ECONOMIC INTEREST AND ACCOUNTING STANDARDS

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THE last twenty years have seen a great deal of change in accounting standards, mechanisms for setting them, and the accountant's understanding of standards. Heated controversies have raised new questions and doubts in the minds of professional accountants and managers about the nature and socio-economic function of standardization in accounting practices, about how it affects their work and economic welfare and about how they should react to proposals for new or modified standards.

ECONOMIC INTEREST

Accountants think of accounting standards as being rooted in a set of basic assumptions, (e.g., economic entity, going concern, monetary unit, periodicity, etc.) and basic principles (e.g., historical cost, realization, matching, consistency, full disclosure and verifiability) modified by considerations of materiality and conservatism. Education, training and the traditions of the accounting profession promote the premise that accounting standards enhance the socio-economic relevance of accounting by providing "true and fair" financial statements using uniform practices, and by helping the auditors and financial executives meet their ethical obligation. Accountants are keenly aware of the influence standards have on accounting policy choices, on interactions between the auditors and auditees and, most importantly on their own behavior.

The premise that financial accounts are expected to present a true and fair picture of the firm and its operations is widely accepted. If the balance sheet and income statement could not be relied upon to be truthful, they will cease to serve the function expected of them. The shareholders will no longer have the assurance that their capital is well managed; the creditors will be uncertain as to the value of the collateral and the government will receive little assurance from audited financial statements that taxes due have been paid. Truthfulness of financial statements seems to provide the very basis of their perceived value. Everything done to preserve and enhance the truthfulness of financial statements, therefore, seems desirable.

Truthfulness of financial statements, it is often argued, should be the key criterion for choices made among alternative accounting methods by firms and by bodies entrusted with the setting of accounting standards.

Yet, the day-to-day practice of accounting and the reporting of accounting issues in the financial press, etc., clearly indicate that these same standards and practices appear to be shaped by the pressures exerted by conflicting economic interests. The accountant can hardly fail to recognize considerations that sometimes lead his clients to adopt accounting policies that he finds unacceptable or highly objectionable; nor is he unaware of the influence accounting standards can have on his own economic survival and prosperity. The interplay among conflicting economic interests provides a relatively general, practical and even fascinating interpretation of accounting phenomena. Accounting practice, when looked at this way, appears as a compromise solution which balances the economic interests of various groups such as the investors, creditors, managers, auditors and the government. Each group seeks to advance its own economic advantage and therefore, attempts to install a system of accounting that seems to be better for itself. These economic interests may be incorporated into accounting standards through three different processes (to be explained later in the article in greater detail): direct negotiation, political process and the market. If all interested parties agree to a solution, in absence of evidence to the contrary, we must conclude that such a solution is more desirable from the point of view of the society as a whole.

EXTERNALLY DEFINED CRITERIA

In traditional accounting theory, externally defined characteristics of accounting methods and statements such as verifiability, relevance, truthfulness, etc., have been all important.[1] However, when we look at accounting from the perspective of economic interest, we find that while such externally defined criteria may be useful for determining individual choices, they are not useful for determining the social choice (except in the trivial case when all groups have the same choice).

Verifiability, for example, may serve the interests of the auditors in the form of lower costs or risks and therefore, they can be expected to advocate the use of accounting methods, and standards are more easily verifiable. The economic interests of financial executives (showing the entity they represent in the most favorable light consistent with the desire to limit tax liabilities) may be served by a less verifiable method of accounting, which they would favor. Thus, the utility of verifiable methods/accounting standards in the broader context of society is not determinable merely on the basis of the principle that "a more verifiable accounting method/standard is better." It may well be that the cost or damage inflicted by the use of a relatively verifiable method of accounting on one group is far in excess of the benefits conferred on other groups. The socially desirable solution may well be to adopt the less verifiable method of accounting.

Similarly truthfulness or representational faithfulness, cannot be used as a criterion for social choice. Accountants trained to use approximations of quantities and prices know too well that truthfulness of accounting numbers in representing assets and liabilities of a firm is itself a matter of judgement. A few accounting numbers are no more able to provide a "truthful" representation of a complex organization than a photograph can provide of an object, or a map can provide of a piece of land. Even an excellent photograph can only be an acceptable representation of an object for certain purposes. A map can at so best be designed to serve limited purposes. Financial statements similarly convey a limited idea about a firm and can hardly be expected to serve all or even most purposes. "Truth" is in the eye of the beholder. The same fact may be "truthful" for one party and "untruthful" for another. An external criterion, such as verifiability or truthfulness, may be desirable for some interest groups and undesirable for other. It is generally difficult to establish a connection between a specific accounting policy or standard and the external criteria that it satisfies.

