expansion of production facilities and, if necessary, to provide for the actual construction of needed facilities.

The support of labor had been critical for Truman's 1948 election; thus it was not surprising that the president consistently supported the United Steelworkers of America (USWA) in labor-management conflicts after 1948. Tiffany (1988, p. 83) reports that "the industry experienced rising labor costs...while attempts to generate necessary capacity-expansion funds through higher prices almost invariably met with stiff governmental resistance." When the USWA wanted to reopen contract talks with the steel producers in May 1949, Truman appointed the Steel Industry Board to investigate union demands for higher wages and company-funded pensions in order to make policy recommendations. Although the Board rejected the USWA's demand for a wage
increase, it did recommend company-funded pensions. The steel makers rejected the Board's recommendations, and a month-long strike began on September 30. A new contract with provisions similar to the recommendations of the Steel Industry Board was subsequently negotiated, and the mills were operating again by mid-November.

In November 1949, USS announced a price hike to offset higher operating costs, followed by the inevitable investigation of the price increase by the Joint Economic Committee. The Committee released its report in March 1950, with the majority (eight Democrats) concluding that "increased steel prices for United States consumption were possible only because competitive conditions in the steel industry were lacking" (U.S. Cong., 1950, p. 457). The six Republicans on the Committee dissented in a minority report.

A Special Subcommittee on the Study of Monopoly Power, chaired by Emanuel Celler of New York, began to study monopolistic practices in the steel industry in April 1949. In his opening remarks, Celler (1949, p. 1) noted that the subcommittee was

...concerned with monopoly power. The problem of monopoly power is one of the great issues facing this country...The purpose of our hearing will be
to determine whether specific changes in our laws against monopoly are required so that free and competitive enterprise may be maintained. Representatives of USS testified before the subcommittee for three days. Although the steel industry appeared to be victorious (i.e. no Justice Department dissolution suit was filed), Tiffany (1988) suggests that the outcome may have been for reasons other than the testimony presented by industry spokesmen. The Korean War broke out during the period when the Subcommittee was finalizing its recommendations, and the threat to national security that could result from a slowdown in steel production may have taken precedence over any perceived threat to competition.

The Revenue Act of 1950 and the Defense Production Act of 1950 provided for accelerated depreciation (through certificates of necessity) for new investment in plant and equipment required for the war effort and for low-cost funding for those facilities. Under the certificates of necessity, the steel makers could write-off capital investments over five years, rather than twenty years, for tax purposes. The steel makers, who had previously argued that depreciation based on historic cost was inadequate to fund expansion of capacity, were pleased.
In December 1950, Truman imposed wage and price controls on materials and products deemed critical to the military. Shortly before implementation of those controls, steel makers increased prices for finished steel and gave labor a pay hike. The war intensified in 1951, and the need for steel remained strong. When the USWA made new wage demands, the steel makers refused to bargain unless they received guarantees for price increases. The Wage Stabilization Board (WSB) responded by recommending both a wage increase and a compensating price hike. Although the union accepted the recommendations, the steel makers refused. They felt the price increases recommended by the WSB were inadequate.

The Department of Defense kept pressure on Truman to take whatever measures were necessary to ensure continued production of steel for the war (McCoy, 1984); and, on April 28, 1952, Truman seized control of the steel industry. Benjamin Fairless (President of USS) and Philip Murray (USWA) immediately entered into negotiations. Just when it appeared that agreement between labor and industry was imminent, the Supreme Court issued a preliminary ruling on the steel seizure favoring industry; negotiations ceased.
The Court issued a final ruling in favor of the steel makers on June 2, and the union went on strike for fifty-three days. A new contract was eventually negotiated, granting labor wage increases and a modified union shop clause and giving industry compensating price increases. Truman was the real loser in the 1952 steel seizure; it was a defeat from which he never recovered.  

United States Steel Corporation

Remarkably, USS described its management/labor relations as a "truly cooperative relationship" in its 1947 Annual Report. The firm provided labor with a general wage increase of 12-1/2 cents per hour and employees with at least 25 years of service with three weeks paid vacation (USS, Annual Report 1948, pp. 15 and 17).

The tone of the 1948 Annual Report was somewhat different. USS reported that, in April 1948, the USWA exercised the right to bargain for a change in pay rates: the union requested a sizable wage increase, as well as an

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McCoy (1988, p. 293) states that "seldom had the Supreme Court so soundly rebuffed a president. Truman had sought not only to resolve the steel crisis but also substantially to expand the president's powers in a single action...He had gambled badly, and he had lost badly."
employer-financed plan of life, accident, health, medical and hospitalization insurance benefits. USS did not accede to the union demands, choosing instead to lower prices on a wide array of products in a professed attempt toward economic stabilization. This attempt failed to produce the desired results, and USS subsequently agreed to increase employee wages approximately 9%. The wage increase became effective in July, but no agreement was reached on insurance (USS, Annual Report, 1949, pp. 13, 15).

Depreciation taken by USS from 1902-1940 was based on systematic allocation of historic cost on a straight-line basis. The company shifted its policy in 1940 for facilities deemed necessary for the war effort. The Second Revenue Act of 1940 provided for a sixty-month amortization period for the emergency facilities for taxes, and Accounting Research Bulletin (ARB) No. 13 made special provisions for financial reporting for the amortization of the cost of additional facilities that would lose much of their economic usefulness at the conclusion of the war.

