Accounting Historians Journal
Vol. 34, No. 1
June 2007
pp. 1-23

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THE SEC PREEMPTS THE ACCOUNTING PRINCIPLES BOARD IN 1965: THE CLASSIFICATION OF THE DEFERRED TAX CREDIT RELATING TO INSTALLMENT SALES

Abstract: In 1959, the Accounting Principles Board (APB) replaced the Committee on Accounting Procedure because the latter was unable to deal forthrightly with a series of important issues. But during the APB's first half-dozen years, its record of achievement was no more impressive than its predecessor's. The chairman of the Securities and Exchange Commission (SEC), Manuel F. Cohen, criticized the APB's slow pace and unwillingness to tackle difficult issues. This article discusses the circumstances attending the SEC's issuance of an *Accounting Series Release* in late 1965 to demonstrate forcefully to the APB that, when it is unable to carry out its responsibility to "narrow the areas of difference" in accounting practice, the SEC is prepared to step in and do so itself. In this sense, the article deals with the tensions between the private and public sectors in the establishment of accounting principles in the U.S. during the mid-1960s. The article makes extensive use of primary resource materials in the author's personal archive, which have not been used previously in published work.

INTRODUCTION

In 1959, the American Institute of Certified Public Accountants (Institute, AICPA) appointed a new body, the Accounting Principles Board (APB), to succeed the Committee on Accounting Procedure (CAP). The APB had been charged to do a better job than its predecessor in raising the standard of accounting practice [see Zeff, 2001]. But the APB got off to a slow and uncertain start. In an embarrassing decision made in early 1962, it rejected the recommendations of a research study it had commissioned on broad accounting principles and shelved the

Acknowledgments: The author is grateful to Hugo Nurnberg, Sundaresh Ramnath, and an anonymous reviewer for comments on an earlier draft, as well as to Bill Coxsey and Travis Holt for services provided.

study [see Moonitz, 1974, pp. 17-20]. In early 1963, the APB was rebuffed by the Securities and Exchange Commission (SEC) on the investment tax credit [see Moonitz, 1966]. Finally, in 1964-1966, the APB seemed poised to right its course. Foremost among the reasons for this turn of events were (1) the decision by the Institute's executive committee to abandon its policy of appointing only the strong-willed managing partners of the Big Eight accounting firms to the board, and (2) the decision by the new board chairman, Clifford V. Heimbucher, a past president of the Institute and a partner in a small San Francisco CPA firm, to organize the board's work more effectively [Carey, 1970, pp. 130-132]. These were administrative improvements of considerable importance.

But there was a third reason – the increasing public pressure from the activist chairman of the SEC, Manuel F. Cohen. In a series of speeches, he urged the APB to make the difficult decisions so as to "narrow the areas of difference and inconsistency in practice," which the CAP had set as one of its objectives in 1953, and which had been laid down as an objective for the APB by the Institute's Special Committee on Research Program in 1958 ["Report to Council of the Special Committee…," 1958, pp. 62-63].

In 1965, the APB was drafting an *Opinion* on the status of the CAP's *Accounting Research Bulletins*. In its exposure draft, it proposed to classify the deferred tax credit as a current liability when it relates to installment sales receivables shown as a current asset. Then the board recanted its position, greatly annoying one of its supporters, Arthur Andersen & Co. (AA). In late 1965, AA petitioned the SEC to require its classification as a current liability, thus overruling the APB. Manuel Cohen seized upon the petition as an opportunity to lecture a delegation from the APB at a specially called meeting of the Commission and then to issue an *Accounting Series Release* on the deferred tax classification as requested by AA. It was unprecedented for the SEC to issue a rule on accounting recognition, measurement, or classification in an area in which the accounting profession had declined to act after having initially undertaken to do so.[1] This action by the SEC has been little noticed in the literature

[1]To be sure, the SEC's accounting staff had exerted its influence on the CAP and the APB in other ways. The only comparable confrontation between the standard setter and the SEC on income tax allocation occurred in 1945, when the SEC issued *Accounting Series Release No. 53* [SEC, 1945] in order to limit the applicability of *ARB No. 23* [CAP, 1944].

[cf. see Pines, 1965, pp. 739-740; Defliese, 1974, p. 39], and there is some evidence to suggest that the SEC's release was a factor contributing to the APB's greater inclination to address difficult questions head-on in 1966-1967, especially on pensions and income tax allocation. In its later years, however, the APB foundered once again, in particular on accounting for business combinations [see Chatov, 1975, chap. 14; Seligman, 2003, pp. 418-430]. In 1973, the APB was succeeded by the independent Financial Accounting Standards Board. It is the purpose of this paper to examine in some depth this unique intervention by the SEC in the process by which the profession established accounting principles in the mid-1960s.

BACKGROUND

When the APB was established in 1959, the Institute's executive committee, probably at the behest of President Louis H. Penney, decided that only managing partners would be invited to represent the Big Eight firms on the board.[2] The executive committee apparently believed that the board would be making broad policy decisions based on technical support from its research staff, and that the managing partners were the most suited to making such executive decisions. But it quickly became evident that the board could not avoid immersing itself in highly technical issues. It also became clear that a number of the managing partners were not technical specialists, did not always read their agenda materials prior to the meetings, were typically men of strong conviction, and, thus, did not work easily together during the board's early years. Also, the board exhausted itself in lengthy debates leading up to *Opinion Nos. 2* and *4* [APB, 1962, 1964] on the investment tax credit, on which a total of 11 members dissented and a further nine filed qualified assents. Further, the board expended considerable time and energy on the controversial research study on accounting principles [Sprouse and Moonitz, 1962] and on a recommendation to Council on the authority that the board should be given to make changes in "generally accepted accounting principles" (GAAP) [Zeff, 1972, pp. 180-182].

