

The SEC Rules Historical Cost Accounting: 1934 to the 1970s

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Abstract – From its founding in 1934 until the early 1970s, the SEC and especially its Chief Accountant disapproved of most upward revaluations in property, plant and equipment as well as depreciation charges based on such revaluations. This article is a historical study of the evolution of the SEC's policy on such upward revaluations. It includes episodes when the private-sector body that established accounting principles sought to gain a degree of acceptance for them and was usually rebuffed. In the decade of the 1970s, the SEC altered its policy. Throughout the article, the author endeavours to explain the factors that influenced the positions taken by the parties.

It is well known that the United States has long been a bastion of predominantly historical cost accounting for inventories and fixed assets. Not so well known, however, is the fact that the US insistence on the use of historical cost accounting has emanated from the Securities and Exchange Commission (SEC) and has not always been a tenet held and advocated by leaders of the accountancy profession. It is the aim of this paper to trace the SEC's powerful influence over the predominance of historical cost accounting in the United States from its founding in 1934 until the 1970s.

1. Early evolution of the SEC's position on historical cost

The SEC came into existence on July 2, 1934 and was charged with administering the Securities Act of 1933 and the Securities Exchange Act of 1934, the second of which established the SEC.¹ This legislation empowered the SEC to set the rules and regulations

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¹ The Federal Trade Commission administered the Securities Act of 1933 from June 1933 until September 1, 1934, when this authority was transferred to the SEC.

to govern the reporting, accounting and disclosure of financial information by companies whose securities were quoted on any national securities exchange, including the contents of prospectuses and periodic filings with the Commission. The SEC created the position of Chief Accountant in the autumn of 1935, and after a short search it named Carman G. Blough, a Certified Public Accountant and former academic who had joined the Commission's registration division in 1934, to the position on December 1, 1935 (Chatov, 1975:103; Cooper, 1980:22). He remained as Chief Accountant until May 1938, when he left the Commission.

The person who effectively cemented the SEC's policy to insist upon historical accounting was Robert E. Healy. Prior to becoming one of the five founding SEC Commissioners in 1934, Healy had been General Counsel of the Federal Trade Commission (FTC) from 1928 to 1934 and directed the FTC's six-year, Congressionally mandated investigation into the market manipulations by public utility holding companies, with heavy emphasis on dubious accounting practices. In the end, the record of the investigation accumulated to 95 volumes.

Healy had been a justice on the Vermont Supreme Court, and it was said that President Calvin Coolidge, a Vermonter himself, appointed his fellow Republican to direct the FTC's mammoth investigation. Joel Seligman, the SEC's historian, has written, 'The experience radicalized the conservative Healy. Shocked to find that "you can capitalize in some States practically everything except the furnace ashes in the basement", he became an uncompromising advocate of accounting and public utility reform' (2003:108).

Healy was livid at the asset value write-ups that public utilities had been booking. It was not only the write-ups themselves, 'however arrived at' (as he said), that incensed him as much as the utilities' follow-on accounting practices. He complained of 'write-ups used to create income or to relieve the income accounts of important charges', which would be debited to the revaluation reserve account that had been credited with the write-ups (Healy, 1939:1). He was driven to the conclusion that all upward departures from historical cost were veritably heinous. In testimony to a Congressional committee in April 1934, he said, 'the purpose of bookkeeping and accounting was to make a historical

record of events'.² Later in the 1930s he wrote, 'I think the purpose of accounting is to account—not to present opinions of value' (1938:6).

Remarking on Healy's influence within the SEC, Carman Blough wrote as follows, 30 years later,

'One of the first members of the newly formed SEC to be appointed was a former General Counsel for the Federal Trade Commission who had been in charge of that Commission's very comprehensive investigation of the public utility holding companies. During that study the flagrant write-up policies of the holding companies and their subsidiaries and the havoc they caused when the crash came in 1929 and 1930 kept impressing themselves on the chief investigator to the point that their evil became almost an obsession with him....So strong were his convictions and so convincing were his arguments against write-ups that all of the other members of the Commission were persuaded to take a positive stand against them from the very first case in which the question arose.' (1967:10).

Homer Kripke, a distinguished legal scholar who was an SEC attorney in 1939-44, has written,

'Healy's strong views dominated the Commission in the 1930s and 1940s when it was still struggling to undo the effects of the indiscriminate departures from [historical] cost in the 1920s. They influenced a whole generation of SEC accountants, the seniors of whom had served during his incumbency, until the retirement of Andrew Barr as Chief Accountant in 1972. It would be unfair to attribute the SEC's position *solely* to Healy, since the position continued for over a quarter of a century after his death. His position became that of other commissioners and a long succession of staff members because it suited their needs to emphasize objectivity at the expense of other potential attributes of an accounting system.' (1979:182)

² This quotation was taken from 'Stock Exchange Practices', Testimony before the Senate Committee on Banking and Currency, April 2, 1934, p. 7607. This passage was quoted in de Bedts (1964:93).