ECONOMIC INTEREST AND INDIVIDUAL BEHAVIOR

One may argue that without the fetters of technically determined standards, which rely exclusively on external criteria such as truth, verifiability, relevance, etc., individuals are likely to behave in a narrow, selfish and shortsighted manner. Individuals may just as likely behave in a farsighted and socially responsible manner, realizing that their own welfare in the long run may be better served by standards opposite to those that may serve them well in the short run. An explicit recognition of the conflicts of economic interest inherent in the choice of accounting methods and standards is likely to clear the way for more stable and widely accepted standards.

ECONOMIC INTEREST AND INTERACTIVE PROCESSES

The economic interest of various groups and individuals may get incorporated into accounting standards and policies through a variety of mechanisms. We shall confine our attention to three major parts: direct negotiation among the parties, the political process and the market process.

DIRECT NEGOTIATION

External auditors and the financial executives of a firm are continually in touch with each other on the matters of accounting policy. When differences arise between them, discussion and negotiation are used to resolve them. Little data are available on the nature of these negotiations, especially those that conclude successfully. However, when occasionally the negotiating process breaks down leading to the resignation of the auditors, enough information becomes available to suggest that it is the economic self interest as perceived by the negotiating parties that plays the key role in the process. Auditors weigh the risk of law suits, damage to their reputation with other clients and their standing in the profession, potential revenues and ability of their partners to negotiate with management of other firms in the future. Managers are often driven by considerations of the effect their financial statements may have on the stock market, relationship with the bankers, government, unions and on their own job security and compensation. Accounting policies and standards are in part, the result of such private negotiations among managers and auditors driven by economic interest as perceived by them.

THE POLITICAL PROCESS

The effects of economic interest on accounting practice and standards through the political process are manifested less frequently but are no less profound. It was through the congressional initiative and support of the executive branch of the government that independent audit of publicly held firms became a legal requirement in the U.S. in 1933-34. CPA profession lobbied for its economic interest and won the right to conduct such audits by successfully persuading the lawmakers that they can do the job better than the government auditors. Creation of the SEC itself, with its profound effect on accounting and auditing practice was a decision taken at the political level to meet the various economic pressures brought to bear on the government at the time.

Direct intervention of the Congress or the executive branches of government in the matters of accounting and audit practice is infrequent, but not unknown. In 1971, the government decision on accounting for investment tax credit led to a restructuring of the accounting rule-making mechanism in force since 1959. In the midseventies, the Metcalfe and Moss Committees in the U.S. Congress

induced much rethinking in the accounting circles and led to the creation of Public Oversight Board and the Peer Review System in public accounting.

Appointments to key government positions such as the membership of the SEC and its chief accountant are yet another means by which economic interests are brought to bear on the accounting environment through the political process. Appointments to such positions reflect the political philosophy of those in power and influence the choice of accounting standards and policies in their administration.

THE MARKET PROCESS

Finally and most profoundly, accounting policy and standards are affected by economic interests brought to bear on them through the operation of various markets. The effect is not discussed as often as others merely because it operates more slowly but at a very pervasive level. Slow response of the markets makes it more difficult to establish the correlation between the activity in various markets and accounting policy.

The first market we consider is the one through which capital resources are obtained for the enterprise. In arriving at the supply function of capital to a firm, or class of firms, such suppliers will assess the perceived risks and rewards of the proposed investment in the light of the information available to them currently and promised to them in the future. Promise of prompt, accurate and reliable information about the firm in the future forms an important consideration for investors. Other things being equal firms which operate a more satisfactory accounting system, and this depends to a great extent on the firms' accounting and auditing policy, will be able to raise capital at a lower cost. The firm will thus, enjoy a competitive advantage over other firms unless the additional cost of such an accounting system outweighs the savings in the cost of raising capital. On the margin, operation of the capital market will tend to push the accounting and audit policy towards a point where the marginal reduction in the cost of raising capital is balanced by the marginal increase in the cost of operating an accounting system.

The market for managerial skills is the second market that affects accounting policy. In determining the supply function of managerial labor, the potential entrants to this market weigh the total package of rewards, obligations and risks of their jobs. More onerous accounting and reporting requirements may subject them to a level of risk they are either unwilling to take or for which they demand additional compensation greater than the additional benefits conferred by such reporting on other parties. Thus, on the margin, accounting standards and policy must strike a balance between the demands of managers on one hand and the investors and government, etc., on the other.

