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# The fall of management accounting: The NIRA and the homogenization of cost practices in the U.S.

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# **The Fall of Management Accounting The NIRA and the Homogenization of Cost Practices in the U.S.**

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**The Fall of Management Accounting  
The NIRA and the Homogenization of Cost Practices in the U.S.**

**Abstract**

This paper explores the impact of societal trends on cost practices, and the management techniques used to support business structures, within the United States. Specifically, the influence of the National Industrial Recovery Act [NIRA] on the development of the costing and pricing policies is explored from the perspective of social rule system theory. The premise of the paper is that the NIRA, as enforced through the symbol of the "Blue Eagle" displaced the free market economy in the United States. This resulted in a pseudo-competitive market structure where full cost recovery and the earning of a fair and reasonable profit became the basis for market pricing and business management. The displacement of the competitive market by the NIRA is argued to account for the apparent loss of relevance in modern costing theory and practice during the mid- to latter part of the twentieth century. It is also contended that these practices may have enhanced the shocks to the U.S. economic associated with the global marketplace. The paper concludes by suggesting that relevant management accounting theory has to be reconstructed within a competitive market framework that reflects key drivers of competitive advantage.

## **The Fall of Management Accounting The NIRA and the Homogenization of Cost Practices in the U.S.**

The last two decades of the twentieth century witnessed an intense dialogue surrounding the relevance of current management accounting and control systems. There has also been a plethora of suggestions made about how best to "fix" these ailing systems (Johnson and Kaplan, 1987; Cooper, 1989; Johnson, 1992; Shank and Govindarajan, 1993; Noreen, et.al., 1995). Throughout this dialogue, the focus has been on how to adapt accounting-based calculative practices to better provide the type of information needed by companies competing in the global marketplace. The economic impact of globalization provides the backdrop for the urgency and thrust of the messages delivered by these "new accountants." Unless changes are made to our "accountings", they argue, the future will be bleak indeed.

It is clear the world that accounting serves is undergoing significant changes. The rapid decline of major industries (e.g., steel, electronics, and automobiles), the displacement of major segments of the working population, and the loss of competitive power caused by the onslaught of foreign competition are just a few of the powerful forces reshaping business practices in the U.S. The radical upheaval in the American market that has followed on the heels of developing global markets harkens back to an earlier time of crisis in U.S. economic history: the Great Depression of 1929. Both of these events represent significant shifts in the economic stature and health of the United States. It will be argued here that these two periods are linked in many ways. Specifically, it will be suggested that the market rules (formal and informal) set down in response to the economic crisis of the Depression may have set the stage for the apparent failure of the American economy to rapidly adapt to the demands of the global market.

To develop this argument, the paper explores the history of the National Industrial Recovery Act [NIRA] including its *de facto* continuance through an informal social

mechanism (the Blue Eagle) and subsequent war-based price stabilization boards.<sup>1</sup> Having presented the historical framework of the research, the paper then examines the overall impact these combined forces may have had on the *laissez-faire* capitalistic structure that lay at the heart of the market mechanism formed in the U.S. during its early history. Using the logic of social rule system theory (Burns and Flam, 1987a, 1987b; Burns, 1986), and the phrases and thoughts from original source documents from the period of the "New Deal" and the NIRA, this paper will explore the displacement of the competitive market, and the consequent abandonment of economically sound theories of cost, that this macro-economic movement entailed.

By providing a historically- and economically-based analysis and explanation for the proliferation of full cost recovery practices, and the subsequent abandonment of economic, or market-driven, theories of cost, this paper stands to make a major contribution to our understanding of the historical development of management accounting and control practices. This enhanced understanding may support a constructive dialogue about the underlying assumptions, and implications, of the full cost recovery model and its potential for hampering the competitiveness of American companies in the global economy.