Healy served on the SEC from 1934 until his death in November 1946. He was the longest-serving member in the Commission's history. Blough's immediate three successors as Chief Accountant—William W. Werntz (1938-47), Earle C. King (1947-56), and Andrew Barr (1956-72)—all had joined the Commission's accounting staff in the 1930s. Healy and like-minded Commissioners succeeded in instilling in them an aversion to upward departures from historical cost if they had not already held that view. In fact, Barr had studied under A. C. Littleton, at the University of Illinois, who was the intellectual leader of the historical cost school.

In a comprehensive study of write-ups, R.G. Walker found that in the SEC's first several years its staff discouraged write-ups, and the Commission rejected asset appraisals that were devoid of adequate supporting evidence, not so much because of the revaluation practice *per se* (1992:10-15).³ In some cases, notably *Northern States Power Company*, a divided Commission (with Healy in the minority) allowed appraisals if there was sufficient disclosure of the procedure used (Healy, 1938:2-3). Around 1937/38, however, the SEC and its accounting staff began to take a more categorical stance against write-ups and by the 1940s were actively banning them. Walker wrote, 'It appears that the SEC had virtually eliminated write-ups from the accounting practices of its registrants by the mid-1940s' (1992:22). By 1970, Kripke would write, 'In effect the SEC has made it an exercise in futility for practicing accountants or anyone else to argue for revision of valuation methods in balance sheets or income statements' (1970:1189).

In 1936, the SEC received some academic support for its historical cost position when the American Accounting Association's executive committee, led by Association President Eric L. Kohler, published 'A tentative statement of accounting principles affecting corporate reports', which strongly endorsed 'original cost' for physical assets. Not surprisingly, SEC Chief Accountant Blough said in 1937 that he agreed with the Association's tentative statement (1937:30). Four years later, the Association published an important monograph written by two members of its 1936 executive committee, William A. Paton and A. C. Littleton, which contained an elegant conceptual rationale for

³ Reflecting predominantly on the Commission's early years, Barr and Koch (1959:181-2) have written, 'A review of the informal cases involving appraisals shows that the Commission usually effected the elimination of the appraisal'.

the use of historical cost accounting. Yet in their final chapter, entitled ‘Interpretation’, the authors (chiefly Paton) objectively discussed the pros and cons of replacement cost accounting and ‘common dollar’ accounting. As to the latter, they said, ‘At the most what is needed is a special report supplementing the usual periodic statements and designed to trace the main effects of general price movements upon the affairs of the enterprise’ (1940:141), which was a heady proposal at that time. Of the two authors of the monograph, Littleton was, throughout his career, an arch historical coster. Paton was a ‘value’ man. The historical cost portion of this monograph became a standard text used in accounting curricula and was widely read by practitioners as well.

2. Developments in the 1940s and 1950s: the SEC’s position hardens

2.1. Write-ups

Even though the SEC’s position on asset write-ups had become firm by the 1940s, the US body that established accounting principles (as standard setting was then known), the Committee on Accounting Procedure of the American Institute of Accountants (AIA), began looking for ways to gain acceptance for upward departures from historical cost.⁴ In 1945, the Committee, which was composed of 19 practitioners in accountancy firms and two academics, unanimously resolved to elaborate on a previous *Accounting Research Bulletin* on accounting for quasi-reorganizations so as to allow such write-ups. The term ‘quasi-reorganization’ referred to an accounting procedure by which a company in severe financial straits could avoid the expensive process of a legal reorganization by writing down asset values to levels that were justified in the light of its economic prospects, as if the company were engaging in a fresh start. Today, we would use the term ‘impairment’ to describe a similar procedure. The Committee’s proposal, made in the form of a resolution in October 1945, was to open the door to the acceptability of an upward quasi-reorganization when ‘supported by convincing evidence and [when] effected with due formality’ (‘Annual Report’, 1946:104). The argument was made that, since a company could liquidate and come into existence afresh by recognizing contemporary current

⁴ The Institute had set up the Committee in 1938-39 with the encouragement of the SEC. Yet it was well known that the SEC possessed the unquestioned authority to establish accounting principles for purposes of the statutes it administered. As will be seen, the Committee could go no further than the SEC would allow it to go.

costs, whether higher or lower, in its balance sheet, why should it not be possible to establish a new basis of accountability without actually liquidating and re-launching the company? The Committee proceeded to consider drafting an *Accounting Research Bulletin* to reflect this unanimous view.⁵ Yet, the following year, the Committee made it known that it had decided to postpone the preparation of a formal *Bulletin* ('Annual Report', 1947: 109). The reason was that SEC Chief Accountant William Werntz had publicly made known his antipathy to using the quasi-reorganization to record a write-up of assets (1945:386-7). Instead, the Committee was content to write a letter to the AIA's executive committee dated October 20, 1945, saying

'a new cost may and should be recognized whenever a new basis of corporate accountability is established by reorganization or quasi-reorganization if the carrying value of assets on the books has ceased to be representative of their value.'⁶ (the letter was reproduced in Research Department, 1950:390)

Five years later, in 1950, the Committee returned to the question, following the postwar inflation. It decided, again unanimously, to issue a *Bulletin* to recommend quasi-reorganization accounting that would allow write-ups. But the SEC scotched the initiative by advising the Committee that it would not accept financial statements with write-ups of the kind envisaged in the proposed *Bulletin*. Hence, the *Bulletin* was never issued (see Zeff, 1972:156-7).