By 1964, it became clear to the Institute's executive committee that its policy on managing partners had been a mistake,

[2]The lone exception was Weldon Powell, the senior technical partner of Haskins & Sells. Powell had chaired the special committee that called for establishment of the APB and the new accounting research division to provide the board with technical support.

and it proceeded to appoint the Big Eight firms' senior technical partners as the terms of their firms' managing partners expired [see Zeff, 1972, p. 193]. (It was always the Institute's unstated policy to have one representative on the board from each Big Eight firm.) By 1966, all but one of the managing partners of the Big Eight firms had departed the board. The lone exception was John W. Queenan, who had succeeded Weldon Powell as the representative of Haskins & Sells in 1963. But Queenan had served on the CAP from 1949 to 1954 and was strongly interested in technical accounting issues.

When Heimbucher became chairman of the board in 1964, he established subject-area subcommittees to study and draft *Opinions*. Previously, the board itself had done the drafting *in plenum*. Also, he arranged for an administrative staff to circularize exposure drafts and to read and analyze the letters of comment, thus freeing up time for the accounting research staff to concentrate on research. In addition, he set up a planning committee to set priorities and target dates for the board's agenda of projects. Finally, he allowed board members to bring an adviser to board meetings [see Heimbucher, 1966].

All the while, the board was being criticized in the financial press, in speeches by Leonard Spacek, the outspoken and feisty managing partner of AA, and by SEC Chairman Cohen. The issue coming in for the greatest attention was over "uniformity" v. "flexibility" when companies made choices of accounting principles, including the consequent diversity of accounting practice. Spacek spoke in favor of greater uniformity, while several other large firms, such as Price Waterhouse & Co. and Haskins & Sells, defended flexibility in the choice of accounting principles.[3] The SEC was on record for many years as favoring greater uniformity, and, in a speech in late 1964, Cohen [1964, p. 12] became more insistent that decisive progress be made in that direction. He said that "an immediate and pressing objective is to eliminate the use of alternative accounting principles underlying financial statements not justified by differing circumstances." During its first 5½ years, by the end of 1964, the APB had issued only five *Opinions*, and none had had the effect of narrowing accepted practice.[4]

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[3]See the symposium, "Uniformity in Financial Accounting" [1965], for papers by Spacek, Weldon Powell, J. Arnold Pines (of the SEC staff), and others. For the Price Waterhouse view, see Bevis [1965] and Grady [1965, pp. 32-34].

[4]It was not for lack of trying, however. In *Opinion No. 2* [APB, 1962], a divided board tried mightily to limit to one the number of ways to account for the investment tax credit. But the SEC was lobbied into allowing an alternative

WHY THE CLASSIFICATION OF THE DEFERRED TAX CREDIT BECAME IMPORTANT TO SPACEK AND ANDERSEN IN 1965

It was in this roiling environment that Leonard Spacek and AA became concerned about the diversity of practice allowed for treating the deferred tax credit arising from retailers' use of the installment method for recognizing gross income for income tax purposes coincident with recording sales revenue for financial reporting purposes as soon as an installment sale was made. Retailers, especially the department stores and mail-order houses, were the industry most significantly marked by this diversity of practice. The majority of companies had been classifying the deferred tax credit as a noncurrent liability. A few were displaying it as a current liability. Some companies had deducted the deferred tax credit from the installment receivables [see Hicks, 1966, p. 130].

Norman O. Olson [1966, p. 60], a partner in AA's executive office, explained why the deferred tax credit was becoming of increasing importance to companies in the retail industry. Referring to the divergence in practice between its classification as current or noncurrent, he wrote:

> The effect of this divergence in practice was assuming greatly increased significance by 1965, and it was likely to increase even further. With the expanded use of revolving credit plans and various other installment payment plans by merchandising companies and with the relatively recent regulations of the Internal Revenue Service permitting sales under revolving credit plans to be treated as installment sales for income tax purposes, many companies were accumulating an increasingly large amount of deferred income taxes on installment sales.

Olson added that the classification of deferred tax "has a significant effect on the determination of a company's working capital and the credit rating it receives."

The classification of the deferred tax credit became an important issue to Spacek and AA in early 1965, when the president of one of its major retail clients, Montgomery Ward & Co., Incorporated (MW) complained about having to show its credit

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method, and, in *Opinion No. 4* [APB, 1964], the board reluctantly conceded defeat. This rebuff of the board by the SEC provoked considerable comment in the press.