Following the war, USS took an unprecedented step in determining its depreciation expense for 1947, challenging the historic cost allocation model held sacrosanct by the
accounting profession. It based its 1947 depreciation expense on the replacement cost of fixed assets. USS (Annual Report 1948, p. 33) justified this approach by asserting that

\[
\text{(t)he added amount \[\$26.3 \text{ million}\]...is a step toward stating wear and exhaustion in an amount which will recover in current dollars of diminished buying power the same purchasing power as the original expenditure. Because it is necessary to recover the purchasing power of sums originally invested in tools so that they may be replaced as they wear out, this added amount is carried as a reserve for replacement of properties.}
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Price, Waterhouse & Company, auditor for USS, issued a qualified opinion, stating that depreciation based on replacement cost was not in accordance with generally accepted accounting principles (USS, Annual Report, 1948). However, George O. May, senior partner of Price, Waterhouse & Company from 1911-1926 and 1934-1940, let it be known privately that he approved of the USS replacement cost depreciation policy. An article in Fortune (December 1947) reported that May was even more heretical than USS and that he had never been committed to the concept of historic cost for either the income statement or the balance sheet.
The SEC took exception to the use of replacement cost depreciation by USS, concluding that depreciation should continue to be based on historic cost. In 1948, USS responded by adopting accelerated depreciation, making the method retroactive to 1947. The "Review of the Year by the Chairman" in the 1948 Annual Report included the following:

U. S. Steel believes that the principle which it adopted in 1947 and continued in 1948 is a proper recording of the wear and exhaustion of its facilities in terms of current dollars as distinguished from the dollars which it originally expended for those facilities. However, in view of the disagreement existing among accountants, both public and private, and the stated position of the American Institute of Accountants, which is supported by the Securities and Exchange Commission, that the only accepted accounting principle for determining depreciation is that which is related to the actual number of dollars spent for facilities, regardless of when or of what buying power, U. S. Steel has adopted a method of accelerated depreciation on cost instead of one based on purchasing power recovery (USS, 1949, p. 5).


**Chrysler Corporation**

The automobile industry was also targeted for Congressional investigation for administering prices. Thus
the automobile industry, like the steel industry, had an
incentive to adopt accounting methods that would decrease
reported profits and lessen its visibility. Chrysler
Corporation chose to adopt a method of accelerated
depreciation based on historic cost in 1947, justifying its
decision as a response to "disturbed price levels." In a
letter to the stockholders, K. T. Keller, President of
Chrysler Corporation stated that

...the inflationary cycle in which it appears our
economy is currently involved presents all
industry with a long-term financial problem which
it is difficult to appraise at this time, and even
more difficult to reflect properly in short-term
accounting (Chrysler Corporation, Annual Report,
1948, p. 4).

Touche, Niven, Bailey & Smart, auditor for Chrysler,
acknowledged that the firm had changed its depreciation
policies, but did not take exception to the change. The SEC
also did not question Chrysler's use of accelerated
depreciation based on historic cost in 1947, and the
automaker continued to use accelerated depreciation in 1948.

Although both USS and Chrysler Corporation expressed
concern about the adequacy of depreciation reserves based on
historic cost to cover replacement of facilities at postwar
prices, their responses to the problem elicited dramatically
different reactions from their auditors and the SEC. USS directly challenged the venerable historic cost allocation model, while Chrysler found a way to increase depreciation expense and lower profits within the confines of the traditional accounting model.

Union Reaction

Labor's response to the depreciation methods adopted by USS and Chrysler Corporation was swift and disparaging. Both Stanley H. Ruttenberg, Director of the Department of Education and Research for the Congress of Industrial Organizations (CIO), and Otis Brubaker, Director of Research of the USWA, suggested that industry was trying to conceal profits and distort net income with the use of replacement cost depreciation. Brubaker also opposed the use of accelerated depreciation for financial statements and taxes, stating that accelerated depreciation could be used to conceal profits in the same manner as depreciation based on replacement cost. He argued that the steel industry had achieved the same effect through the use of accelerated depreciation as they would have achieved through the use of price level depreciation.
The American Federation of Labor (AFL) also resisted accelerated depreciation for taxes that would result in tax reductions for business. But Congress appeared impervious to union opposition; and the 1954 Internal Revenue Code allowed the double-declining balance method to be used to calculate depreciation expense for taxes. Shortly after acceptance of the double-declining balance method for taxes, CAP recognized it, as well as the sum-of-the-years-digits method, as generally accepted methods for calculating depreciation for financial statements (Vangermeersch, 1984).

Solomon Barkin (1951), Director of Research for the Textile Workers Union of America (TWUA), CIO, criticized accountants for auditing statements prepared using principles and practices developed to serve only the needs of management, equity owners, creditors, and government. He charged that changes in accounting procedures for inventory and depreciation continued to focus on the needs of a limited number of property interests. Barkin chastised accountants for ignoring the economic, social, and political desirability of the new accounting procedures and the impact of the new procedures on other economic interest groups.
Accountants responded to labor's criticisms of the profession by suggesting that, as independent professionals, they were in a unique position to provide objective data that could be used to resolve industrial conflict. They also initiated an educational campaign to explain, to labor, why reported profits were not excessive, never wavering from their commitment to business and the private property rights paradigm. Accountants tackled the theoretical issues of the replacement cost/historic cost debate in the Study Group on Business Income (SGBI), established through a joint effort of the American Institute of Accountants (AIA) and the Rockefeller Foundation in 1947 to develop a functional concept of business income.

The Study Group on Business Income

The SGBI brought together the expertise of a diverse group of individuals (accountants, economists, attorneys, government officials, and business leaders), including Percival F. Brundage who served as Chairman of the SGBI and George O. May who served as Research Consultant. Members of the SGBI introduced two additional concepts/principles/assumptions into the debate on profit measurement:
conservatism and objectivity. Conservatism, a tradition in accounting, is generally construed to mean that, when alternative solutions to an accounting problem can be reasonably supported, the accountant should choose the alternative that is least likely to overstate net income and net assets of the current period. Objectivity is usually defined as unbiased and based on fact. In their classic monograph, Paton and Littleton (1940, p. 19) described objective as "the expression of facts without distortion from personal bias." Although there was concern in the United States about administered prices following World War II, the input data of accounting, original (historic) cost, never came under attack in the monographs or proceedings of the SGBI.

A Legal Concept of Income

Arthur H. Dean (1950, rpt. 1980) examined legal concepts of income determination in a monograph prepared for the SGBI. Although the Supreme Court of the United States had indicated that depreciation was a factor to be considered in the calculation of income by 1909, no court had addressed the problem of depreciation in periods of
devaluation of the dollar. Dean (1950, rpt. 1980, p. 89) suggested that "constructive legislation--particularly in the field of taxation--could greatly assist in solving some of the problems presented by changes in the value of the dollar." He contended that the taxing authorities had provided some relief from the ravages of inflation in the area of inventory by adopting an economic concept of income for that limited purpose, but the concept had not been extended to fixed assets. Dean declared that, at current tax rates, it would take approximately $1.61 in pretax income to have $1.00 available to cover excess replacement cost. He cautioned that the high standard of living enjoyed by the American people was dependent upon productivity and that productivity was dependent upon maintaining both productive capacity and working capital; the productive powers of labor alone (without economic capital) would be insufficient to maintain the current standard of living (Dean, 1950, rpt. 1980, p. 87).