### **The Depression and New Deal: A System Rule Theory Perspective**

Social rule theory focuses on the development of markets as defined by the context, or cultures, in which they emerge (see Figure 1). This growing body of literature explores the socio-political processes relating to the maintenance and change of markets and related rule regimes (Burns and Flam, 1987a). According to social rule theory, market rule formation can occur through legal and administrative acts created and implemented through political and government processes, by the collusion of groups of sellers and/or buyers who establish rules of market entry and rules for procedures and transactions, by the influence of norms, including informal rules, that are supported by a status group, and

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<sup>1</sup> Two primary price control boards were used in the United States during the 1941-1953 period. The Office of Price Administration (OPA) was in existence from 1941-1945 as part of the President's emergency war powers. The OPA was in all key practices and procedures a continuance of the NIRA. During the Korean War a similar form of legislation, the OPS (Office of Price Stabilization) again imposed significant aspects of the NIRA on the American economy.

through the granting of credit and access to contracts within the economic system. As noted by Burns and Flam (1987a), such market rules affect transaction costs as well as imply that there will be the potential for increased prices due to the impact of these social rule-based agreements on the supply and demand relationships within a market.

At the heart of the argument that market relationships can be shaped by social rules rather than economics is the belief that "markets are social organizations, structured and regulated by more or less well-defined social rule systems" (Burns and Flam, 1987a: 125). Burns and Flam go on to suggest that there are two basic ways that this market organization may be brought about (Burns and Flam, 1987a: 127):

1. **Strategic structuring**, informal or formal, whereby social agents, including the state, establish a rule regime regulating market access and transactions.
2. **Emergent structuring**, whereby participants discover or adopt certain similar strategies within bounded rationality and situations with certain opportunity structures and incentive structures. Social network and ecological properties result in relatively well-defined aggregate performance characteristics.

Social rule theory, then, provides a useful framework for analyzing the development of markets, as well as providing insights into the forces that can bring about changes in the social structuring, or rule systems, that govern their functioning (see Figure 1).

[Insert Figure 1 about here.]

### **Social Rule System Theory and the Creation of Markets in the United States**

A *laissez-faire* free market structure is one of the defining features of the capitalistic model developed and used to frame transactions within the United States during its early years (Brand, 1988). Prothro (1954), writing about this period, emphasizes that this formative period in the American economy was characterized by traditional business concerns with economic liberty and the preservation of private property, without a hint of any orientation toward, or desire for, increased business-government relations. Consistent with the "rugged individualism" that defined the developing social structure of the United States, the American marketplace and the businesses that comprised it were left to function with minimal interference from outside forces.

The resulting "neo-classical" market model (Baker, 1984) within the U.S. was built upon a minimal set of market rules, open micro-networks and undifferentiated macro-networks of buyers and sellers as the basis of its structuration. Facing minimal transaction costs and situational constraints, such a neo-classical market is depicted as one of "hyper-rationality" that is based on the tacit agreement of rule-abiding participants for its functioning (Baker, 1984). In other words, within the neo-classical structure, there is no reason to expect standardization in costing or accounting practices, unless such standardization supports the efforts of the micro-networks of buyers and sellers in reducing their market transaction costs (Burns and Flam, 1987a, 1987b; Burns, 1984).

At the heart of the cost debate was a belief that customers would not pay a company for its waste. This theme—the need to separate productive cost from various forms of waste—led to a heated debate on the proper treatment of the cost of idleness in 1919. What is of interest to this research effort is not the topic of idle capacity cost, but rather the fact that “cost” as a construct appears to serve a central role in management decision-making and analysis. In other words, the various forms of cost accounting that existed during the early 1900s, and the management practices that they supported, were driven by the need for information to make decisions within the organization, not by government or professionally-defined accounting rules. Cost was perceived as a concrete representation of economic reality.

### **Market Structuration and the NIRA**

By 1933, the United States was in the fourth year of the most serious economic depression it had ever faced. As suggested by Lyon, et.al. (1935), it is this crisis that led to the election, and installation, of a new Administration that was skeptical of the rugged individualism of the past and convinced that a greater degree of collective action was the solution the ailing economy needed. The term "New Deal" became the hallmark phrase denoting the policies, rules, regulations, and sanctions that were to reshape the market structure of the United States.