as a current liability in its 1964-1965 financial statements (fiscal year ending on February 3, 1965). In line with a position which it had recently announced, AA [1962, pp. 66-67] insisted that MW classify its deferred tax credit as a current liability. The current portion of the deferred tax credit balance in its balance sheet dated February 3, 1965 was $3.9m, which represented 1.8% of its total current liabilities excluding the credit, but the president surely knew in early 1965 that this percentage would increase steeply in the years ahead. (It did indeed rise to 6.5% by February 2, 1966 and to 9.7% a year later.) Sears, Roebuck and Co., a much larger retail company, also based in Chicago, and audited by Touche, Ross, Bailey & Smart, had been displaying its deferred tax credit as noncurrent. The balance of Sears' deferred tax credit on January 31, 1965, the end of its fiscal year, was $454m, equal to *one-third* of its total current liabilities on that date.[5] MW's president wanted to know why his company should be penalized for carrying the credit as a current liability while most other major retailers were not. Spacek agreed that his company should not be penalized, and he offered him a deal. If MW would agree to show the credit as a current liability in its 1964-1965 financial statements, and if Spacek could not get the APB to call for a uniform classification of the credit as a current liability by the end of 1965, he would approve of MW's adoption of noncurrent treatment in its 1965-1966 financial statements. MW's president agreed to the deal.[6]

SPACEK'S EFFORT TO PERSUADE THE APB TO ACT ON DEFERRED TAXES

Previously, the CAP had dealt with the tax effect of a timing difference between reporting accelerated depreciation for income tax purposes and recording straight-line depreciation expense for financial reporting purposes (*Accounting Research*

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[5]Neither MW nor Sears disclosed the current portion of its deferred tax credit, that is, the portion relating to installment receivables shown as current assets, in their 1965 year-end annual reports. Yet both companies had to break down their deferred tax credit account into its current and noncurrent components in their February 2, 1966/January 31, 1966 balance sheets, owing to the dictum in *Accounting Series Release No. 102* [SEC, 1965] (see below). They were also obliged to give, which they did, the comparative current/noncurrent breakdown for the previous year's balance sheet. As will be seen, the SEC release dealt with the classification of the deferred tax credit only in relation to installment receivables shown as current assets.

[6]This anecdote is recounted in interviews with George R. Catlett, September 3, 1970 and May 3, 1978.

Bulletin [*ARB*] *No. 44 Revised*) [CAP, 1958]. It had recommended that, except in special circumstances, such differences should be accounted for as deferred taxes. The CAP announced in 1959 that the deferred tax credit account relating to the depreciation differential should be shown in the balance sheet as a liability or deferred credit, not as part of equity capital [CAP, 1959]. As far back as 1944, the CAP had recommended that a provision should be made for the estimated tax to be paid on installment sales which were deferred for income tax purposes (*ARB No. 23*, final paragraph) [CAP, 1944]. The CAP reaffirmed this position in paragraph 18 of Chapter 10B of *ARB No. 43* [CAP, 1953]. But the CAP did not say how to classify the deferred tax credit account. In the retail field, as indicated, there was a lack of agreement whether the deferred tax credit should be shown as a current or noncurrent liability when the installment sales receivable was shown as a current asset.

During 1964-1965, the APB was deliberating a pronouncement, which became *Opinion No. 6* issued in October 1965, in which it was to announce which of the CAP's *Accounting Research Bulletins* should be continued without amendment and which should either be revised or be withdrawn entirely.[7] All of the board members, as well as Andrew Barr, the SEC chief accountant, were invited by Chairman Heimbucher to give their views on which of the *ARBs* should be retained, in their original form or as amended. In a letter dated May 26, 1965, Leonard Spacek, who was in his last year of service on the board, replied that the definition of current liabilities in *ARB No. 43*, Chapter 3A, paragraph 7 [CAP, 1953] should be amended to include deferred taxes to the extent that they relate to current assets, such as the current portion of installment sales receivable. It was expected that much of the impact of this amendment would be on retailers.[8] On June 4, 1965, Andrew Barr replied at length to

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[7]The board's review of the *ARBs* became necessary after the AICPA Council decided in October 1964 that any departures in company financial statements from accounting principles accepted in the board's *Opinions* and in the *ARBs* had to be disclosed either in the footnotes or in the auditor's report, effective with financial statements for fiscal periods beginning after December 31, 1965. The board, therefore, had to determine which of the contents of the *ARBs*, with or without amendment, were to serve as this benchmark.

[8]The references to board correspondence and board minutes are drawn from files that AA generously allowed the author to copy during the summers of 1982 and 1983 in the firm's Chicago executive office, at the invitation of Arthur R. Wyatt. Documents have been obtained from other sources as well. Researchers interested in pursuing the issue raised in this article are invited to inspect copies of the related documents in the author's personal archive.

Heimbucher's invitation, and, among other things, stated that "Paragraph 7 [of *ARB No. 43*, Chapter 3A] should be expanded to specifically state that liabilities maturing in the time period of the operating cycle should be included in current liabilities, such as liabilities related to installment receivables and deferred income taxes on installment sales."

Spacek sought the view of Anson Herrick, a retired San Francisco practitioner who, as a member of the CAP in the 1940s, had drafted *ARB No. 30*, "Current Assets and Current Liabilities – Working Capital" [CAP, 1947], which served as the basis for Chapter 3A of *ARB No. 43*. Herrick replied that he supported the proposed classification of the deferred tax credit as a current liability in such circumstances. He said that "[the classification] is completely consistent with the cycle theory which I originated."[9]

In 1953, no less an authority than Carman G. Blough, the Institute's director of research, who attended the meetings of the CAP, had opined that the deferred tax credit relating to installment receivables should be shown as a current liability in line with *ARB No. 30* [Blough, 1953, p. 347].