It was customary when SEC Chief Accountants criticized upward departures from historical cost that they raised the spectre of the indiscriminate write-up practices of the 1920s, as if it were a nightmare that should not be experienced again.

It was apparently of no moment to the SEC's Chief Accountant that an 'upward' quasi-reorganization had won the support of two of the intellectual leaders of the profession. The *doyen* of the accountancy profession, George O. May, a retired partner of Price Waterhouse & Co. and a member and a former vice-chairman of the Committee,

⁵ An 'upward quasi-reorganization' might be labelled today as an 'enhancement gain' as the opposite number of an impairment loss.

⁶ It is not clear what authority such a letter would possess, although it may be assumed that the SEC's accounting staff knew of it. In effect, by sending the letter instead of issuing an *Accounting Research Bulletin*, the Committee was registering its view without 'officially' proposing a practice to be followed.

had given support to such a procedure in a major book (1943:99). William A. Paton, an accounting professor at the University of Michigan who was a member of the Committee from 1939 to 1950, had been writing since 1940 that there was an urgent need to allow an ‘upward’ quasi-reorganization in order to correct for historical costs that were out of line with current economic realities (see Zeff, 1979:115, 122-6).

Between these two ill-fated attempts to issue a *Bulletin* in favour of ‘upward’ quasi-reorganizations, which were crushed by explicit opposition from the SEC, the Committee faced the question of accounting for the effects of the high postwar inflation. In 1947, several major companies, including United States Steel, DuPont, and Sears Roebuck, opted to record depreciation at replacement cost. Industry was concerned that companies with a sizable depreciation charge were significantly overstating their reported earnings. Such earnings reports, companies believed, would be a stimulus for encouraging labour unions, which had been prevented from pursuing negotiations over wages during the war, to press for significant wage increases and pension benefits. Also, major companies sought a way of defending themselves against public criticisms that they were profiteering at the public’s expense (see Smith, 1955: 172, 363-5, Appendix B). Finally, major industry hoped that the use of replacement cost depreciation in their financial statements might persuade Congress to give them comparable relief from being taxed on capital. But SEC Chief Accountant Earle King, as could be predicted, immediately objected to these upward departures from historical cost (1947a:22), which prompted the companies instead to adopt accelerated historical cost depreciation on their postwar expenditures for property, plant and equipment, which, as it happens, produced financial results that were not all that different from the use of replacement cost depreciation (see McMullen, 1949; Blough, 1947). Congress, like the SEC, preferred the objectivity of historical cost, and in 1954 it struck a compromise by introducing two new methods of accelerated depreciation on historical cost into the income tax law.

Because of the suddenness of the decision of these major companies in 1947 to adopt replacement cost depreciation in the determination of earnings, the Committee had to act quickly to express its view as soon as possible. After the rebuff administered by the SEC two years earlier to the Committee’s attempt to sanction write-ups under the head of quasi-reorganizations, it is likely that some Committee members who favoured the use of

replacement cost depreciation would have voted against it because of inevitable opposition of the SEC. Therefore, it is difficult to know whether all of the Committee members were voting their genuinely held views. The Committee reacted quickly by publishing a statement in the October 1947 issue of *The Journal of Accountancy* (Committee on Accounting Procedure, 1947).⁷ The Committee's decision, which was taken with one qualified assent and one abstention,⁸ was that any depreciation in excess of what normal historical cost depreciation for the year would have been should be recorded 'below the line', meaning as an appropriation of net income or surplus. It said that 'consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time'. Of course, by the time a stable price level were to be achieved, the opponents of an upward departure from historical cost depreciation could dismiss the issue as no longer important. SEC Chief Accountant King, who had attended the Committee's meeting, lauded the Committee's statement (1947b:127-8).⁹

In October 1948, the Committee reaffirmed its position on replacement cost depreciation in a letter to Institute members (Committee on Accounting Procedure, 1948). But by then the vote attracted four dissenters—the chairman who was the senior technical partner at Peat Marwick (Samuel J. Broad), two well-known partners from middle-sized firms (Maurice E. Peloubet and C. Oliver Wellington, a former chairman of the Committee), and an accounting professor (Paton). These four disagreed with the Committee's view that 'no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present [inflationary] conditions' (1948:381). It was the first time in the Committee's history that the chairman had registered a dissent. But, as always, the SEC won the day.

For its part, the SEC took a step in 1950 towards institutionalizing historical cost in registrants' financial statements. It announced a general revision of its *Regulation S-X*,

⁷ The Committee issued this statement as *Accounting Research Bulletin No. 33*, entitled 'Depreciation and high costs', dated December 1947.