One of the central pieces of legislation of the "New Deal" was the National Industrial Recovery Act, or NIRA. The NIRA targeted the perceived "predatory competition" of the pre-Depression era that was argued by Roosevelt and his followers to be the major cause of this market failure (Johnson, 1935: 160). Coupled with an increasing concern for the advancing "rationalization" of American industry between 1922 and 1929 (e.g., the displacement of men by machinery; Lyon, et. al., 1935: 6), a defensible basis for redefining the rules of the marketplace was defined. The result was an attack on free market competition, the perceived causal factor in the economic collapse.

The NIRA was the backbone of this anti-free market movement, representing a visible and direct development of rules to reshape the market economy (Brand, 1988; Lyon, et.al., 1935; Johnson, 1935). One of the main enforcing mechanisms of the NIRA, as defined and structured by Hugh Johnson, its director, was the development of a broad number of cost protection codes. In all, 352 separate code items dealing with the concept of "cost" were developed during the two short years the NIRA functioned (Lyon, et.al., 1935).

Developing uniform costing practices, then, served as the backbone of the NIRA's attack on the perceived inadequacies of the free market structure. And it was not simply any form of costing which was to serve this purpose--it was full cost recovery that became the "accepted" means of measuring, and hence setting prices on the basis of, incurred costs. The implications of this change in the role, and method, of costing was clearly noted and understood by those shaping the economy as detailed by Lyon, et.al. (1935: 588):

“It is highly probable that in every instance in which the NRA guaranteed cost protection to industries it was expected that such protection would bring about a price higher than the competitive price. It is needless to say, therefore, that it is in effect price fixing. Unless the cost systems, the use of which was required by individuals, included elements of cost that **were not being earned** (emphasis added), there would be no demand on the part of industries for such provisions. The precise extent to which no-sales-below-individual-cost provisions bring prices above competitive prices depends in part upon the elements included in costs ...An analysis of the first 16 accounting systems approved indicates that in each cost system

elements of "cost" specified not only direct labor and material costs, but a large proportion of indirect manufacturing expenses ....."

It would appear that within the formation and functioning of the NIRA, full cost recovery practices were to play a pivotal role in redefining the competitive market place. As such, then, the NIRA appears to provide a potential explanation for the apparently radical, and troubling, shift away from a rich, economics-based theory of costing, as detailed and promoted by Church (1930), Gantt (1915), and Clark (1923), toward the modern accounting-centered system. It was a change designed, not to improve business performance, but rather to radically change the structure of the *laissez-faire* free market system that was the foundation of the American economy.

### **Reforming the Market: The Blue Eagle Takes Off**

At this point it is important to acknowledge the transitory nature of the NIRA. Signed into "law" as a temporary action in June of 1933, the NIRA was terminated in 1935 on the heels of a series of legal and legislative battles that brought its constitutionality directly into question, as suggested by the following: "The NIRA was declared unconstitutional as an excessive delegation of law-making power to private groups and government agencies" (Lowi, 1971: 75). Cut short by the Supreme Court's decision in the *United States v. Schechter Poultry Corporation*, the NIRA faced growing resistance from big-business during 1934 and 1935, and was ultimately abandoned (Brand, 1988).

To the casual observer of the period, then, the NIRA is a transitory blip in the operation of the free market that had some interesting cost implications. The framers of the NIRA, though, were not so naive in their attempts to reshape the economy. While the formal legislative structure of the NIRA was dismantled, it was not the only way the Act, and its intentions, were enforced. Specifically, the development of the National Recovery Administration (the administrative arm of the NIRA) by Hugh Johnson was framed around the use of a symbol: The Blue Eagle. It is the Blue Eagle, and its ongoing use throughout the period leading up to and immediately after World War II that provides the second, and perhaps most interesting, part of the unfolding drama.