SEC Chairman Cohen [1966, p. 59] was later to say that, in 1965, "no fewer than four different reporting methods were used by companies for which the [deferred tax] item was of considerable importance. … Significantly, each method carried the opinion of an independent public accountant reporting that the financial statements had been prepared in accordance with generally accepted accounting principles." Clearly, a uniform approach was lacking.[10]

At its meeting on June 21-23, 1965, the APB unanimously approved Spacek's proposed amendment of paragraph 7, and it was duly included in the board's exposure draft that was issued in July ["Exposure Draft of Tentative Opinion…," 1965].[11] The draft was widely circulated, including a special mailing to the presidents of the some 1,300 companies listed on the New York Stock Exchange. The pertinent passage in the exposure draft appeared in paragraph 13. In that paragraph, it was stated that the AICPA's accounting research division will conduct a research study on current assets and liabilities, and that, "[p]ending completion of this study, and publication of a Board Opinion

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[9]letter from Herrick to Spacek, dated June 17, 1965

[10]This matter was also discussed at length by Rappaport [1972, pp. 3-7 to 3-10].

[11]AICPA – APB, minutes of meeting, June 21-23, 1965, p. 1

thereon," the following paragraph was to be added to Chapter 3A (p. 58):

> 10. Whenever it is appropriate to record deferred income taxes, such deferred taxes should be classified as a current liability in the balance sheet to the extent that they are related to current assets which give rise to the tax deferment.

As can be seen, the proposed change was solely one of balance-sheet classification, and it was to be reconsidered once the board could review the research study on current assets and liabilities. The provision did not pretend to impose tax allocation accounting (today known as deferred tax accounting) where it had otherwise not been recommended by the CAP or the APB. Indeed, the APB was then considering whether to pronounce in favor or against tax allocation generally, and two of the Big Eight firms (Price Waterhouse & Co. and Haskins & Sells) had already registered antipathy, or at least profound skepticism, toward any tax allocation at all. AA was the Big Eight firm that was the strongest advocate of tax allocation.

During the board's June meeting, George R. Catlett succeeded Spacek as AA's representative on the board. He later recalled that board member Ira Schur of S.D. Leidesdorf & Co., a middle-sized firm based in New York City, said that his firm had been trying to persuade City Stores, one of its clients, to reclassify its deferred tax liability relating to installment receivables as current but had been unable to do so because of the noncurrent classification used by most other companies in the industry. He also recalled that board member Donald J. Bevis of Touche, Ross, Bailey & Smart said that he had always favored the current classification for the deferred tax credit relating to installment sales.[12] Touche, Ross, the auditor of Sears, was then the predominant Big Eight firm with major clients in retail trade – department stores, mail-order houses, etc. [see Zeff and Fossum, 1967, p. 317].

Key commentators on the exposure draft expressed reservations or outright opposition to paragraph 13 on the current classification. The Panel on Accounting Principles of the Financial Executives Institute argued that the paragraph prejudged the research study on current assets and liabilities still under way

[12]internal AA memorandum from George R. Catlett to partners R.I. Jones, W.J. Mueller, J.J. Brice, and J.W. Boyle, dated July 1, 1965

by the board's research staff.[13] Awaiting the results of research has always been an easy argument to make against unwelcome changes in accounting principles. The Retail Committee on Accounting Principles of the National Retail Merchants Association (NRMA), representing 15 major department stores and mail-order houses (including MW, Sears, and City Stores), objected to the reclassification. It argued that only income taxes payable during the current year should be shown as current: "The deferred income taxes of retailers arising out of the installment method of tax accounting are, in effect, a long-term obligation which is not payable until the outstanding receivables are liquidated – a very remote possibility in a going business."[14]

Of the 15 companies represented on the NRMA's accounting principles committee (apart from MW and Sears), five had balances in their deferred tax credit account relating to installment receivables that were equal to or exceeded 15% of their total current liabilities, excluding the credit, at the end of their 1964-1965 fiscal years: J.C. Penney Company, Inc. (16.8%), Broadway-Hale Stores, Inc. (18.8%), May Department Stores Company (20.3%), Miller & Rhoads, Inc. (48.9%), and Rich's Inc. (50.6%) . Five of the other companies disclosed that they had balances of less than 15%, while no information is available for the remaining three companies.[15]

One reason why retail companies objected to the current classification of the deferred tax credit was that it did not represent a current claim on liquid assets and, thus, would give a misleading impression of a retailer's ability to meet its financial obligations. It would also place such companies in an awkward position because of the working capital requirements stipulated in their bond indentures.[16]

In correspondence among board members following issuance of the exposure draft, the two Big Eight firms that were known to be unsympathetic toward tax allocation, mentioned

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[13]letter from J.R. Janssen, chairman of the Panel, to Richard C. Lytle (APB administrative director), dated September 15, 1965

[14]letter from K.S. Axelson, chairman of the committee, to Richard C. Lytle, dated September 15, 1965

[15]These percentages were developed from ProQuest's Historical Annual Reports service and from *Moody's Industrials* for the year 1966. Because of the unavailability of the other three companies' annual reports and their omission from *Moody's Industrials*, it was impossible to determine how much of the balances in their deferred tax credit account, if any, was attributable to installment receivables.

