THE POLITICS OF ACCOUNTING STANDARDS

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Not so very long ago, according to Solomons, accounting could be thought of as an essentially non-political subject[1]. Accountants generally looked upon themselves as being primarily highly qualified technicians, whose expertise was exercised, inter alia, in the preparation of final accounting reports. The measurement conventions adopted by accountants in preparing such reports were seen as neutral and purely technical phenomena and resulted in calculating the 'true income' of the firm. Accountants believed that by analysing economic facts about a firm's operations, they could determine which accounting procedures would most accurately reflect these economic facts[2]. This traditional view of accounting is well expressed by Chambers who wrote "A company is better or worse off as a result of a year's business events by a definite amount . . . Rules cannot change the amount of profit which a company makes in a year, for profits are made in the market place, not in the counting houses. Such rules are a matter of technology"[3]. The essence of Chamber's argument is that concepts of income and value are free from human value judgement and therefore, by implication, subject to natural laws of computation.

In an attempt to develop definite rules which govern the disclosure and measurement issues of financial reporting the Accounting Standards Committee was formed in the U.K during 1969/70 (formerly the Accounting Standards Steering Committee). The formation of such a committee was itself a political action, being a direct response to public criticism over the flexibility of accounting practice. Singer for example had earlier remarked that accounting was largely a matter of taste[4]. There were many events which occured in the U.K. during the 1960's which can be singled out as confirming Singer's observation. These events are now known and documented. Zeff succinctly summarises the situation: "a few dramatic cases have an enormous effect on public opinion and there is no doubt that several such cases coming close together as they did, caused

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considerable disquiet in the financial world and it has to be admitted that these events were a severe blow to the image of the accountancy profession"[5]. The council of the I.C.A.E.W. eventually responded to the criticisms regarding the diversity and flexibility of accounting practice which had been acceptable to the respective firms of auditors. On December 11th, 1969, a press conference was held to announce a 'Statement of Intent on Accounting Standards in the 1970's', which heralded the formation of the A.S.C.[6] Included in the terms of reference for this new committee was the intention "to prepare for the approval of the Councils of the governing bodies definite standards of financial accounting and reporting"[7]. Since 1970, therefore, the role of accounting policy maker in the U.K. has been entrusted to the A.S.C. The term 'policy making' is increasingly used to describe the process by which individuals or groups in power choose general rules for action tht may affect others within an organisation or perhaps affect an entire society[8]. Thus, formulating accounting policy involves deciding which measurement and reporting alternatives should be adopted by reporting entities, but the fomulation of accounting policy requires a commitment to goals and therefore requires a policy maker to make value judgements. Let us first examine this unique aspect of accounting policy, namely, goal formation.

MEASUREMENT AND DISCLOSURE OBJECTIVES

Financial statements by and of themselves cannot have objectives; there can only be objectives *for* financial statements. Chambers prefers to talk in terms of functions rather than objectives of financial statements[9]. Nevertheless the selection of functions or objectives is inherently a value judgement and so debate about objectives is a debate about value judgements. These value judgements are neither right nor wrong, but must be established by the political process of compromise and agreement. An examination of the official pronouncements by the accountancy profession during the past twenty years reflects how these value judgements gradually change over time. Traditionally, financial statements were regarded as reports on 'stewardship'. For example, in 1952, it was stated that "the primary purpose of annual accounts of a business is to present information to the proprietors, showing how their funds have been utilised and the profits derived from such use"[10]. This approach was subsequently (1965) codified with the announcement that "the purpose for which annual accounts are prepared is not to enable individual shareholders to take investment decisions"[11]. More recently there have been some notable attempts to formulate the objectives for financial statements e.g. the Trueblood Report[12] and the Corporate Report[13]. In keeping with the approach adopted by these two studies the F.A.S.B. stated that financial reporting "should provide information to help present and potential investors and creditors, and other users in assessing the amounts, timing and uncertainty of prospective net cash receipts."[14] The basic theme of all these recent studies is the measurement and communication of information about the accounting entity relevant to the needs of various potential user groups. The potential users of accounting reports are quite diverse and it is reasonable to suggest that accounting reports using one measurement method may be highly relevant to one category of users and irrelevant to another. Nevertheless there is growing consensus that the usefulness of accounting statements should be judged according to the relevance of the information provided for decision making[15], an approach which is commonly referred to as "decision oriented financial accounting"[16].