Burns and Flam (1987a) make a point of stating that unwritten rules and informal norms are one way that rule regimes can pursue the active shaping of supply and demand curves through the active determination of, or interference with, market prices. In other words, it appears possible that the influence of the NIRA on both the market, and the costing practices which defined it, may have remained in force through the operation of an informal set of rules that were conveyed through the Blue Eagle symbol.

### **Business and New Deal Economics**

Pulling the threads of the argument together, it appears that the Blue Eagle provides a mechanism for the continued influence of the NIRA beyond 1935, including its pursuit of uniform costing methods as embodied in full cost recovery. To gain acceptance from business, though, the increased costs of doing business inherent in the New Deal legislation had to pass through to the public in the form of price increases that effectively moved prices above the competitive market level. In order to create acceptance of the NIRA by business, companies were allowed to pursue a "reasonable profit" based of full cost recovery of both "earned" and "unearned" costs (Lyon, et.al., 1935). In other words, in agreeing to abide by the NIRA, and to signal this adherence through display of the Blue Eagle, business was awarded with a guaranteed profit, or return, on all of its costs, whether value-adding or not.

The implicit agreement to overturn the market as the basis for price setting, replacing it with a full cost recovery plus "reasonable profit" mode of operation, is the essential element of the NIRA and its impact on the extant market economy of pre-1933 America. As noted throughout the texts of the period, the goal of the NIRA was to define the concept of "fair" competition, and to weed out the predators that were charged with the destruction of the economy. In essence, the businesses who prescribed to the NIRA, and its symbol (the Blue Eagle) agreed to disengage from the market-based pricing mechanisms that formed the basis of the neoclassical, *laissez faire*, form of market competition, replacing it with a "full cost plus reasonable profit" price mechanism. Cost accounting practices played a constituent role in shaping the New Deal economy and its pseudo-competitive market structure.

By tacitly agreeing to compete on a cost-based definition of market value, or price, business was creating a safety net for itself that would effectively remove it from the harsh realities of the free market system. The redefinition of price to reflect full cost recovery plus "reasonable profit" on the basis of full cost provided business with a means to stabilize and improve its financial performance. In its early phases, then, the NIRA was supported by business because business itself stood to benefit.

### **The Blue Eagle, Full Costing, and Its Implications**

The key to the reforms driven by the NIRA was the intense desire to get people back to work (Slichter, 1934; Richberg, 1934; Johnson, 1935). This can hardly be faulted as a reasonable goal given the dire straits the American economy found itself in. Hooked to the various efforts to increase both employment and wages e.g., the Works Progress Administration, the creation of the Securities and Exchange Commission, and a large number of public works, the New Deal's attack on the free market system was consistently driven by the belief that the essence of a fair, and sustainable, market economy lay in the full employment of all citizens. People were desperate for work, and businesses were desperate for consumers with the funds necessary to purchase their goods. It was not a time for lofty ideals; it was a time for action (Johnson, 1935; Richberg, 1934).

Yet, the Blue Eagle, and the cost-based, pseudo-competitive market structure that emerges from this period had several troubling implications. The first of these is most effectively captured by simply reprinting a cartoon found in Johnson's autobiography (Johnson, 1935: 229; see Figure 2]. As can be seen, Hugh Johnson is depicted as removing feathers from the American Eagle in order to create the Blue Eagle. There is no more striking evidence of the underlying intent of these self-appointed architects of the New Deal economy.

[Figure 2 about here.]

Herein, then, lies the primary issue and concern represented by the NIRA and its "enforcer," the Blue Eagle: They appear to have sought to undo the democratic state. This may seem like an overstatement of the facts presented so far, but the juxtaposition of the

NIRA, the concept of "rugged individualism," and laissez-faire capitalism, the dominant social rule system of the United States preceding the New Deal, was consciously made by Johnson. A cost-based, and governmentally-defined, economic structure was the solution sought, and effectively implemented, through the NIRA and the Blue Eagle.