[16]letter from Malise L. Graham, of the New York law firm of Faulkner, Dawkins & Sullivan, to William D. Hall, a partner of AA, dated March 30, 1966

above, made known their disagreement with paragraph 13. In retrospect, it is surprising that they assented to the provision during the June meeting of the board. Board member Herman W. Bevis, the senior partner of Price Waterhouse, recommended that the paragraph be deleted, as it was not clear, he said, whether the deferred tax credit was a liability at all, even though it must be shown on the liability side of the balance sheet. He believed that it was, in essence, only a contingency.[17] Bevis said he had canvassed his partners for their views, and it seems likely that his partners had in turn canvassed the views of their retail clients. Haskins & Sells submitted a memorandum in which it also opposed the provision, as it believed that the amount might never fall due. The firm said that the balance in the deferred tax credit account might constantly grow and, thus, may never mature as an amount to be paid. The firm conceded that it would be more theoretically defensible to classify the deferred tax as a current liability if it were expected to mature within one year from the balance sheet date. The firm also argued that the board's proposed reclassification goes beyond prevailing practice. Furthermore, it said, any such recommendation should await completion of the research studies on current assets and liabilities and on tax allocation accounting.[18] Letters submitted by the board members from Ernst & Ernst (E&E) and Lybrand, Ross Bros. & Montgomery (LRB&M), which were two of the other Big Eight firms, did not mention the proposed reclassification in paragraph 13.[19]

At the board's next meeting, on September 16-17, 1965, it reversed its unanimous approval of paragraph 13. The board voted 14-2 to delete the provision on the classification of deferred tax "on the condition that a subcommittee would be appointed to consider the subject."[20] It was the only item in the exposure draft that the board deleted in its entirety [Lytle, 1965, p. 72]. George Catlett "objected strenuously to deferring this question" [Olson, 1966, p. 61]. Richard C. Lytle [1965, p. 72], the board's administrative director, gave the following reasons for the board's action:

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[17]letter from Herman W. Bevis to Reed K. Storey (AICPA director of accounting research), dated August 9, 1965

[18]memorandum attached to the letter from Oscar S. Gellein to Richard C. Lytle, dated September 10, 1965

[19]letters from Hassel Tippit (E&E) to Richard C. Lytle, dated July 20, 1965, and from Philip L. Defliese (LRB&M) to members of the APB, dated September 13, 1965

[20]AICPA – APB, minutes of meeting, September 16-17, 1965, p. 4.

> Unlike other changes proposed in the exposure draft, this paragraph was directed to a matter not specifically covered in the ARBs and its inclusion would have been consistent with what appears to be the more predominant accepted practice currently.

He added that it could have "important implications with regard to the broad area of accounting for income taxes," a subject on which a research study was being completed (which had been in preparation since 1961). One major question, he said, was "whether deferred income taxes are a 'deferred credit' or a 'liability'." This last point, which had been debated for years, was probably significant in crippling the effort to classify the deferred tax, if only in defined circumstances, as a current liability. In its *Executive Letter* to partners and managers, Price Waterhouse said: "The APB decided to omit the [reclassification] requirement from Opinion No. 6 largely because it was out of context with an opinion having the avowed purpose of revising existing pronouncements in order to 'obviate conflicts between present accepted practice and provisions of outstanding Bulletins'" ["Special Bulletin…," 1965, p. 4].

AA's Catlett was convinced that the reversal was a clear result of client pressure brought on the firms, whose board representatives had not realized in June how large the impact of the reclassification might be on their clients' balance sheets.[21] Not surprisingly, the paragraph had met with considerable opposition from retail industry commentators on the exposure draft, including a number of major companies, such as Broadway-Hale Stores, Sears, Spiegel, and MW, which wrote separate letters apart from the letter from the NRMA.[22] Many of those opposing the paragraph on classifying deferred tax criticized the precedent of linking an item on the liability side of the balance sheet with one or more classes of assets; instead, they believed that the deferred tax should be classified according to when it will be liquidated. Others questioned whether the deferred tax would ever actually be paid, and, thus, they saw no ground for requiring that it reduce working capital. Some said that the reclassification went beyond the scope of the pronouncement, which was to determine which pre-existing positions in the *ARBs* were to be regarded as still in force. *Opinion No. 6*, "Status of Accounting Research Bulletins," was published in October

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[21]interview with George R. Catlett, May 3, 1978

[22]These separate letters were in the batches of comment letters conveyed to the board by Richard Lytle.

1965 and reproduced in the November issue of the *Journal of Accountancy*.

AA PETITIONS THE SEC

On October 1, 1965, two weeks after the board meeting at which paragraph 13 was deleted, AA petitioned the SEC to issue an *Accounting Series Release* (*ASR*) that would classify the deferred tax arising from current assets such as installment sales receivable as a current liability. AA knew, of course, that SEC Chief Accountant Andrew Barr had advised the APB that he favored such a classification. And, as mentioned above, SEC Chairman Cohen had been railing against the diversity in accounting practice. The firm had reason to believe that the SEC might be sympathetic to its cause. Yet it privately harbored doubts that the SEC would act favorably on its petition.[23]

As was the SEC's practice in such matters, AA's petition was held in confidence, except that Barr notified Richard Lytle, at the board, that AA had filed the petition. Barr inquired if the board might be able to act on the deferred classification by November 15, which was viewed as the deadline for the SEC to publish a proposed accounting rule that, after a 30-day exposure period, could be adopted in time to apply to financial statements ending on or before December 31. At Lytle's request, and with the acquiescence of Barr, AA provided the APB with a copy of the petition for confidential circulation to the board members. The board's planning subcommittee met on October 22. It concluded that the subject was too complex for the board to be able to act on the matter by the end of 1965.