An Economist's Concept of Income Measurement

Sidney S. Alexander (1950, p. 11), an economist, examined various concepts of income measurement in a
monograph prepared for the SGBI, defining annual income as "...the amount of wealth that a person, real or corporate, can dispose of over the course of the year and remain as well off at the end of the year as at the beginning." This definition of income was adopted from J. R. Hicks (1946, p. 172), who stated

(t)he purpose of income calculations in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves. Following out this idea, it would seem that we ought to define a man's income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning.

It is interesting to note that Hicks never intended for his definition of income to be used by accountants. Thirty years after the final report of the SGBI was published, Richard P. Brief (1982, p. 98) examined Hicks' views on accounting and concluded that

Hicks' emphasis on the need for objectivity and his conception of the meaning of stewardship led him to defend the traditional practice of valuing assets at original cost less depreciation and to argue that accountants should not make price-level adjustments. These views will surprise those (and there were many) who have used the Hicksian income concept to develop a conceptual framework in accounting.
In a letter to Brief in the early 1980s, Hicks concurred with Brief's assessment, lamenting that "I had no idea when I wrote that chapter in Value and Capital that it would be taken up by accountants" (Brief, 1982, p. 98).

Alexander (1950, pp. 1-2) addressed the problem of determining what was meant by the term "as well off at the end of the year as at the beginning" and concluded that

...when values are changing both because of changes in prices and changes of expectations of earning power, there is no unique well-defined ideal concept of income against which can be compared the actual practice of income measurement...Because different interpretations are possible, and because any concept of income is justified only by the use to which it is put, the only criterion by which a choice may be made among various methods of measuring income is the relative effectiveness of the different methods in serving the purposes for which income is to be used.

He suggested that, when choosing a concept of income measurement, accountants had introduced the requirements of objectivity and conservatism in an attempt to avoid responsibility for the human judgments required to go from an examination of the accounts to the administration of business affairs. Thus, the businessman had to adjust the accountant's measure of income to conform with reality.
Alexander fielded questions from members of the SGBI at a meeting held in May 1950. He again suggested that no single concept of income exists and concluded that economists and accountants are seldom talking about the same thing when they discuss income. He further proposed

...that this concept of income, the amount that can be disposed of, leaving the person real or artificial, as well off at the end of the period as he is at the beginning, is a useful concept of income; that the result of the traditional manipulation of recorded costs and revenues by the accountant will be an approximation to this concept which I have taken only under special circumstances, which are the circumstances of a static state or stability; and that the divergence may help as a guide (Alexander, 1950, p. 214).

George O. May was impervious to Alexander's rhetoric. May emphatically reminded the Study Group that its objective was to arrive at a concept of income that could be implemented by accountants, warning Alexander that an economic concept of income was of no practical use to the Study Group. He concluded that the value of the economist's "excursion" was to conclusively prove that a different path must be followed to find a definition of income that could be used by accountants. May (1949f) developed his own concept of income in a monograph prepared at the request of the Executive Committee of the SGBI.
May's objectives in his monograph were to study existing accounting concepts, postulates, and conventions as they pertained to reports of business income and to determine how income statements could be made more valuable. He defined income as

...the income that flows to the entities which carry on, provide the capital for, and assume the risks of business enterprise. It is income for a short period of time, such as a year, that is normally significant...Business income is broadly an excess of revenue over costs and expenses (May, 1949f, pp. 2 and 5).

His study stressed the importance of two postulates of accounting in the determination of income: (1) the firm will continue in existence and will not be liquidated (the going-concern concept) and (2) the income statement for the current period is part of a continuous and integrated series. While May acknowledged the American Institute of Accountants' (AIA's) preference for the use of historic cost for accounting determinations, he suggested that accounting information would be more meaningful (useful) if revenues and charges against revenues were stated in units of the same purchasing power and if all costs were treated as homogeneous.
May (1949f) outlined a proposal that would require railroads and public utilities to supplement charges for depreciation based on cost with charges adjusted for the decline in the purchasing power of the dollar. The total charge would then be divided into two parts; the part based on historic cost would be credited to "Depreciation Reserve," and the adjustment for the change in the purchasing power of the dollar would be credited to "Special Capital Reserve for Increase in Replacement Costs." Both reserve accounts would be deducted to arrive at net capital assets for rate-making purposes. If at any time the price level fell below cost, operating cost would be credited and the special reserve account would be debited. Depreciation based on cost would be continued if the special reserve account was ever reduced to zero.

May (1949f) recommended that industrial companies should adopt similar procedures for depreciation whenever depreciation represents a material amount in determining
their income. Initially, the adjustment could be made optional for industrial companies. However, if the method is used for tax purposes, it should be required for financial statements.

Although the SGBI (1952, p. 105) conceded that statements of income in which revenues and expenses are "stated in units of substantially the same purchasing power would be significant and useful for many of the purposes for which income determinations are used," they concluded by supporting the continued use of historic cost for financial reporting. May's influence, however, is evident in their additional recommendation that corporations with widely distributed ownership should be encouraged to provide supplemental information that would facilitate determination of income measured in units of approximately equal purchasing power.

27May (1949, p. 67) reported that the ratio of depreciation (on cost) to income available for interest and dividends for electric utilities was approximately 42.5 per cent in 1947 and that "in the case of United States Steel Corporation it was on comparable basis about 48 per cent."
Final Report of the Study Group on Business Income

In their final report, the SGBI (1952) acknowledged the increasing importance of income determination in the social and economic life of the United States, noting that the increase in size and complexity of business enterprises during the previous half century had made income determination more difficult. The SGBI identified three postulates of accounting traditionally considered the most important components of a framework of assumptions for income accounting: the postulate of permanence, the monetary postulate, and the realization postulate. The members had no reservations with the postulate of permanence (i.e. that the firm will continue in existence in perpetuity). However, they did express reservations with the realization postulate in respect to extraordinary transactions and with the monetary postulate. The members were particularly cognizant of "the defects of the medium of exchange as the standard of value for long-term indebtedness or accounting" (SGBI, 1952, p. 53).