Full cost recovery accounting methods played a major role in this quest to reshape the overall nature of American social and economic structures (Lyon, et.al., 1935; Johnson, 1935). This non-market based costing model became the basis for competition, for the definition of "market price", and the definition of value-added, and waste, within the post-Depression economy. As long as all industrialists agreed to adhere to this costing ideal, which in fact it was in their self-interest to do, the economic order would be restored and all would benefit. This was the underlying logic that drove the New Deal proponents. As Roosevelt stated, "the NIRA was to restructure the economy for all time." And perhaps it might have, had the United States been able to avoid, or defend itself, against the onslaught of the global marketplace.

### **The Fall of Management Accounting**

The NIRA and the Blue Eagle have been argued to represent an intentional form of restructuring of the American economic system away from laissez faire, or free market capitalism, to a more general political economic model (Burns and Flam, 1987a,b) premised on government interference in markets. Reinforcing these formal policies was the adoption of informal norms that suggested that full cost recovery become the basis for setting "fair" market prices (Lyon, et.al, 1935; Johnson, 1935). In this process, the rich history of economics-based costing, which argued that the market equilibrium price would not accommodate excessive levels of cost or waste, appears to have fallen into disuse. And, as suggested, it may have resulted in an almost religious adherence to full cost recovery-based pricing and its assurance that a company will earn a reasonable profit. As such, the NIRA and the Blue Eagle appear to result in a major market fracturing and reconstruction of the guiding social rule system within the United States economy.

This argument suggests a logical explanation for the apparent mass amnesia that surrounds management accounting today. Specifically, the rich history of dialogue surrounding the economics of cost that defined the pre-1933 world of accounting would appear to have no ultimate demand, or purpose, in a market system that defines *competitive price* as what a company spends plus a fair return. Such a mass amnesia, or ignorance argument, though, is normally troubling. What is missing in a mass ignorance argument is motive and force. In exploring the accounting literature in the twentieth century, the marked fissure in the literature is striking. It is clear that the existence of some powerful, all-encompassing force is necessary to explain why the wisdom of writers such as Church (1930), Gantt (1915) and Clark (1923) falls into disuse, and ultimately, disappears from modern management accounting literature.

Many have argued that the SEC Acts of 1933 and 1934 were responsible for this decline in management accounting (Johnson and Kaplan, 1987), yet a careful reading of these Acts betrays no global prescription for "full cost recovery." Only the NIRA, which specifically promoted, and relied upon, the logic of full cost recovery in its framing and operation appears to provide a reasonable explanation for this major change in the role, and definition of, relevant management accounting data. In redefining the set of social rules that defined the market economy in the United States, Roosevelt, with intent, employed full cost accounting methods to define, and stabilize, the pseudo-competitive market structure. In linking cost to a new social rule system, Roosevelt created the platform for a blind adherence to full cost recovery methods. Yet, as Johnson (1992) suggests this apparent "blind adherence" to full cost recovery logic is proving to be a handicap in the global marketplace. It is this final issue to which this paper will now turn.

### **Redefining Management Accounting: A Free Market Perspective**

Is it not possible that the combination of these events, and the 40 years of history over which they transpired, may have led to the apparent loss of knowledge that significant, and valuable, alternatives to full cost recovery methods of costing might be usefully applied in various business settings (Johnson and Kaplan, 1987)? This series of arguments might be seen as a set of unfounded claims, yet it is a common theme that runs

throughout current management accounting literature (for instance, Johnson and Kaplan, 1987; Cooper, 1989; Johnson, 1992; Shank and Govindarajan, 1993). Johnson and Kaplan (1987) appear to have made this logic, the perceived "fall" of management accounting, the basis for a rebirth of the economic theory of cost.