⁸ The abstaining party was William Paton, who wrote to the author on December 6, 1971 that he left the Committee's meeting room in despair before the vote was taken.

⁹ King wrote, '[Assistant Chief Accountant Andrew] Barr and I were present at the meeting at which this release was decided upon and it was strongly advocated by us'. Letter from Earle C. King to The Commission, dated October 22, 1947 (in the author's files).

which governs the contents of financial reports filed with the Commission and until then had dealt chiefly with matters of disclosure. The proposed revision incorporated a number of substantive accounting policy positions that had been dealt with during the 1940s in *Accounting Series Releases*. These included a new provision that said, 'Except as otherwise specifically provided, accounting for all assets shall be based on cost' ('Security [sic] and Exchange Commission', 1950:160). The effect of this new provision would change an *ad hoc* position of the Commission on the use of historical cost to one that was set in stone. So strong was the negative reaction within the accountancy profession to many of the SEC's proposed changes in *Regulation S-X*, which included a rare expression of opposition from the assembled members at an annual meeting of the American Accounting Association (Zeff, 1966:64-5), that the SEC in 1951 withdrew the provisions dealing with accounting principles in the proposed *Regulation S-X* in return for an assurance that the Committee on Accounting Procedure would, among other things, codify its series of *Bulletins* (Zeff, 1972:158-9). Yet the SEC achieved its objective by another means: the revised *Regulation S-X* included a provision that in effect incorporated the *Accounting Series Releases* in the regulation (see Barr, 1979:51).

In 1953, the Committee issued *Accounting Research Bulletin (ARB) No. 43*, which was a restatement and revision of the Committee's previous *Bulletins* dealing with accounting procedure. This was the codification sought by the SEC. Chapter 9A of the *Bulletin* was a reaffirmation of *ARB No. 33*, but six of the 20 Committee members dissented, which was one vote short of defeating the reaffirmation. The dissenters included senior partners of Peat Marwick and Price Waterhouse, three well-known partners of middle-sized firms, and an academic. The Committee felt obliged to state in Chapter 9B of *ARB No. 43* that, in cases where upward revaluations in depreciable assets had been recorded, the subsequent depreciation should be computed on the written-up amounts.

In the late 1940s and into the 1950s, there was disagreement within and among the largest accountancy firms on the propriety of using replacement cost depreciation.

Evidently, Peat Marwick was opposed, but senior partners in Price Waterhouse and Arthur Andersen were at odds within their respective firms on the contentious subject.¹⁰

From 1954 to 1958, consecutive subcommittees of the Committee on Accounting Procedure laboured to develop a *Bulletin* that would allow the upward revaluation of assets, using the analogy of a quasi-reorganization. Curiously, these efforts had been encouraged by a suggestion from SEC Chairman J. Sinclair Armstrong that it would be helpful to have an authoritative statement of the circumstances in which upward departures from historical cost might be justified (see Armstrong, 1956:159-60). Yet in 1958, by which time Armstrong was no longer on the Commission, the SEC's accounting staff signified to the Committee that there was no need for such a general statement. Thereupon, the Committee removed the project from its agenda.¹¹

2.2. General price-level accounting

Since the late 1940s, interest had been growing in the use of general price-level adjustments applied to historical cost, rather than the use of current cost, to reflect the impact of the increase in prices on financial statements.¹² Perhaps a reason for this different tack, in the minds of some, was the hope that the SEC might view it as less open to objection than the use of current cost. In 1952, the report of the Study Group on Business Income, which was engineered by George O. May, recommended that 'corporations whose ownership is widely distributed should be encouraged to furnish

¹⁰ Two successive senior partners at Peat Marwick, Samuel Broad and John Peoples, dissented from *ARB No. 33* and Chapter 9A in *ARB No. 43* (see below), respectively. In Price Waterhouse (PW), John B. Inglis, who gave U.S. Steel a qualified report in 1947 because of its use of replacement cost depreciation, voted in favour, but the redoubtable George O. May, by then retired but very much an active thinker and writer, and his protégé in the firm, Paul Grady, together with several other senior PW partners were opposed. In Arthur Andersen, Paul K. Knight, a partner in the firm's New York office and a member of the Committee, was in favour, while Leonard Spacek and the partners in the Chicago home office were opposed. The academic who opposed Chapter 9A was C. Aubrey Smith, of the University of Texas, who had spent the summer of 1935 in the SEC's registration division. From outward appearances, the leading partners in Ernst & Ernst, Haskins & Sells, and Lybrand, Ross Bros. & Montgomery were in favour of the position adopted in *ARB No. 33* and in Chapter 9A of *ARB No. 43*.

¹¹ Report of the Committee on Accounting Procedure, dated September 30, 1958 (in the author's files). Ironically, the Committee chairman at that time was former SEC Chief Accountant Werntz, by now a partner in a major accountancy firm.