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28 Under the realization postulate, no unrealized appreciation is included in income or profit. The monetary postulate ignores fluctuations in the value of the monetary unit.
The SGBI (1952, p. 82) recognized that there are "obstacles that stand in the way of acceptance of the idea of taking cognizance of changes in the purchasing power of the dollar in measuring charges for exhaustion of property" (Study Group on Business Income, 1953, p. 82) and acknowledged that there was pressure to ignore the varying effects on different interest groups. They suggested that financial entities, industries supported by current expenditures for intangibles, and light industries using the last-in-first-out (lifo) method for valuing inventory had minimal problems with the exhaustion of physical capital during periods of inflation. They also contended that labor is able to adjust for changes in the price level of commodities by quickly demanding and obtaining wage increases consistent with inflation. The Group concluded

\[29\] For example, Wilcox and Greer (1950) proposed that depreciation calculations would become meaningless if price-index adjustments were added to the already numerous variations allowed in the computation of depreciation. Price-index adjustments would destroy all meaningful comparisons between companies and between years. Wilcox and Greer cautioned "It is difficult to imagine a more disastrous step, or one more calculated to bring financial reporting into general disrepute, and to pave the way for governmentally imposed rules of accounting for all industry" (p. 503).
that it is the heavy industries, those employing large amounts of consumable capital assets with relatively long lives, that have to endure a disproportionate burden.

Although the SGBI (1952) recommended that primary statements of income continue to be based on historic cost, the final report did encourage corporations to furnish additional information that would allow the financial statement user to determine income measured in units of approximately equal purchasing power. Accountants' willingness to retain historic cost for the primary financial statements may have reflected political reality and the SEC's firm resistance to any deviation from historic cost. Deviation from the historic cost allocation model might have weakened the perception of accountants as unbiased professionals. The SEC, intent on restoring investor confidence in the business sector following the crash of 1929, did not want to challenge the historic cost allocation model, revered for its objectivity and neutrality. To do so might have caused investors to ask questions about what accounting profit measured—questions the SEC did not want to address.
Not all of the members of the SGBI approved the final report of the Study Group for publication; eight members wrote dissents to be included with the report. It is significant to note that the dissenters included George D. Bailey, Chairman of CAP (1944 - 1947) and a member of the accounting firm responsible for auditing Chrysler Corporation, as well as Carman G. Blough, Earle C. King, and William W. Werntz, all having served as Chief Accountants for the SEC (SGBI, 1952, pp. 110-112, 117-118, 122-123, and 130-133). Blough and Werntz had previously held the position of Chief Accountant of the SEC; while King held that position from April 1947 to November 1956. Bailey, Blough, King, and Werntz advocated continuance of the use of historic cost for corporate financial statements and questioned the advisability of any wording in the Report which might be construed to advocate adjustment of historic cost for changes in the purchasing power of the dollar.

Interest Groups and Issues: Shifts in the Debate

Much of the debate over determination of income and the size of corporate profits focused on the cost used to compute depreciation expense. Two questions must be
answered regarding cost. What attribute (basis of valuation) should be measured—historic cost, replacement cost, or current cost? What unit of measurement should be used—nominal dollars or constant dollars? Theoretically, the debate could have included six alternatives: (1) historic cost/nominal dollars, (2) historic cost/constant dollars, (3) replacement cost/nominal dollars, (4) replacement cost/constant dollars, (5) current cost/nominal dollars, and (6) current cost/constant dollars. The attribute debate in the Congressional Hearings on Corporate Profits centered primarily on the historic cost/nominal dollars and replacement cost/nominal dollars alternatives. But the debate shifted in the SGBI to historic cost/nominal dollars versus historic cost/constant dollars.

The Congressional Hearings on Corporate Profits will be used as a starting point for an examination of the alignment

Historic cost represents the exchange value when the asset was purchased. Replacement cost is the cost to obtain an asset today that will perform the same tasks as the original asset. Current cost is the cost to obtain an asset today that is identical to the original asset.

Nominal dollars are dollars that are not adjusted for changes in general purchasing power; constant dollars are dollars that are adjusted for changes in general purchasing power.
of interest groups (different voices) involved in the
discussion and of the shift in the issues addressed
throughout the debate. This will be followed by an
examination of the monographs and final report of the SGBI,
the correspondence of individuals involved in the debate on
business income, and the response of the SEC.

In testimony before the Subcommittee on Corporate
Profits, Slichter (1949), an economist, adopted a private
property rights perspective that corporations should be
operated for the benefit of their owners. Accountants Paton
and Bailey agreed. All three criticized the government for
refusing to acknowledge the adverse impact of inflation on
the value of the dollar and for taxing "illusory" profits.
Slichter (1949) and Paton (1940) proposed that financial
reporting should be modified to reflect the changing
purchasing power of the dollar. Although Bailey (1949), an
accounting practitioner and member of CAP, was quick to
criticize the government for taxing "illusory" profits, he
continued to advocate the use of historic cost for financial
reporting, reflecting the profession's position that
historic cost data was objective and value free. Bailey
did, however, stress that corporate profits were not the
same as distributable profits and that current economic conditions must be considered when interpreting financial statements.

Harris (1949), an economist, joined labor leaders Cruikshank (1949), Ruttenberg (1949), and Montgomery (1949) in portraying the nation's large corporations as quasi-public institutions. They urged Congress to prevent these corporations from exacting a tribute by increasing taxes so that they would not unjustly benefit from their ability to administer prices. The labor leaders testified that corporate profits were excessive and called for equity in the distribution of national income--equity in the distribution of the rewards of production.