Contrary to what some might have expected, namely, that AA would publicize its petition to vaunt the role it was playing to achieve greater uniformity in financial reporting, the firm rarely mentioned its authorship of the petition in its publications, and only well after the event.[24] Chief Accountant Barr had advised AA that the Commission would prefer that the firm not publicize the petition until it was acted upon, and the firm complied.[25]

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[23]interview with George R. Catlett, September 3, 1970

[24]The only two mentions the author has found are in Olson [1966, p. 61] and AA [1969, p. 67]. Spacek did not mention the petition in his speeches. The author can find no other mentions in the literature of AA being the source of the petition. Cohen [1966, p. 59] said that "a leading accounting firm" had petitioned the SEC but did not name the firm.

[25] interviews with George R. Catlett, September 3, 1970 and May 3, 1978

THE SEC CONFERS WITH A DELEGATION FROM THE APB

In November 1965, the SEC invited the APB to send a delegation to meet with the five members of the Commission to discuss the AA petition. The four members of the APB's planning committee, composed of Chairman Clifford Heimbucher, Herman Bevis (Price Waterhouse and APB vice chairman), John Queenan (Haskins & Sells), and Frank T. Weston (Arthur Young & Company), accompanied by two senior staff members, attended the conference. All four of the APB members in attendance were practitioners who were held in high regard for their serious dedication to the development of accounting principles. The hour-long meeting was held in the SEC's offices in Washington on November 22. SEC Chairman Cohen presided, and Chief Accountant Barr attended.[26] It was one of the rare occasions on which the Commission met formally with members of the APB, and it was rarer still for such a meeting to be recorded on a stenographic transcript.[27] In his prepared remarks, Cohen made it known that the Commission's staff had "as early as August, 1950 recommended to a committee of the American Institute of Accountants to take a firm position" (p. 3) in the matter of the classification of deferred tax in such cases. He added: "The increasing incidence of these practices and the growing significance of the amounts involved convince us that the petition is right in urging us to act now rather than to tolerate further delay which your procedures would seem to require" (p. 3).

Cohen quoted from the AA petition as follows:

> Some companies which have heretofore included the deferred taxes in current liabilities have changed the classification to noncurrent liabilities. Other companies (some of which are our clients) are now taking the position that they will change the classification to noncurrent at the end of the current fiscal year if other companies are permitted to continue the noncurrent classification. This represents a retrogression in ac-

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[26]"In the Matter of Conference with Representatives of the Accounting Principles Board re: Arthur Andersen & Co. Petition," Official Transcript of Proceedings before the Securities and Exchange Commission, Washington, D.C., November 22, 1965 (ACE-Federal Reporters, Inc, Official Reporters). Quotations from this transcript will be indicated by page number.

[27]On December 21, 1962, following issuance of the board's controversial *Opinion No. 2* [APB, 1962] on the investment tax credit, a delegation from the board met in Washington with four SEC Commissioners and several SEC staff members, but, as far as is known, no transcript was prepared.

counting which occurs when such alternative practices exist.

Cohen stated that the SEC's staff had already drafted a proposed release that would effectuate the AA petition, but that, before issuing the release, the Commission wanted to have the benefit of hearing the comments of the APB's delegation. And then he bluntly expressed his unhappiness with the board's performance and issued a thinly veiled threat (pp. 4-5):

> ...before we hear your comments I do want to take this opportunity to observe that this Commission, as you know, has been quite patient with the efforts of the accounting profession to solve a number of accounting matters as to which questionable alternative solutions have been accepted for some time. I am sure you are aware that, we and important persons in other parts of Washington, hear and receive many complaints that the profession seems unable to come to grips with the problems and to adopt solutions, even though extensive studies have been made and published.
>
> As you know, we have certain statutory responsibilities. It has been suggested strongly that if you cannot or will not move with reasonable dispatch to cope with these issues, we should. Now, while our patience has not been exhausted and we believe that cooperation with the Board has been most helpful and should continue, I wish to make the point that we do have a responsibility and that we do have to account for it.

In reply, Heimbucher stated that the board's decision to drop the paragraph on deferred tax from *Opinion No. 6* [APB, 1965] was that it had become controversial and that the pronouncement had to be issued with dispatch. He added that "some of those who voted to remove it from the bulletin at that time did so on the condition that a committee of the Board be appointed immediately to deal forthwith with this question" (p. 8). He said that he expected a three-man committee to report in time for the board's next meeting, in December, "and it is our earnest belief that we will be able to reach a conclusion on this during 1966, allowing for all of our exposure requirements, which take two or three months, and then a final ballot on the draft" (p. 9). Heimbucher hoped to persuade the SEC not to issue its release. Cohen then reminded the board members that the issue concerning the Commission is a larger one, namely, that "the profession finds great difficulty in arriving at solutions to problems which, albeit difficult, nevertheless appear to be subject to solution" (p. 10).

Herman Bevis pointed out that "these questions are far more difficult and far more complex than those you can state in rather simple form, and I myself believe, and I think you would agree, that what we are looking for is not just any solution which can't stand up in trial very long. We are looking for sound solutions" (p. 11). Cohen replied that he shared Bevis' view, but "as I pointed out this problem was addressed with a certain amount of conviction by our Chief Accountant 15 years ago, and I would think anyone would agree that is a reasonable period within which to find a solution" (p. 11).