However, an objective such as "decision usefulness" is vague and non-operational and allows considerable debate on what is the optimal accounting method. There have been many proposals but the proposers often focus on too few of the attributes of a particular method and are guilty of failure to present empirical findings. Indeed, it appears that those who advocate change are united only by their dissatisfaction with the existing historic cost system.[17] Scapens points out that there are still fundamental issues which must be addressed, viz, "who are the users, what uses do they make of financial reports, what information do they require and also what order of priority should be attached to the user groups in the case of a conflict of interest?".[18] For accounting objectives to be made operational they need to be made more concrete, but Gerboth argues that the odds are overwhelmingly against the profession obtaining consensus on a set of objectives specific enough to be operational.[19] Even if general agreement on such objectives can be reached, policy makers are still confronted with a choice between various measurement and disclosure alternatives which best achieves those stated objectives. There is growing recognition, according to Rappaport, that such measurement and disclosure issues must be viewed more broadly than simply from a technical accounting perspective.[20] In other words, accounting and accounting standards can no longer be thought of as non-political. This expanded view of standard setting stems from the notion that the numbers that acocunting reports have, or at least are widely thought to have, a significant impact on economic behaviour.[21] This potential impact on economic behavour can affect resource allocation and therefore the redistribution of wealth within the economy. Empirical work to date indicates that financial accounting reports do affect economic behaviour and therefore wealth distribution in two principal ways. It is proposed to look first at the impact of accounting reports on share prices which in turn affects the wealth of shareholders. Secondly, the process whereby management decision making is changed in a reporting company as a result of the requirements imposed by accounting standards is examined.

ACCOUNTING POLICIES AND MARKET EFFICIENCY

The efficient-markets theory states that share prices always fully reflect publicly available information and that any new items of information are immediately impounded in those prices. Thus any new information of economic value contained in published accounting reports should cause an immediate reaction in share prices as they adjust to this new information. It is not surprising, therefore, that much of the empirical research in financial accounting during the past decade has been directed towards testing this relationship between accounting numbers and share prices. The evidence, mainly from the U.S.A. and the U.K., confirms that accounting information does have an impact on share prices. (Accounting reports, it should be stressed, are not the only source of information available to market participants). The accounting information which is impounded in the share price is, however, governed by disclosure and measurement conventions codified by financial accounting standards. Thus, one can conclude that accounting standards have an economic impact by their impact on security prices and thereby on the wealth of market participants. Accounting standards are, therefore, in the nature of legislation (drafted and theoretically enforced by the *private* sector) which redistributes wealth. The ASC in its role of accounting policy maker affects the economic well-being of business entities and the lives of thousands of individuals. Because of such power it is only natural that individuals and groups exert political pressure on the ASC. This is especially true where power is controlled by a small group of policy makers. Thus accounting standards which govern measurement and disclosure issues should not be thought of as neutral and technical choices, but as political choices involving wealth distribution. Because we live in a democracy, accounting policy-making must inevitably be subject to popularity testing. If there is widespread hostility to a proposed accounting policy, then there is little chance of its implementation. Readers will readily recall the controversies and the extent of lobbying which occured in relation to topics such as "deferred taxation" and "inflation accounting". The setting of accounting standards is as much a product of political action as of theoretical appeal or empirical research. Since accounting standards depend for their success on public confidence and acceptance, then accounting policy-making must be seen as a political and not simply as a technical activity.