Accounting profit measurement became the focus of the debate in the Congressional Hearings. Those who viewed the economy from a neoclassical perspective argued that the usefulness of historic cost data had been undermined by rampant inflation and that accounting income greatly overstated corporate well-being, resulting in confiscatory tax policies. Labor leaders, adopting a Keynesian perspective, contended that the ability to administer prices made it possible for corporations to insulate themselves
from the ravages of inflation. They staunchly supported retention of historic cost for the calculation of corporate profits.

Members of the SGBI can be divided into two fundamental groups--the economists and the accountants. Alexander (1950), an economist, adopted an economic view of income measurement consistent with the concept of physical capital maintenance. He suggested that accountants introduced the concepts of conservatism and objectivity into income measurement to avoid responsibility for progressing from an examination of accounts to the administration of business affairs and stressed the importance of the earning power of assets as a guide to calculating depreciation. Accountants successfully shifted the focus of the debate from capital maintenance to the measurement scale issue by demanding a concept of income that could be implemented by accountants--an accounting concept of income.

May (1949f) reflected the accounting viewpoint regarding the use of different measures of worth for different objectives. May (1949f, pp. 223-224) told Alexander that
One of the points of your thinking is that you assume a value determined by sale and demand, by demand and supply; and you are dealing, when you talk about capital assets, in the commodities for which there is no market, there is no demand, there is no supply, because there is nobody wanting to buy machinery where and as it is. So you have an imaginary market, you have an imaginary value, and you get about the fifth degree of imagination into your concepts.

In their final report, members of the SGBI acknowledged that the assumption of "the stability of the monetary unit—the monetary postulate is an obvious fiction" (SGBI, 1952, p. 46). They also conceded that there was pressure to ignore the effects of the exhaustion of property on different interest groups. Although the sentiments of the Group were most closely aligned with industry, they proposed that the primary statements of income should continue to be based on historic cost and that supplemental information could be furnished that would allow the financial statement user to adjust for changes in the purchasing power of the dollar. Their decision to retain the use of historic cost for income determination may have been more the result of political pressure than persuasive theoretical debate.
Correspondence Related to Depreciation and Business Income

An examination of the correspondence of individuals involved in the debate on business income provides a unique opportunity to read the private words of the participants--words that were not meant for public viewing. The authors can be more outspoken in private correspondence than in public speeches or articles. Primary sources, such as correspondence, can lead to a better understanding of differences in the views of the individuals. The letters examined are from the correspondence files of George O. May, Research Consultant for the SGBI. May had previously served as senior partner of Price Waterhouse in America and as vice-chairman of CAP.

Correspondence of William A. Paton, University of Michigan: January, 1948

In 1948, William A. Paton, a member of CAP, wrote to Carman G. Blough, Director of Research of the AIA, and outlined his reasons for abstaining from voting on Accounting Research Bulletin No. 33, Depreciation and High Costs, which advocated continuation of depreciation based on historic cost. Paton suggested that supporters of replacement cost depreciation were more effectively
supporting actual cost than those who supported continuation of historic cost depreciation. He was adamant that the problem of depreciation was a problem of utmost importance for continuation of the American economic system. Paton (1948a, p. 2) wrote that

(with England gone socialistic and with this country full of powerful groups trying to impair property rights in every possible way, as the means of finally suppressing or straitjacketing private enterprise on this side of the Atlantic too, it is late in the day to do anything to arrest the trend. However, I believe that we should still try to fight a delaying action in the hope that events may develop that will give the competitive market economy a chance to survive. Thus far accountants have gone blithely along encouraging understatement of assets by a half-dozen well-known devices, and thus bringing about general overstatement of the rates of return realized by American business concerns. This is simply playing into the hands of our totalitarian enthusiasts, who are smart enough to use every available device—including the limitations of conventional accounting practice, with some added perversions of their own—to gain their ends.

Correspondence Between George O. May and T. H. Sanders, Harvard University: July 19. 1949, to August 16, 1949

From July 1949 to August 1949, George O. May corresponded with T. H. Sanders regarding May's monograph for the SGBI. May indicated that he was deeply troubled by SEC acceptance of the Chrysler method of accelerated
depreciation (adopted in 1947) and was further disturbed that the AIA had not challenged it. May suggested that the Institute had been pressured by the SEC to place emphasis on uniformity rather than significance. He also criticized George D. Bailey, Chairman of CAP, and partner of Touche, Niven, Bailey & Smart, auditors of Chrysler Corporation during the critical years of 1947 and 1948. May (1949c, p.2) stated that

(i)n the fall of 1947 the close approach to uniformity in allocation of depreciation between years was threatened by the price rise. The Committee moved hastily to meet this threat...Almost simultaneously, a corporation that happened to be an important client of the chairman of the Committee presented another threat to the uniformity which the Committee had called for. The Chrysler Corporation which, as recently as July 1947, had stated its depreciation policy to be the orthodox straight-line depreciation on actual cost felt compelled to abandon its policy. The chairman was in a difficulty. His common sense, no doubt, told him that this course was pragmatically wise but he was left in an ambiguous position which has continued ever since.

May became more aggressive in his letters to Sanders as he tried to sway the academician to accept his position on depreciation. He proposed that statements of income would be more significant if both revenues and charges against revenues were measured in terms of units of the same
purchasing power. May (1949a, p. 1) concluded "(t)his is the position that I take, and if you do not accept it, why there is a difference between us that nothing can bridge."

In a later letter, May (1949b, p. 1) criticized the intellectual level of the entire accounting profession:

Over the years I have tried to "debunk" accounting before it was done from the outside. And rather inconsistently no doubt, have tried to create the impression that the profession's thinking was on a higher intellectual level than it actually has been.

Correspondence of George O. May Regarding George D. Bailey: 1951

May (1951a) continued his harangue of Bailey in letters to Percival F. Brundage, Chairman of the SGBI, criticizing Bailey's inconsistency regarding depreciation. Bailey lauded the progress of accounting toward a single concept of income while advocating acceptance of accelerated depreciation. In his correspondence with Brundage, May (1951b, p. 1) stated

I was confident that the moment George Bailey attempted to put anything on paper he would pretty well dispose of his own case...His letter has now come in and my expectations have been more than fulfilled. I am enclosing my copy together with a memorandum which I immediately wrote after verifying my recollection of what took place in
1934 to 1936. I am sorry that he should have aired what should have been internal differences among accountants.