¹² An early indication of this interest was the publication in April 1949 by the AIA's Research Department of a memorandum entitled 'An inquiry into the reliability of index numbers', which was originally intended 'for use as background material for consideration by the committee on accounting procedure in its deliberations as to the feasibility of using index numbers for adjustment of depreciation and/or property carrying values' (Research Department, 1949:312 fn 1).

[supplementary] information that will facilitate the determination of income measured in units of approximately equal purchasing power', subject to audit where practicable (1952:105). SEC Chief Accountant King, who was a member of the broadly constituted Study Group, strongly dissented from this recommendation (1952:122-3). The Study Group's report provided encouragement for the emerging interest, stimulated by the earlier writings of Henry W. Sweeney (1936) and William Paton (1941), in general price-level (GPL)-restated financial information to deal with the recent run-up of inflation.

Beginning in 1953/54, under the aggressive leadership of Leonard Spacek, Arthur Andersen & Co., which had a large client base in the public utility industry, were an outspoken advocate of current cost accounting or, alternatively, the use of GPL indices to restate historical cost depreciation.¹³ Indeed, in March 1954 the firm boldly petitioned the SEC to require companies using historical cost depreciation to state in a footnote the amount by which net income failed to reflect GPL-restated depreciation. In May 1954, the SEC denied the firm's petition, saying as follows:

'The Commission has concluded that [the firm's proposal] is not in accordance with sound and generally accepted accounting principles, that it does not have substantial authoritative support, and that its adoption is not necessary or appropriate in the public interest or for the protection of investors or consumers to carry out the provisions of the statutes administered by the Commission.'¹⁴

A more categorical denial could hardly be imagined.

In the 1950s and 1960s, Spacek's activism led his firm to support the efforts of several of its public utility clients to record GPL-restated depreciation or current cost-adjusted depreciation in their financial statements, one client also doing a GPL-restatement of its fixed assets in the balance sheet. The companies' motivation was to

¹³ In the UK, GPL accounting became known as Current Purchasing Power (CPP) accounting. GPL accounting was not regarded by theorists as a departure from historical costing but instead as an adaptation of historical cost accounting to inflationary conditions.

¹⁴ Letter from Orval L. DuBois, Secretary, Securities and Exchange Commission, to Leonard Spacek, dated May 28, 1954. The firm's petition as well as the letter from DuBois are in the author's files. The term, 'substantial authoritative support', has been used by the SEC since 1938 as the criterion for sound accounting practice. See the SEC's *Accounting Series Release No. 4* (1938), which continues to be in effect today.

show a reduced net income in the light of a larger investment base following the postwar inflation, so that this lower rate of return on assets would support their argument to regulators for higher energy rates to consumers. Those of its clients that were SEC registrants were required to relocate the depreciation charge 'below the line' in their filings with the Commission (see Randall, 1974; Staff of the Accounting Research Division, 1963:194-9, 211-17; Zeff, 1992:457-9). Barr would write in 1959, begrudgingly, that the SEC 'probably would not object to the inclusion of such [GPL-restated] statements as supplementary material in a filing with the Commission' (Barr and Koch: 1959:182).

Apart from its work with audit clients, Andersen issued a series of publications from 1959 onwards in which it advocated one or another form of price-level depreciation, price-level accounting, and eventually 'value accounting' (*Memorandum on Price-Level Depreciation*, 1959; *Accounting and Reporting Problems of the Accounting Profession*, 1969:5-16; *Objectives of Financial Statements*, 1972).

Also during the 1950s, the American Accounting Association, the organization of accounting academics, studied GPL-restated financial reporting. In 1951, an Association committee, which included a leading practitioner (Maurice H. Stans, of Alexander Grant & Company), recommended that companies include comprehensive GPL-restated financial statements as supplementary information to their primary statements ('Price level changes and financial statements', 1951). In 1955-56, the Association published three monographs that explained, illustrated, and argued the merits of GPL-restated financial statements (Mason, 1955; Jones, 1955; Jones, 1956).

In 1957, the Association committee charged with revising its 'principles' statements turned a corner. A committee of seven leading accounting academics, chaired by Robert K. Mautz, recommended that investors should be furnished with supplementary data 'to reflect the effect of price changes in the specific assets held by the enterprise during the period, to show the effect upon the enterprise of movements in the general price level, or to achieve both purposes' (Committee on Accounting Concepts and Standards, 1957:544).

In 1963, the Accounting Principles Board (APB), which had succeeded the Committee on Accounting Procedure in 1959, sponsored the publication of a research

study that explained and illustrated GPL-restated financial statements (Staff of the Accounting Research Division, 1963). In an APB research study published in 1965 and written by Paul Grady, a senior partner in Price Waterhouse, he carried forward the views of his late mentor, George O. May, by advocating a supplementary reporting of the financial effects of price-level changes (1965:370). His recommendation may have given encouragement to an APB subcommittee that shortly began developing a pronouncement on the subject.