John Queenan emphasized that the APB's program of research studies was now coming to the stage where the board will become more active in issuing *Opinions*. On the matter of income tax allocation, he said that he was one of those who did not consider it as a liability. To have approved the deferred tax as a current liability in some cases would, he said, have prejudged the outcome of the research study on tax allocation accounting that was still in preparation. Queenan also doubted that it was as urgent a matter as AA had argued, as he believed that the predominant practice was to show the deferred tax "outside of current [liabilities]" and that there are relatively few companies showing it as current. Hence, he implied, there would be few occasions for switchovers.

Chairman Cohen said he had no reason to question that the board could resolve the issue in 1966, but "I don't know how your resolution will come out...." (p. 18). It was clear to everyone that the Commission had made up its mind on the matter.

Herman Bevis, who was no more sympathetic with the current liability classification than was Queenan, proceeded to argue a point that could be described as *reductio ad absurdum*. He cited Spiegel Co., which showed $120m of long-term debt and only $30m of noncurrent assets. He then proposed that, if the deferred tax associated with installment receivables (a current asset) should be shown as a current liability, "it immediately raises the question of whether 90 of the 120 million of the long-term debt shouldn't also go up there, because it has to apply to something on the current asset side"[28] (p. 19). Chairman Cohen dismissed the argument peremptorily, as if everything

[28]This same point was made by a number of commentators on the exposure draft.

on the right side of the balance sheet should be linked to everything on the left side. This strained argument by Bevis could not have given Cohen confidence in the board's ability to solve the deferred tax problem. Then Bevis argued that most of the companies that show the deferred tax as a noncurrent item are the ones where the amount is the most significant, while those that show it as a current liability claim only small amounts, as if to suggest that the issue is not all that important. Amused at Bevis' analysis, Chairman Cohen interjected, "May I partially in jest – I hope it will be so understood – say that I draw from what has been said that where the amount is not material and really can't affect the current ratio very much they assign it to the current section, but where it is material and could affect the current ratio it is assigned elsewhere. Is that too unfair a suggestion?" (pp. 21-22). Bevis was not able to disagree with this reconstruction of his argument as an opportunity for manipulation.

Cohen then ventured the view that the Commission's draft release, being an interpretation of existing requirements, could be issued forthwith, without any prior exposure. He said he was interested in issuing the release in time to affect financial statements for the year ending December 31, 1965. Cohen also expressed exasperation with the board's process: "there ought to be an end to all the studies and all the committees that review the work of prior committees, and someone ought to decide something" (p. 25).

In the course of the discussion, Heimbucher and Weston said they would classify deferred tax as a liability, while Queenan and Bevis had taken the other side. These matched pairs could not have filled Chairman Cohen with confidence that the board would successfully resolve the issue, even in 1966.

At the end of the meeting, Heimbucher and Weston urged the Commission not to act in a way that would reflect unfavorably on the standing of the board, and Cohen expressed sympathy with their view. In fact, in a speech delivered eight days later, he was reassuring on this point. Cohen [1965, p. 11] said:

> We are now considering some limited action of our own [on accounting] – action which is not designed to undermine the efforts of the leaders of the profession but rather to emphasize to the entire profession the urgency of immediate and effective support of those who are seeking sound procedures to obviate unjustified differences in the treatment and presentation of similar problems.

THE SEC ISSUES *ACCOUNTING SERIES RELEASE NO. 102*

On December 7, 1965, the day before the next APB meeting, the SEC issued *Accounting Series Release No. 102*, "Balance Sheet Classification of Deferred Income Taxes Arising from Installment Sales."[29] In the release, the Commission said: "Where installment receivables are classified as current assets in accordance with the operating cycle practice [citing *ARB No. 43*, Chapter 3A], the related liabilities or credit items maturing or expiring in the time period of the operating cycle, including the deferred income taxes on installment sales, should be classified as current liabilities." The SEC made no mention in the release of AA's petition or of the fact that the matter had been under study by the APB.

Although AA had asked in its petition that the rule take effect for fiscal years beginning after December 31, 1965, the SEC opted for a much faster implementation. The rule would apply to fiscal years *ending on or after* December 31, 1965. Catlett had informed Chief Accountant Barr of his firm's "deal" with MW, and he told Barr that if the SEC's rule were not to take effect until 1966 fiscal-year reports, MW and others in the small minority of retailers who were classifying the deferred tax liability as current would all switch to noncurrent in their 1965 reports. Catlett believed that this argument may have been a factor in the SEC's decision to accelerate the effective date.[30]

THE AFTERMATH OF *ACCOUNTING SERIES RELEASE NO. 102*

At the outset of the meeting of the APB on December 8-10, 1965, Chairman Heimbucher handed out confidential copies of the transcript of the meeting with the SEC and said that, at the time of the meeting with the SEC, the members of the APB's delegation were "certain" that the Commission would proceed to issue its draft release.[31] Heimbucher then quoted from SEC Chairman Cohen's remarks during the meeting that the board is taking much too long to solve the problems before it. Heimbucher was trying to impress on the members that, if the board

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[29]Publication of the release was reported in "SEC Acts to Make Concerns More Uniform in Handling of Assets-Liabilities Accounts," *Wall Street Journal*, December 8, 1965, and in "SEC Prods Accountants," *Business Week*, January 15, 1966, p. 102.