May (1951c) also admitted, in a letter to William A. Paton, that he was "somewhat nettled by George Bailey's constant boasting of what had been done in the way of sharpening up the income account." May's correspondence regarding Bailey was particularly vitriolic and serves to illuminate the intensity of the debate on business income in the postwar years—an intensity often obscured in the more public writings of the participants.

The Securities and Exchange Commission

Congress established the SEC to restore investor confidence in the business sector following the crash of 1929. The SEC was thrust into the debate on the determination of business income when USS adopted replacement cost depreciation in 1947, directly challenging the historic cost allocation model which was prized for its objectivity and neutrality.

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32 Bailey used the term "sharpen up" the income account to describe the progress that had been made in developing a single concept of income.
The Fourteenth Annual Report of the Securities and Exchange Commission acknowledged that high prices and a high level of business activity generated an exceptional amount of discourse regarding some fundamental accounting and reporting problems. One of the problems highlighted in the report was claimed to stem from the theory that

...depreciation of fixed assets is related directly to replacement and that reserves for depreciation are inadequate if they are not equal to replacement cost of the property at the time of its retirement from service (Securities and Exchange Commission, 1949a, p. 111).

The SEC stated that one of the largest companies in the United States (i.e. USS) used that theory to justify depreciation expense based on replacement cost rather than historic cost in its 1947 report to its stockholders. The Commission further stated that the problem "is being given serious consideration and will be the subject of continuing study" (SEC, 1949a, p. 111).

The Fifteenth Annual Report of the Securities and Exchange Commission reported that a small number of registrants had deviated from historic cost depreciation in 1947. The SEC responded by taking exception in all of the cases, holding conferences with representatives of the
registrants involved, and concluding that depreciation charges should continue to be based on historic cost. That decision may have been influenced by several factors. Deviation from historic cost might be perceived as subjective and this might undermine investor confidence (SEC, 1949b). Also, as Edelman (1964) points out, regulatory agencies prefer not to become embroiled in issues where powerful interest groups have conflicting interests. Thus, given the heated debate between labor and management, the SEC probably chose to avoid approving new methods of accounting that could position them at the center of the controversy. Congress may also have influenced the SEC's decision. Congress wanted tax revenue and may have put pressure on the SEC to support historic cost.

Summary

Rampant inflation in the immediate post-World War II period fueled a debate over the measurement of business income. In the Congressional Hearings on Corporate Profits, management interests demanded abandonment of historic cost for the calculation of corporate profits, while labor leaders argued for its retention. Although management
contended that depreciation based on historic cost was inadequate due to rising replacement costs, labor countered that corporations were already insulating themselves from inflation through administered prices. Some publicly-traded corporations adopted depreciation methods in 1947 that increased their depreciation expense for the year, thus decreasing reported profits. This forced accountants into a highly visible technical debate over the determination of accounting income. Throughout the debate, both in the Congressional Hearings (1949) and later in the Study Group on Business Income (1947-1952), accountants consistently supported the idea that income should accrue to owners and never questioned the private property rights paradigm. They could not, however, advocate deviation from historic cost and continue to maintain their cherished image as unbiased professionals. Other less visible methods had to be found to respond to management concern.

Although the SEC would probably have preferred to avoid the controversy over the determination of business income, it was drawn into the replacement cost/historic cost debate when USS adopted replacement cost depreciation in 1947. The SEC rejected all efforts to deviate from the historic cost
allocation model. This decision may have been based more on political expediency than the conceptual superiority of historic cost income measurement.
CHAPTER IV

THE END OF THE DEBATE

Summary and Conclusions

Changing socioeconomic relationships in the post-World War II period provided the accounting profession with both challenges and opportunities. Accountants had traditionally relied on neoclassical economic theory to justify their income determination model. As long as it could be assumed that competitive markets were functioning effectively, accounting profit could be depicted as providing dependable information about corporate earning power. Investors could then use that data to channel capital into its most productive use. The rapid growth of oligopolistic corporations, characterized by separation of ownership and control, and the Great Depression of the 1930s presented contradictions to the underlying tenets of neoclassical economic theory and accounting profit measurement.

A series of Congressional investigations (1947-1952) documented that large corporations in a variety of industries administered prices. If prices were
administered, then what did accounting profit measure—managerial efficiency or managerial power? The epidemic inflation of the early postwar years also made the assumption of a stable dollar underlying accountants' income determination model problematic. Claims made for accounting income are less compelling when a variable measuring unit, the dollar unadjusted for inflation, is the basis of income calculation.

Although accountants were willing to recognize the measurement scale problem (unstable dollar) and to passionately debate the question of which attribute to measure (historic cost or replacement cost), they refused to acknowledge that a non-competitive market system existed. Their response was not unexpected since recognition of a "managed" economy would have cast doubt on the relevance of traditional profit measurement. Accountants remained wedded to neoclassical economic theory. They continued to depict accounting as providing "verifiable, objective" information based on arms-length transactions—information that investors could use to direct capital into the most capable hands.
Numerous interest groups became involved in an intense debate over the determination of business income following World War II. Government needed tax revenues to operate, labor demanded higher wages to keep pace with inflation, consumers called for lower prices, and business expressed concern with the increasing costs of replacing fixed assets. Wage/price controls, the excess profits tax, and the undistributed profits tax added urgency to the income determination debate; and standard setting became increasingly politicized.

Business and government formed a "partnership of necessity" in the early post-World War II years. Government provided most of the capital to build wartime production facilities. Following the war, the government sold two-thirds of the total value of the facilities at "fire-sale" prices to eighty-seven large firms, the same large firms that operated the plants during the war. In effect, taxpayers donated capital to those firms. Critics questioned why the corporations should not be considered "quasi-public" and why shareholders should be allowed to reap the profits generated by publicly donated funds.
The relationship between government and business became further entrenched when government was forced to call on big business to help sell the Marshall Plan for the reconstruction of Western Europe to an initially unreceptive Congress. Business support was critical in passing this legislation. Ultimately, America provided billions of dollars in foreign aid. Most of the funds flowed back to American corporations since the war had destroyed the productive capacity of most other industrial nations. Critics again questioned why the nation's largest corporations should be treated as private rather than "quasi-public" institutions and why stockholders should be the primary beneficiaries of public investment in the private sector.