The essence of efficient capital markets is that they instantaneously and fully reflect all available *relevant* information. Research into the workings of the "efficient markets" have found that the market is efficient in the sense that investors are not mislead by accounting techniques which report different profit figures for the same economic event. In other words, the capital market can and does distinguish between accounting policies which have no economic significance and those which have economic value. Many accounting standards do not specify disclosure of information with economic value and so such accounting standards are unimportant. The following empirical results are mentioned to illustrate this point and we will then examine why unimportant accounting standards are also subject to the political process of bargaining, compromise and agreement. For example, Archibald assessed the impact on share price of the switch by companies to straight line depreciation from accelerated depreciation.[22] This change in accounting policy increases reported earnings per share under the historic cost convention. The efficient-markets theorists argue that investors recognise that such a change in accounting policy does not represent an economic event (i.e. merely a book-keeping entry) and therefore there would be no change in share price. Archibald found no significant change in share price as a result of changes in depreciation policies and thus his study supported the efficient-markets hypothesis. Ball examined the impact of differences in accounting treatment relating to accounting policies, such as stock valuation, depreciation methods and consolidating the results of subsidiaries.[23] He also found that accounting policy changes had no impact on share prices. A similar study by Kaplan and Roll generally supported the efficient-markets hypothesis in that little abnormal movement in share prices was experienced for accounting changes of no economic consequences.[24] If the results of these studies are accepted as being valid, then one cannot ignore the "troublesome paradox" which emerges[25]. The empirical studies have shown that capital markets do see through cosmetic accounting procedures imposed by various accounting standards. Thus it makes little difference whether a company, for example, adopts the acquisitions or merger method of accounting for business combinations. There is no difference in the cash flows accruing to the firm arising from the use of either method. Yet the accountancy profession have, since 1971, found it exceedingly difficult to produce an accounting standard on this topic![26] If the stock market is not misled by accounting procedures required by some accounting standards then why do they generate so much debate, discussion and conflict? There are three possible explanations which can be offered to solve this apparent paradox.

(1) There appears to be widespread scepticism among financial executives and practicing accountants about the efficiency of capital markets. This attitude was confirmed by the work of Mayer-Sommer, who surveyed the understanding, acceptance and awareness of the implications of the efficient-markets hypothesis among, inter alia, financial controllers in the U.S.A.[27] Only one-third of the respondents understood the concept of market efficiency and only 10 per cent of all respondents accepted the hypothesis and were aware of its implications.
(2) The efficient markets hypothesis is concerned with how the market reacts at an aggregate level to the disclosed information. The market can only react to the information which is available and therefore standards specifying disclosure issues will have a separate impact from

measurement standards. In this respect it is interesting to quote from the Sommer report in respect of market efficiency: "the theory is concerned with how the market reacts to disclosed information and is silent as to the optimum amount of information required or whether the optimum should be achieved on a mandatory or voluntary basis".[28]

(3) The efficient capital markets approach is concerned with the information relevant only to shareholders and therefore is of little use in assessing the usefulness of accounting reports to other user groups. Neverthelss, corporate reports are freely available to other user groups who can use them for their own decision making pruposes. For example, these financial reports could be used by employees and their representatives in wage negotiation; the government may require them in support of commodity price increase applications, or suppliers may adopt existing credit policy on the basis of financial accounting disclosures. Managers must therefore realise that the accounting information which is available to shareholders is potentially available and of use to other groups.

ACCOUNTING CHOICES AND MANAGERIAL BEHAVIOUR

The research to date that has been conducted between changes in accounting policy and share price has assumed a direct and uninterrupted relationship. These empirical studies on accounting changes which have no impact on share price imply market efficiency if and only if the firm's decision-making is unchanged.[29] There is some evidence, mainly from the USA, to suggest that managerial decision making may be influenced by the information which a company is required to report in accordance with the various accounting standards. Managers of the reporting company, in anticipation of adverse reaction to its accounting reports, may choose to alter its intended economic behaviour. This phenomenon is referred to as "information inductance", since the behaviour of the information sender is influenced by the information which he is required to disclose.[30] The adverse reaction may be perceived by management to materialise in the form of removal of directors by shareholders, employees seeking higher wages, or indeed the threat of government intervention. One should also be aware of the possibility that management's financial compensation may be linked to reported profits and/or share price. Thus managements can increase their wealth by inflating earnings where remuneration is based on profit sharing, or alternatively by availing of option schemes at favourable share prices.[31] Management, therefore, by changing this economic behaviour may or may not be acting in their own self-interest.