Trends within the United States suggest that economic theories of cost appear to be undergoing rebirth as one basis for the effective management of competitive business in a global market. For instance, *target costing* (Sakurai, 1989) is an economic model that suggests that companies should work from the market in establishing their price, profit, and hence allowable cost expectations for a product even before it is launched. Target costing is simply one way a company can begin to focus on cost, not as a naturally recoverable expense of doing business, but as rather a constraint, or cap, on the perceived value of goods and services. In this model, cost is what is sacrificed to gain the market price; when such "cost" exceeds the market-determine value of the good or service, a loss is sustained. Target costing, then, appears to start from the belief in a free market economy with supply and demand curves set by perceived product value, or consumer utility functions, rather than from the current "cost" of the resources consumed to create that good or service.

A related recent "innovation" in management accounting, *strategic cost management* (Shank, 1989; Shank and Govindarajan, 1991, 1993) suggests that competitive advantage can be gained by redefining the structure of an industry's value chain. Once again, this popular approach appears to build from the belief that predatory practices that actually seek to disrupt the structure, or existing rule system, of a market represent acceptable, and in fact desirable, competitive actions. The entire logic of strategic cost management adheres to the description of behavior that would occur in a market characterized by having weak moral commitments (Burns and Flam, 1987a).

It is difficult to make the same argument about *activity-based costing* (Cooper, 1990; Kaplan, 1988), not because its proponents are not equally committed to identifying an economic theory of cost that is viable within the free market economy of the global

marketplace, but because this model does not as directly divorce itself from the logic of full cost recovery. Activity-based approaches reconnect costing theory to the tenets of causality, effectively attacking the notion that companies can, and should, recover "unearned costs" (Lyon, 1935) in established market prices, yet in the end, they suggest that all costs are still to be charged to ongoing production (e.g., full cost recovery). This may, in the end, be the critical flaw in activity-based costing.

As each of the major innovations in management accounting take hold, whether they are truly "new" or simply "old wine in new bottles" that date back to pre-Depression theories of the economics of cost, they appear to augment the attack on the status quo (e.g., full cost recovery approaches). These new methods, consequently, appear likely to meet with significant resistance from the existing "enforcers" of the old order, in much the same way that the shapers of the NIRA faced bitter attacks from major industrialists and economists. It seems that in a "winners take all" battle for the power to dictate the social rule system guiding the American economy, either the old or the new model of calculative practice must dominate. The only question which remains is which one?

### **An Eye Toward the Future**

The objective of this paper has been to trace the historical development of the market economy within the United States, suggesting that it has undergone two radical upheavals that have effectively redefined the basis for competition. First, the Depression and its key act, the NIRA, were suggested to represent a deliberate re-structuration of the laissez faire market in a manner consistent with social rule system theory (Burns and Flam, 1987a, b). This period is described as a pseudo-competitive market where fair competition is defined by full cost recovery with a built-in expectation for a "reasonable profit." It is an economic model that is driven, not by the iron laws of the marketplace, but rather by tacit agreement on a prescribed set of market rules and norms.

The second disruption in the American economy is then argued to be driven by the re-emergence of laissez faire capitalism in the guise of the global market. And, as suggested by Burns and Flam (1987a,b), this second disruption appears to have the power to put the



U.S. at severe economic risk, as its accepted modes of doing business, and defining market practices, fall in the face of competitors who do not abide by these market rules.

In recasting economic history in this light, the constitutive role, played by accounting-based theories of cost, become evident. Specifically, it is argued that full cost recovery, which is not an economically-sound basis for competition in a laissez faire free market, serves as a primary tool for enforcing the rules of the New Deal, or pseudo-competitive, market. Ultimately, this very tool of market structuration appears to hinder the responsiveness of the American economy to the changing rule structures embedded in the global economy. It is this disabling influence that may account for the increasingly heated attacks on accounting as the basis for the competitive decline of American industry (Johnson, 1992; Goldratt and Cox, 1993).