Organized labor was not pleased with the emerging partnership being forged between government and big business. Labor wanted to become a full participant in the fruits of American business, to be viewed as a factor of production rather than a cost to be controlled. This would have required a radical change in accounting and would have posed a direct challenge to the dominant private property rights paradigm. The accounting profession sided with
business. While accountants welcomed the opportunity to expand their social obligation and power, they rejected the idea that profit should accrue to labor. Rather than reconceptualize labor as a factor of production, accountants positioned themselves as neutral judges in the labor/management conflict—professionals who could be relied upon as objective reporters of fact. Accountants began a concerted effort to educate labor regarding corporate profits. The goal was two-fold. First, accountants sought to strengthen their power by extending their social obligation. Second, they wanted to convince labor that historic cost income, while reliable, should be interpreted with care (i.e. historic cost income should not be confused with distributable funds) during periods of inflation.

Truman was deeply concerned about the adequacy of production facilities for materials such as steel—materials that were in short supply in the early postwar years. In 1947, a Congressional subcommittee found that many small businesses had difficulty obtaining enough steel to meet pent-up demand and were being priced out of the market. Although subsequent Congressional investigations revealed that large corporations (e.g. United States Steel
Corporation) administered prices, the accounting profession ignored these findings in the business income debate.

Prices soared in 1947, and labor leaders demanded that Congress conduct an investigation of corporate profits in an effort to curtail corporate excesses. In response to public outrage, the Congressional Hearings on Corporate Profits were held in 1948 to consider the size, source and disposition of business profits. While Senator Flanders (1949), chairman of the Congressional Subcommittee stressed the importance of obtaining objective information during the hearings that would help business and labor reach "statesman-like" decisions to halt inflation without unemployment, Senator O'Mahoney (1949) was probably closest to identifying the real purpose of the Subcommittee—to provide information that would enable Congress to determine to what extent government could tax corporations.

The Subcommittee heard testimony from economists, an accounting academic, an accounting standard setter, a professional accountant, labor leaders, and representatives of industry. The conflicting testimony was often biting and intense. Much of the debate centered on the attribute to be
measured when computing depreciation--historic cost or replacement cost.

Industry wanted to keep payments to both government and labor as low as possible. If corporations report lower profits, management can argue more effectively that they do not have the ability to pay higher taxes or to meet demands for wage increases. Industry representatives primarily argued for depreciation methods that would result in lower corporate incomes (e.g. depreciation based on replacement cost). They probably did so to deter imposition of another excess profits tax, to be in a stronger negotiating position under price/wage controls, and to gain acceptance of accelerated depreciation for tax purposes.

Labor looks at income (profit) as one gauge of a firm's ability to meet demands for wage increases. When profits are high, labor can argue more effectively for pay increases based on both ability to pay higher wages and on equity in the distribution of corporate income. The argument becomes increasingly persuasive as profits continue to rise. Unless wages are indexed, labor would be in a disadvantageous negotiating position during inflationary periods if corporate income was calculated using either replacement
cost or historic cost adjusted for changes in purchasing power. During the hearings, labor representatives characterized industry as monopolistic and self-serving, arguing that profits were not overstated. Although no closure was reached in the hearings, it was evident that labor leaders would not support abandonment of historic cost, however irrelevant it might be in periods of high inflation, if the alternative was to use a method that would reduce reported profits.

In 1947, corporate management forced the accounting profession to give some attention to the problem of inflation by adopting new depreciation policies that reduced reported income. United States Steel Corporation (USS) used replacement cost to calculate depreciation, while Chrysler Corporation adopted an accelerated method based on historic cost. Price, Waterhouse & Co. (auditor for USS) took exception to depreciation based on replacement cost as not in accordance with generally accepted accounting principles, while Touche, Niven, Bailey & Smart (auditor for Chrysler) accepted accelerated depreciation based on original cost. Both labor leaders and the public vehemently protested the new depreciation policies, stating that corporations were
seeking to hide profits. Government officials also worried that, if replacement cost depreciation or accelerated depreciation based on historic cost gained acceptance for financial reporting, it might also be accepted for taxes, resulting in a loss of tax revenues.

In its *Fourteenth Annual Report*, the Securities and Exchange Commission (SEC) promised to examine the replacement theory of depreciation used by some firms in their 1947 financial reports. One year later, the SEC reported that it had taken exception to all financial reports using replacement cost depreciation and had concluded that depreciation should continue to be based on historic cost.

However, the SEC accepted Chrysler Corporation's use of accelerated depreciation, which approximated replacement cost, thereby responding to business in a less visible fashion than abandonment of historic cost would have entailed. The SEC's decision reflected the strong partisan interests involved in this issue; it simply would have been politically impractical to depart from historic cost at this time. As Edelman (1964) suggests, regulatory agencies prefer not to challenge powerful interest groups. The SEC
chose a means of responding to business interests by accepting a new accounting technique. Since few outside the accounting profession had the requisite expertise to understand the technical aspects of accounting, this proved to be an effective strategy.

Most accountants welcomed the SEC decision. It allowed them to retain their image as unbiased professionals, neutral and objective reporters of fact. It also appeared to reaffirm the belief that competitive market forces remained operative and that accounting profit could be used by investors as a measure of managerial efficiency. If accountants had lobbied for abandonment of historic cost, rather than acceptance of a technique that attained the same objective of reducing reported profits, this might have raised unsettling questions about all entry values. Accounting standard setters not only accepted accelerated depreciation, they advocated two additional technical changes--reserve accounting and surplus adjustments--that enable management to further reduce reported income.