There are many areas in which an accounting standard may affect managerial behaviour. One such area is that of research and development expenditure.

The original draft on Research and Development published in the U.K. advocated that "expenditure on research and development should be written off in the year of expenditure".[32] Such an accounting policy, however, can be considered a threat to technological progress, especially for smaller companies that may be contemplating access to the capital market and may wish to show good profits before doing so. Forcing immediate write-off of research and development expenditure may therefore reduce the attractiveness of this type of expenditure in the eyes of management. It is possible, of course, that companies would have continued with their respective research and development programmes but not complied with the relevant accounting standard. That situation, however, would have challenged the credibility of the A.S.C. The present accounting standard on Research and Development is accordingly a modified version of its ancestor![33] Management behaviour may have also been influenced by the accounting standard relating to foreign currency translation. The net result of this complex standard was to greatly increase the volatility of the reported earnings of companies with large foreign operations. The efficient markets hypothesis would suggest that such accounting procedures have no new economic impact and therefore would have no impact on share prices. Nevertheless, managements of firms with overseas subsidiaries did take defensive action to offset the potential adverse results from the implementation of SFAS 8[34]. One U.S. study indicated that there was a change in the internal operations of firms as a direct result of the change in accounting.[35] In many cases capital investment decisions were affected, companies engaged in increased "hedging" in foreign currency markets and some companies changed the collection period for receivables dominated in foreign currencies. Thus, SFAS 8 caused significant changes in management practices and procedures. Another controversial accounting standard in the U.S.A involved the reporting by oil and gas producing companies. In July 1977, the FASB proposed in its Exposure Draft to put an end to the Full Cost (FC) accounting method in the oil and gas industry in favour of the Successful Efford (SE) concept.[36] Under the full cost method all exploration costs are carried forward as an asset subject to certain limitations. F.C. accounting defers the costs of unsuccessful drilling and thus allows expanding companies to show higher and smoother earnings.[37] The S.E. method, on the other hand, requires that costs that are known not to have resulted in discovery of oil and gas (e.g. abandonment and unsuccessful wells) must be written off. The proposed switch to successful effort was fiercely resisted, especially by the smaller companies which had been using the full cost method. They argued that the switch in accounting policy would lower and increase the volatility of earnings figures and ultimately affect the prospect of raising fresh capital. Such contentions are inconsistent with the efficient markets hypothesis. Investors can readily determine the impact on a firm's earnings of full cost versus successful efforts accounting. Thus, no new information would have been provided under the proposed accounting standard.

Nevertheless, there was real concern that the enforcement of the S.E. method on small companies might deter management from undertaking high-risk future explorations. This possibility was especially valid where managerial compensation schemes were based on reported net income. Considerations as these even induced Ralph Nader to campaign against the S.E. method on the grounds that it would lead to reduced exploration at the very time when risk taking by energy corporations was essential.[38] Eventually, succumbing to the pressures from small independent producers with strong vested interests and the concerns of other government agencies, the Securities and Exchange Commission decided against the mandatory use of successful efforts. In August 1978 the SEC declared that neither full-cost accounting or successful efforts provided adequate information and eventually suspended the effective date of implementation of its former directive. The events surrounding the formulation of accounting standard for the oil and gas industry clearly illustrates the importance of sociological and political factors in the standard setting process.