The path forward for business, and the accounting systems which support them, appears to lie in rediscovering the essence of the economic theory of costs which drove Henry Ford to constantly search for ways to eliminate waste, and that motivated Church (1930) to discuss capacity as the productive capability of an organization to create value in the market place. This economically-motivated approach to costing theory appears to be the basis for such innovations as target costing, product life cycle costing, and strategic cost management. As such, there appears to be a logic for, and demand for, the rebirth of management accounting theory, a rebirth that reattaches the accounting profession to the logic of the market.

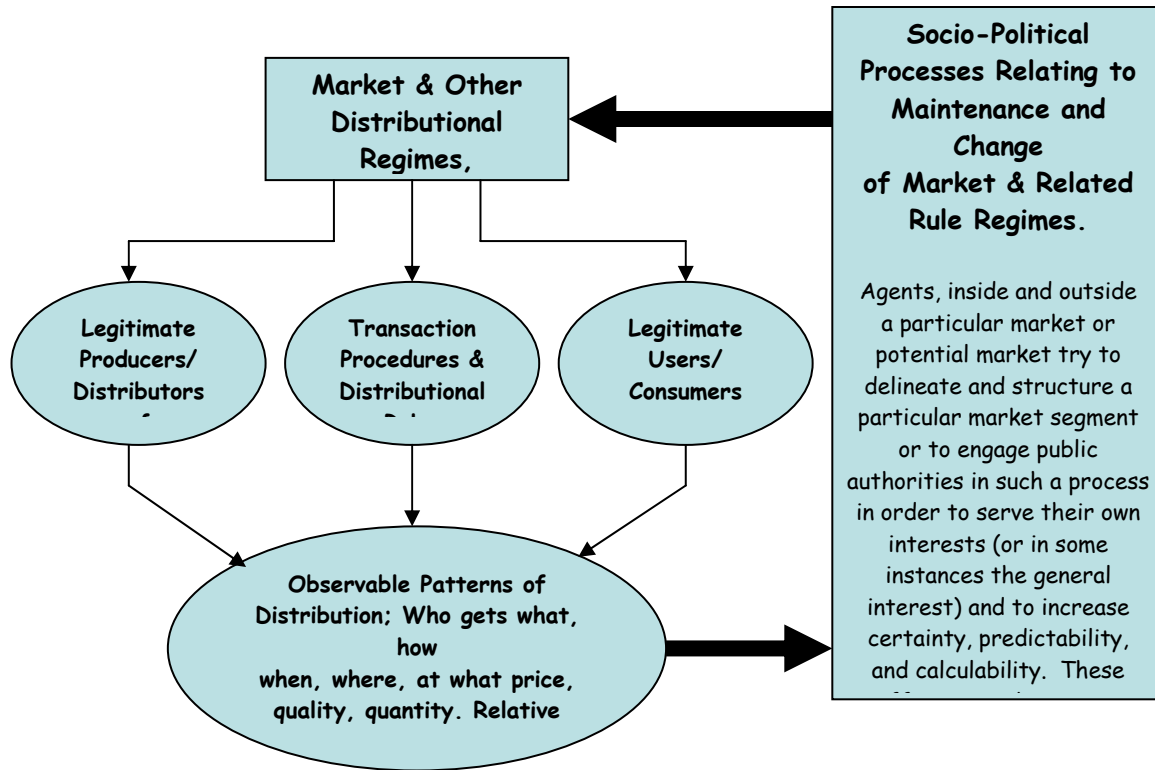
In the end, this paper will have accomplished its purpose if it merely moves the dialogue surrounding costing to one that more accurately places accounting developments within their historical and social contexts. In a search for the "root cause" for the decline of management accounting, this paper, then, represents one potential explanation for the mass amnesia that appears to be at the heart of the fall of management accounting.

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## General Model of Market Structuration



Source: Burns & Flam, *The Structuring of Markets and Other Distributional Systems, The Shaping of Social Organizations*

Figure 1

Figure 2

Worked on the Eagle, Adolf.



Source: H. Johnson, *The Blue Eagle from Egg to Earth*, 1935: 228.

Figure 2