The debate did not end with the Congressional hearings or with the SEC's decision to require publicly traded firms to base depreciation on historic cost. A Study Group on
Business Income (SGBI) was established through the joint effort of the American Institute of Accountants (AIA) and the Rockefeller Foundation in 1947 to develop a functional concept of business income. The SGBI brought together the expertise of a diverse group of individuals including accountants, economists, attorneys, government officials, and business leaders. The accountants in the Study Group demanded a definition of income that could be implemented by accountants--an accounting concept of income. While they acknowledged that the monetary postulate was an "obvious fiction," the SGBI suggested that fictions are sometimes acceptable if they produce results that are more useful than the alternatives. They concluded that historic cost should continue to be used for primary statements of income. The Study Group did, however, recommend that supplemental information be provided to allow financial statement users to adjust for changes in purchasing power. The unwillingness to abandon historic cost reflects the profession's strong commitment to the private property rights paradigm.

Because no one was willing to question the existence of competitive markets and the tenets of the private property
rights paradigm, the postwar accounting debate focused primarily on the measurement scale problem (unstable dollar) and on which market-based attribute to measure--historic cost or replacement cost. Accountants steadfastly refused to question the basic input data of accounting (market price); nor did they question what accounting income measures--managerial effectiveness or managerial power. Documentation of widespread use of administered prices had no impact on the accounting income debate because the rhetoric of the accounting discourse did not change. Instead the debate degenerated into a political struggle with each interest group intent on protecting its own interests and gaining new benefits for its constituents.

May (1952b, p. 440) perhaps summarizes the debate best when he concludes that

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\text{(i)ncome, without any qualifying adjective, is fast becoming, if it has not already become, a political concept, and the business professions cannot expect to be granted the right to define it.}
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Interest in the debate on the determination of business income lessened when inflation abated and accelerated depreciation was accepted for both financial statements and taxes. Acceptance of accelerated depreciation based on
historic cost for financial statements was a compromise that was satisfactory to business interests. Its acceptance effectively aborted the income measurement debate. The Revenue Act of 1950 and the Defense Production Act of 1950 provided for accelerated depreciation based on historic cost for tax purposes for new investment in plant and equipment required for the Korean War effort. Congress accepted accelerated depreciation for investment in other plant and equipment for tax purposes in 1954. These actions stilled the theoretical debate, except for a few academic articles. It was not revived until inflation was again measured in double digits in the 1970s.

This study has validated May's (1952b) contention that accounting had become politicized. Politicalization of accounting can be interpreted to mean influence on the standard setting process by governmental agencies (e.g. Congress and the SEC) or compromise in the standard setting process necessitated by conflicting demands of various interest groups (e.g. taxpayers, labor, management, and accountants). The SEC, by taking exception to all financial reports using replacement cost, sent a clear message to accountants that it would be politically unacceptable to
deviate from the traditional historic cost allocation model in the determination of income—a message most accountants welcomed. The SEC, however, accepted a number of techniques that enabled management to reach its goal of reducing reported income in a less visible manner. Congress could not have acceded to abandonment of historic cost given labor hostility and the need to raise revenues, but did not object to technical changes since they were viewed as the province of the experts.

Retention of historic cost depreciation was depicted as a compromise, benefitting both taxpayers and labor. The compromise, however, reflected a victory for private property rights. Questions about shareholder rights to benefit from public investment were silenced. Retention of historic cost also allowed accountants to maintain their coveted image as objective, neutral reporters of fact. Accountants avoided examining the implications of administered prices for accounting profit measurement, which would have required radical changes in accounting.

While few outside the accounting profession understand accounting techniques, the public does understand the concept of income measurement. Thus, accounting standard
setters, firmly committed to private property (ownership) interests, used techniques--reserve accounting and appropriations--to satisfy management and ownership demands. Although the Committee on Accounting Procedures recommended that reserves and appropriations be made to earned surplus, this was clearly a recommendation rather than a requirement. Many firms, rebuffed in their attempts to use replacement cost depreciation or to adjust for price level changes, began writing off both reserves and appropriations to income rather than earned surplus. Accountants avoided conflict with management by giving management maximum flexibility in determining income through the use of accounting techniques and avoided conflict with labor and government by not acquiescing to management's demands for replacement cost.

Future Research

I used a traditional approach in my examination of the post-World War II debate on the determination of business income for this dissertation. It would be interesting to re-examine the debate from a radical institutionalist perspective. The radical institutionalist considers the market to be a "powerful enabling myth." Dugger (1989,
p. 6) describes an enabling myth as a "myth that enables the upper strata to maintain its position and to continue its predation on the underlying population." He views the United States as stratified according to wealth, with predation taking place through ownership. The radical institutionalist views the market as an effect rather than a cause; the market is the result of class conflict, custom, legislative law, and adjudication. It would be particularly interesting to re-examine the power relationships inherent in the testimony of the witnesses at the Congressional hearings on corporate profits.

An article in the February 26, 1996, issue of Business Week describes the attempt of two Senate Democrats to introduce a proposal for a new kind of federally chartered corporation (the R Corporation) for tax purposes. Kuttner (1996) suggests that the proposal could reopen the debate about the social purpose of corporations. The "R" in R Corporation stands for responsible and is consistent with a stakeholder or value-added approach. Under the proposal, an 11% business activity tax would be used to calculate taxes. The R Corporation could deduct employee training and research and development expenses to determine taxable
income; but wages, dividends, and interest could not be deducted. To qualify as an R Corp., the firm would have to meet certain tests designed to make corporations responsive to the needs of labor. It would be interesting to compare the issues raised in the debate on corporate accountability that will doubtless ensue from the introduction of this proposal with the issues raised in the debate on the determination of business income in the mid-1940s and early 1950s.

Limitations of the Current Research

The focus of the current research is on a single event for a relatively short duration of time (1945-1952). Although the environment surrounding the debate over the determination of business income was complex and dynamic, I am interpreting the event primarily from an accounting perspective; I am not seeking to examine the distributional impact of the unwillingness of accountants to redefine income.

The conditions existing during this time period may not reflect current conditions, thus limiting what we can say about current problems. However, to the extent that
accounting income determination is a political phenomenon, the dissertation should provide insights that will be useful in addressing contemporary problems.

This is a starting point for subsequent research on accounting income determination. It will enable me to recognize similarities and differences in subsequent periods and to evaluate why the historic cost model continues to remain dominant. I will also be able to examine some of the correspondence related to the administered price hearings and the political use of accounting data in future research.
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