Some accounting standards have potential economic consequences. Others, it has been demonstrated, do not. These consequences are important and will occur whether the ASC and the accountancy profession ignores them or not. The accounting choices which cause such consequences should not be viewed as neutral choices but as political choices. Indeed if we ignore the political dimension in accounting, and erect barriers to insulate us from that dimension in order to pursue some notion of strictly technical accounting, the community of users (which is part of the political environment) will be ill-served. Accounting policy makers must recognise the existence of different sub-systems of users and preparers of accounting reports, each with its own special interest, and each which has the democratic right to lobby or protest if it believes its own self-interest to be threatened. To ignore this political environment must inevitably result in measurement and valuation rules which are unacceptable to users and a belief that the accounting profession is unresponsive to the needs of these various user groups. Only if accounting is responsive to social needs can it gain acceptance and authority.

IMPLICATIONS

This political view of accounting standards has a number of important implications. Some people who object to the potential power of accounting standards may question the legitimacy of a private body such as the ASC and argue that the power to set accounting standards should be transferred from the accountancy profession to a public sector organisation. After all, the government has assumed regulatory power in such areas as company law, fire safety, pollution and price control. Horngren offers three predictions regarding an exclusive public sector effort in relation to setting accounting standards, (1) more enlightened direction and performance, (2) not much difference and (3) stultifying bureaucratic control.[39] He suggests that an exclusive public sector effort in establishing accounting standards would not be much different from the existing situation. There are two reasons why one might support Horngren. Firstly, before any official pronouncements were enacted, one might expect a government green paper to be issued, to stimulate public discussions and to allow the various interest groups make representations. On the basis of such representations, government can guage the amount of agreement with or opposition to its proposals. The professional accountancy bodies would therefore become one of the pressure groups working for the introduction or revision of exposure drafts of accounting practice. Therefore an exclusively public sector policy maker would be just as susceptive to lobbying as the ASC. Such lobbying, however, could cause increasing delays and compromises before issuing accounting standards. Secondly, it could be argued that an exclusively public sector standard setting body may have little expertise in accounting and would have to delegate the task of developing accounting standards to the accountancy profession much along the same lines as which standards are currently being formulated. Thus, the existing method of developing accounting standards rests with a body with undoubted technical competence but questionable social legitimacy. On the other hand, an exclusive public sector standard setting body possesses social legitimacy but questionable technical competence. The resolution of such a conflict is ultimately a political value judgement.

The second implication of the political view of accounting is that for policy to be effective it must be acceptable to the various power groups representing the preparers and users of accounting reports. The point is well expressed by Mautz: "a theoretically ideal solution that is unacceptable to the majority of those affected is unlikely to achieve progress. A solution that affects nobody is likely to be as innocuous that progress will be nil. Thus in setting standards we must seek a middle ground so that some progress can be made but yet will find general acceptance with the majority".[40] May and Sundem take a similar position: "the process of selecting an acceptable accounting alternative is a political process".[41].

Policy making of any form in a democratic society is a complex process, because policy places restrictions on human behaviour and therefore policy must be generally accepted.[42] For policy to be effective it must be acceptable because no authority is strong enough to impose unacceptable regulations in a democratic society. The area of accounting policy making is no exception. Accounting policy making must therefore seem as a political process. Because of the potential economic impact of accounting standards, the politicization of accounting standards should not be surprising — it should be accepted.

CONCLUSION

Reaching agreement on the functions of accounting reports and the associated measurement and disclosure issues must be seen as a political rather than a technical activity. It is readily accepted that this political view of accounting and accounting policy making may be difficult for accountants to accept. Nevertheless, one must agree that the impact of accounting statements is but one method of transferring wealth amongst individuals. Accordingly, it is only to be expected that individuals demand theories which prescribe accounting procedures conductive to their desired wealth transfers. Watts and Zimmerman have suggested that "the predominant function of accounting theories is now to supply excuses which satisfy the demand created by the political process."[45] If this is so one may expect a proliferation of accounting theories, making it more difficult for policy makers to arrive at a general consensus. It is unlikely, however, that the proliferation of accounting theories (and theorists) would lead to what Arrow calls "democratic paralysis" i.e. failure to act which is not due to desire to inaction but an inability to agree on the correct procedure.[44] Rather, it is more likely that accounting policy making will remain a reconciliation of differences, a distillation of compromise!

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