By the end of the 1960s, the APB added tempered support for GPL-restated financial statements as supplements to the primary statements. In 1969, the APB unanimously approved a non-binding *Statement* to call for the supplementary disclosure of GPL-restated statements. Initially, the subcommittee that began in 1966 to draft the pronouncement understood that the board intended to consider it as a mandatory *Opinion*. Miller and Redding report that the pronouncement became a *Statement* when the board found that it was unable to secure a two-thirds majority for GPL-restatements as a required practice (1986:91).¹⁵ Had the APB issued an *Opinion*, the SEC would not have enforced compliance with it. Indeed, at the board's August 1967 meeting, LeRoy Layton, the chairman of the subcommittee, informed the board that SEC Chief Accountant Andrew Barr 'was generally not in favor of the positions taken in the draft Opinion principally because of the problems associated with (a) parallel statement presentation, (b) continued restatement of previous financial statements as general price indices change, which he believes would be baffling to readers and might be used as an excuse for "appraisal accounting" by some persons, and (c) possible legal implications'.¹⁶ In the event, few companies adopted the APB's recommendation.

As noted earlier, the periodic intervention of the SEC Chief Accountant on certain drafts of the Committee on Accounting Procedures and the APB, which occurred also on issues other than the ones that are germane to this article, raises a question whether Committee and APB members were voting their genuine beliefs or were bowing to the

¹⁵ Sidney Davidson, who was a member of the APB at that time, has confirmed this reason for the change from an *Opinion* to a *Statement*. Telephone conversation with Davidson on December 31, 2006.

¹⁶ Accounting Principles Board, Minutes of meeting – August 16-18, 1967, page 10 (in the author's files).

inevitable, namely, the position espoused, or known to be held, by the Chief Accountant.¹⁷

2.3. Further on upward departures from historical cost

Those who might have hoped that the APB could open the door, if only slightly, to upward departures from historical cost accounting were rudely taken aback by the APB's perfunctory rejection of its research study on accounting principles, today known as a conceptual framework document, which was published in 1962. The two academic authors of the study, Robert T. Sprouse and Maurice Moonitz, advocated the use of net realizable values or, alternatively, current replacement cost to measure merchandise inventory and the use of current replacement cost to measure plant and equipment (1962:27-34). The research study was coolly received, to say the least, by the members of the APB and by the advisory committee on the project. Indeed, three members of the advisory committee, former SEC Chief Accountants Blough and Werntz and the sitting Chief Accountant, Barr, categorically rejected the authors' recommendations. Barr minced no words when he wrote, 'indiscriminate application of the [recommended] principles could result in false and misleading financial statements and might tend to undermine the confidence of the public in all published financial statements' (Sprouse and Moonitz, 1962:60). For its part, the APB peremptorily discarded the research study and declined to consider it again ('Statement', 1962).

In 1963, Arthur R. Wyatt wrote an accounting research study on business combinations for the APB in which, among other things, he recommended a 'fair-value pooling' concept. This meant that, for business combinations effected by an issue of shares and where the constituents were of approximately equal size, the assets of both constituents should be restated at their fair values, up or down (1963:107). He insisted that this approach was 'applicable *only* when the facts of the transaction indicate clearly that the resultant entity is, in effect, a new enterprise' (107). Yet Chief Accountant Barr

¹⁷ In 1972, Charles T. Horngren, an academic and a member of the APB, argued, 'the SEC (top management) has used decentralization with a master's touch. Its lower-level management (APB) does an enormous amount of work for no salary and has just enough freedom to want to continue the arrangement...the Board has been unjustifiably criticized for timidity or vacillation on several occasions when the basic explanation for the Board's behavior has been no assurance of support from the SEC' (1972:39).

likened Wyatt's 'fair-value pooling' concept for business combinations to the upward quasi-reorganizations to which the SEC had objected some years ago (1965:24). Barr was ever on guard for what he regarded as upward quasi-reorganizations in new guise.

In APB *Opinion No. 6*, issued in 1965, whose purpose was to declare the status of the previously issued *Accounting Research Bulletins* from No. 43 onwards, it was stated that, with respect to Chapters 9A and 9B of *ARB No. 43*, 'property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity' but that 'Whenever appreciation has been recorded on the books, income should be charged with depreciation computed on the written up amounts' (APB, 1965:42). One of the APB members, Sidney Davidson, an academic, qualified his assent to the board's view that fixed assets should not be written up to reflect current costs 'but only because he feels current measurement techniques are inadequate for such restatement. When adequate measurement methods are developed, he believes that both the reporting of operations in the income statement and the valuation of plant in the balance sheet would be improved through the use of current rather than acquisition costs' (42).

A possible reason why US companies may not have been greatly concerned over the impact on earnings of historical cost accounting during times of rising prices was the availability of last-in, first-out (LIFO) accounting for inventories as well as the use by a considerable number of companies of one or both of the accelerated methods of depreciation for financial reporting purposes following enactment of the Internal Revenue Code of 1954.