[30]interview with George R. Catlett, dated May 3, 1978

[31]AICPA – APB, minutes of meeting, December 8-10, 1965, p. 2

did not begin to act more expeditiously, others, such as the SEC, would fill the void. Following the board's three-day meeting, George Catlett reported to his partners that he detected more of a sense of urgency about achieving constructive and effective progress than had ever existed since the board's inception. Not surprisingly, he said he noticed a degree of resentment toward AA on the part of some members, yet the salient point was that the impact on board members of the encounter with the SEC was palpable.[32]

Two members of the APB's research staff recalled that an effect of *Accounting Series Release No. 102* was that the board became more careful to include in exposure drafts only those views for which there was strong support.[33]

At a later point in the board's meeting, some members thought it would be desirable for the board to state publicly that it was not in conflict with the SEC over *Accounting Series Release No. 102*. The board therefore voted to authorize the administrative director to publish a statement in the *Journal of Accountancy* ["SEC Issues Opinion...," 1966] that it was "in substantial agreement with the position of the SEC." Yet the informal vote to do so was 11-5, a bare two-thirds majority.[34] The statement appeared in the January 1966 issue. While there apparently were only a few board members who disagreed in principle with the position espoused in the SEC's release, other board members had procedural concerns, including the belief that the board should not express a view on the classification question until the research study on current assets and liabilities, and perhaps also that on income tax allocation, were completed.

In April 1966, Kenneth S. Axelson, the financial vice president of J.C. Penney Company and chairman of NRMA's accounting principles committee, attacked *Accounting Series Release No. 102* in a letter to the *Journal of Accountancy*. He said that the NRMA had petitioned the SEC to delay the effective date of the release by three months, but that its petition was denied [Axelson, 1966, p. 27].[35]

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[32]memorandum by George R. Catlett to his partners in AA, dated December 15, 1965

[33]interview with Reed K. Storey and Paul Rosenfield, August 1970

[34]AICPA – APB, minutes of meeting, December 8-10, 1965, p. 9

[35]Perhaps because of a belief that the retail industry should be better represented on the APB, the Institute's executive committee appointed Axelson to the board in 1968.

In May 1966, Leonard Spacek [1966, p. 381] said in a speech that "the SEC came to the rescue of professional accountants ... while the accounting profession remained in an immobile state of indecision." On the other hand, Herman Bevis [1966] criticized the SEC's release as supporting uniformity of method over genuine comparability in financial reporting.[36]

By coincidence, in early December 1965, AA published a 42-page booklet, *Establishing Accounting Principles – A Crisis in Decision Making*, in which it criticized the APB for its ineffectiveness in narrowing the areas of difference in accounting practice. Copies of the booklet were distributed at the APB's meeting on December 8. AA [1965, p. 28] argued in the booklet that the APB should take steps "to deal with current problems on a timely basis and carry out its responsibilities in a truly professional manner." AA called for the establishment of a U.S. Court of Accounting Appeals in order to promote the uniformity of accounting practices prescribed by U.S. federal regulatory agencies, including the SEC [see "Accounting Court...," 1966]. At the board's meeting, Chairman Heimbucher took the time to quote from SEC Chairman Cohen's strong remarks during the hearing as well as from AA's charge to the APB to improve its effectiveness. The minutes of the board meeting reported that "Mr. Heimbucher stated that he quoted from these documents to emphasize the necessity for action on the part of the Board in dealing with accounting principles and to stress that, if the Board does not, other groups will assume the responsibility."[37]

George Catlett, who was a member of the APB from 1965 to 1971, said that the SEC's release was the event that prompted the board to begin taking difficult decisions on matters that would change prevailing practice, and to begin paying more attention to the SEC than to their clients.[38]

For his part, SEC Chairman Cohen [1966, p. 59] sent a strong message to the APB in a speech in May 1966. He said that *Accounting Series Release No. 102* was an example that "Stronger leadership by the Commission is one avenue being followed" in moving toward the goal of uniformity in accounting practice. He added:

> Although Accounting Series Release No. 102 was used to resolve one problem of uniformity, I do not be-

[36]See also the searing criticism of the release by Theodore Herz [1966], one of Bevis' partners.

[37]AICPA – APB, minutes of meeting, December 8-10, 1965, p. 3

[38]interviews with George R. Catlett, September 3, 1970 and May 3, 1978

> lieve it will be necessary for us to use that device with great frequency—although the option is always open to us. The extent to which action on our part is required will depend in large measure on the vigor and determination of the Accounting Principles Board. . . .

In December 1967, the APB issued *Opinion No. 11*, "Accounting for Income Taxes," which, in paragraph 57, explicitly adopted the SEC's position in *Accounting Series Release No. 102*. The APB really had little option but to do so. Three board members dissented, saying that this treatment "would contribute to a lack of understanding of working capital, because of the commingling of contingent items with items which are expected to be realized or discharged during the normal operating cycle of the business."[39] The *Opinion* passed by the barest two-thirds majority, 14-6.

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[39]The dissenting board members were John P. Biegler of Price Waterhouse, Sidney Davidson of the University of Chicago, and John Queenan of Haskins & Sells. All three members also dissented to the overall requirement for income tax allocation.

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