3. Coping with the inflation of the 1970s—the SEC recants on current cost/value

A major changing of the guard within the SEC occurred in 1972. Andrew Barr, the last of the Chief Accountants who had joined the SEC's accounting staff in the 1930s, retired. He was succeeded by an activist, John C. (Sandy) Burton, an accounting and finance professor at Columbia University who had studied accounting at Haverford College with Philip W. Bell. It was Bell, together with Edgar O. Edwards, who wrote a highly influential book in 1961, *The Theory and the Measurement of Business Income*, in which they explained and advocated the use of current cost accounting. Burton was

already on record as favoring a change in the traditional accounting model that would better depict economic reality (1971:50). Burton, at age 39, had not been an accountant during the 1930s and thus would not have been haunted, like his predecessors, by tales of the write-ups during the 1920s.

US inflation was high throughout the 1970s, and one of the earliest exposure drafts issued by the newly established Financial Accounting Standards Board (FASB), which succeeded the APB in July 1973, was entitled ‘Financial reporting in units of general purchasing power’ (1974). Prior to the issue of the exposure draft, the FASB had published a discussion memorandum and held a public hearing on the subject. The recommendation in the draft was that companies’ conventional financial statements should be accompanied by a comprehensive GPL-restatement of their statements. Almost immediately, SEC Chief Accountant Burton derided the FASB’s ‘Units of general purchasing power’ proposal as ‘PuPU accounting’ (1975:70). He argued that GPL-restated financial statements would not provide investors with any better information than conventional statements. He observed that ‘the impact of inflation falls with dramatic unevenness on various sectors of the economy and various parts of firms’. True to the teachings of Philip Bell, he said, ‘it is essential that rapid movement take place in the direction of replacement cost accounting so that investors can perceive the effects of inflation on the activities of business enterprise’ (70). Coming from the SEC, this was indeed a revolutionary call for reform.

Burton meant what he said. In August 1975, the SEC announced a proposed revision to *Regulation S-X* to require that a set of large companies make footnote disclosure of replacement cost information for such items as cost of goods sold, depreciation, inventories, and fixed assets [‘SEC proposes’, 1975]. The proposal, affecting about 1,000 of the country’s largest nonfinancial corporations, went into effect in March 1976, when the SEC issued *Accounting Series Release (ASR) No. 190*, thereby rebuffing the FASB, which had opted for GPL-restatements (‘SEC adopts’, 1976).¹⁸ Although the required replacement cost information was not to be reflected in the body of

¹⁸ To be sure, the SEC stated in the release that ‘it did not and does not view its [1975] proposal as competitive with that of the FASB’, because companies could adopt GPL-restatements in conjunction with historical costs or replacement costs. Yet the SEC clearly had taken the initiative for dealing with the effects of inflation out of the FASB’s hands.

the financial statements, this was nonetheless a historic deviation from the SEC's defense of the primacy of historical cost accounting. The pivotal role played by the Chief Accountant was attested to by Charles Horngren, a close student of the US accounting standard-setting process:

'As chief accountant, John C. Burton persuaded the SEC to mandate fair values....strong influential leaders can make a difference, especially if they are at points of leverage in the process. And timing counts too. For example, as chief accountant of the SEC, Andrew Barr had a well-known aversion to upward departures from historical costs. If Barr were sitting in Burton's chair in 1976, I wonder if the replacement cost requirements would have been issued.' (Horngren, 1986:38)

Under Burton's leadership, the SEC performed a role in the United States similar to that played by the Sandilands Committee in the United Kingdom in 1975, when the latter suddenly refocused the field of debate from Current Purchasing Power accounting, which had been recommended by the Accounting Standards Steering Committee in a provisional accounting standard, to current cost accounting (see Tweedie and Whittington, 1984:chap. 5).

The FASB quickly sought to recover its lost ground. In 1979, it issued *Statement of Financial Accounting Standards No. 33*, which called for the supplementary disclosure of both current cost and GPL-restated data, dubbing the latter as 'constant dollar accounting', which, like the SEC release, applied only to very large corporations. Accordingly, in October 1979, the SEC issued *Accounting Series Release No. 271* to delete the disclosure requirements set out in *ASR No. 190* once the FASB's *Statement No. 33* went into effect. Although the FASB had issued the standard that governed practice, it was a direct reaction to the SEC's powerful intervention.

The SEC took a further step away from its long embrace of historical cost accounting, later in the 1970s, by calling for current value information in the body of the financial statements of oil and gas producers.¹⁹ The issue arose in the aftermath of the Arab Oil Embargo of the United States and other Western nations in 1973. Congress

¹⁹ For a full and authoritative treatment of this oil and gas accounting episode, see Gorton (1991).

enacted the Energy Policy and Conservation Act (EPCA) of 1975, which directed the SEC, after receiving formal advice from the FASB, to eliminate the diversity of accounting practice used in oil and gas production. Until then, some producers would capitalize only the costs incurred in successful production, while expensing the costs associated with failed attempts at discovering oil or gas deposits. This method, used mainly by the large, vertically integrated oil and gas companies, is known as ‘successful efforts costing’. Other producers would capitalize all of the costs associated with oil and gas exploration. This method, used mainly by the smaller companies, is known as ‘full costing’.

In 1977, the FASB issued *Statement of Financial Accounting Standards No. 19*, which, by a 4-3 vote, recommended that only the ‘successful efforts costing’ method be permitted. As required by the EPCA, the SEC held public hearings, covering 12 days and accumulating 2,700 pages of transcript, with all five members of the Commission in attendance. Furthermore, there was intense pressure brought on the SEC from the smaller oil and gas companies, much of which was transmitted through members of Congress and federal departments, such as Justice and Energy. They used all of their lobbying might to defend against the imposition of ‘successful efforts costing’, which, they believed, would make their earnings trend much more volatile. For one of the few times in the SEC’s history, all of the Commissioners—who rarely are versed in accounting—personally became immersed in an accounting issue.²⁰ Not being steeped in accounting, the Commissioners had no allegiance to historical cost accounting, and they believed that, for the oil and gas industry, it was market values, not historical costs, that were relevant to investors. Indeed, this view was pressed on them numerous times during the hearings. It helped that the Chairman, Harold M. Williams, although trained as a lawyer, had been formerly a business school dean and a board director of a major oil and gas company. The Commissioners also believed, as did their accounting staff, that neither ‘successful efforts costing’ nor ‘full costing’ was demonstrably superior to the other. Accordingly, in August 1978, the SEC issued *Accounting Series Releases No. 253*, which required oil and gas producers to use ‘reserve recognition accounting’ (RRA), a variant of current value

²⁰ An earlier such hearing was on November 22, 1965, when the Commissioners met with a delegation from the APB to discuss the classification of the deferred tax credit, which led to the issue of *Accounting Series Release No. 102* (SEC, 1965).

accounting, in the body of their financial statements. Under RRA, the unrealized holding gains and losses were to be taken to earnings. For the first time since the founding of the SEC in 1934, the Commission required a class of registrants to depart from historical cost accounting in their financial statements *per se*. Times had indeed changed, and by then the memories of the flagrant write-ups of the 1920s had faded.

Following the issue of the SEC's release, the major oil and gas companies began to bring pressure against the use of current values for their proven oil and gas reserves because of its impact on the perceived size and profitability of their enterprises in the eyes of the public. In the end, in February 1981, the SEC reconsidered its requirement that RRA be used in the body of producers' financial statements and instead announced its support of a move by the FASB to develop a comprehensive footnote disclosure that would reflect the principles implicit in RRA. The FASB issued that guidance in *Statement of Financial Accounting Standards No. 69*, issued in November 1982.

But the precedent had been set. In 1978, for the first time, the SEC had announced as a matter of policy that historical cost accounting was not always to be preferred over the use of current values in the body of companies' financial statements.

It was not until the 1990s, spurred by the need to account for the complicated financial instruments that began to be developed by Wall Street in the 1980s, including especially derivatives, that the SEC concluded that there were major areas of financial reporting in which historical cost accounting was deficient for the needs of investors.

4. The indirect impact of the SEC's historical cost policy on accounting education

Because, for almost four decades, US university-level accounting textbooks, curricula, and course content in the United States have been dominated by the Uniform CPA Examination, which means accepted practice, generations of Certified Public Accountants have not been exposed in their studies, in any meaningful way, to departures from the traditional accounting model, such as GPL-restatements, current cost accounting, or current value accounting (see Zeff, 1989). Consequently, as the authoritative literature in the United States moves inexorably towards shades of fair value accounting, its qualified accountants are only now learning about a regime of accounting that had been systematically excluded from their professional education. This

circumstance makes any transition from the traditional model to fair value accounting all the more difficult to achieve successfully and with good effect in the United States.

5. Conclusion

One can see from the foregoing analysis that the SEC established and restated its position time and again on the primacy of historical cost during its first 38 years (that is, until 1972), even when the Committee on Accounting Procedure or the Accounting Principles Board was disposed to approve upward adjustments in one way or another from conventional historical cost. This posture of the SEC explains the deeply held attachment to historical cost accounting that one associates with US financial reporting during much of the 20th century. The year 1972 marked the arrival of a Chief Accountant who was unencumbered by memories of the indiscriminate write-ups of the 1920s and, moreover, was schooled in the merits of current cost accounting. Owing to his proactive influence, the SEC approved the required use by more than 1,000 large companies of supplementary replacement cost disclosures during the inflationary 1970s. The SEC took one major step further when, during an intense period of controversy over accounting for oil and gas exploration in the second half of the 1970s, it called for the integration of current values into the body of companies' financial statements as a better solution than arbitrating the supremacy of 'full cost costing' or 'successful efforts costing'. The SEC had entered a new era in the regulation of company financial reporting, but one can ask whether the accountancy profession was ready for it.

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