The third important market to be considered is the market for audit services. If a change in accounting/auditing policy or standard places the burden of higher risks without compensating rewards on the auditors, they will shift their supply function until their economic interest is optimized in the altered environment. Like the managerial labor, operation of the market for audit services ensures an equilibrium between the demand and supply of audit services through adjustment of accounting/auditing policy on the one hand and the number of people willing to work as auditors on the other.

The speed with which these three markets respond to changes is not equal. Because the cost of adjustments in the capital markets are relatively small, the investors can adjust readily, and at relatively low-cost to the new environment and do not have to rely on either direct negotiations or on the political process to protect this economic interest. On the other hand, the costs of adjustment for managers and auditors being large, the response of these markets to changing conditions is sluggish and, of necessity, they resort to greater reliance on direct negotiation and on the political process to protect their own economic interest with respect to accounting. In the long run, however, even the presence and availability of direct negotiation and political mechanism cannot keep the supply and demand of auditors and managers from moving towards a point where they are in equilibrium with the accounting/auditing methods and standards in force.

IMPLICATIONS FOR STANDARD SETTING

Those who find the economic interest a useful instrument of comprehending accounting phenomena will be inclined to ask: What are its implications for setting accounting standards? In the present section we discuss some of these implications.

MARKET BASED VS. TECHNICAL STANDARDS

Effectiveness of standards depends on the breadth of their acceptance among various economic interests. This is the reason why standards which find broad acceptance are likely to be those which make only marginal adjustments to interests of various groups, thus enabling the standard setting body to anticipate the adjustment in their behavior in response to the standard more accurately. In contrast, standards which confer big advantages or impose large costs on some parties are likely to induce drastic changes in behavior of parties when they are enforced, thus making it difficult for the standard setters to anticipate the effect of the standard. Accounting standards for leases (SFAS 13) and foreign currency translation (SFAS 8) are two examples of standards, enforced on purely technical grounds which in absence of broad acceptability were rendered ineffective by altered behavior of certain parties. Note that the point here is not that the power of enforcement of the FASB should be enhanced because the FASB had virtually all support of the government on these matters. The point is that the absence of broad acceptability of a standard itself renders it ineffective when economic interests alter the behavior of interest groups in response to the standard.

It is easy to be lulled into thinking that given enough enforcement power and statutory backing, a technically desirable standard can be made effective. But, as in civil or criminal law, once you set the rules, people choose their own behavior which they find optimal in the new environment. If a particular standard places a burden of bearing extra risk on auditors, they will either demand adequate extra compensation or, failing to receive it, will cease to perform the function. No matter what the power of enforcement, it is fallacious to think that a standard can be enforced merely because it is technically sound.

Given the ethical terms in which discussions of these matters are usually couched, the stronger the economic consequences of a standard the more difficult it is for the standard setting body to learn how people will change their behavior in response. Thus, strong technical standards, in absence of broad acceptance carry seeds of their own ineffectiveness.

Emphasis on general acceptability of standards, a criterion which does not even appear in the list of qualitative characteristics produced by the FASB (1980) recently, leads directly to greater reliance on the "market" for choosing accounting standards and less reliance on standards based on technical research or posing brand new solutions to accounting issues. Accounting methods already in the market place have received broad exposure, provided an opportunity to a variety of economic interests to understand their consequences for themselves and to adjust their own behavior to them. The effects of market based standards can, therefore, be anticipated more easily than the effects of brand new technical solutions which take time to be understood and to be adjusted to. Considerable amount of turbulence in the reactions to financial accounting standards in recent years seems to have been caused by an inadequate appreciation of this difference between our ability to measure the economic consequences of accounting standards derived from the market and from technical research.

Emphasis on market based standards rather than those based purely on technical research will mean fewer big or revolutionary changes in accounting systems. It will disappoint those who may regard such changes per se, as a measure of progress in accounting. However, for those whom the progress of a social system like accounting implies movement towards a stable solution which is satisfactory to a larger and larger number of participants, will find that a greater reliance on the market for accounting methods will result in progress.

Excessive reliance on technical research in formulating accounting standards leads to pronouncements which are not generally accepted, require frequent revisions or even recissions, and finally create more chaos in accounting and create an unstable image for the concept of accounting standards.[2] Frequent changes in accounting standards defeat the purpose of standarization itself. A primary task of the standard setting bodies is to find the right balance between the speed of adjustment and the frequency of errors.

SUNSET STANDARDS FOR CHANGING ENVIRONMENT

Demands for change in accounting standards are largely based on observed changes in environment such as inflation, new tax laws (investment tax credit) or new business practices (leasing). It follows that an accounting standard which is satisfactory in one environment may not be satisfactory in another. The changing environment should be reflected in changing standards.

Instead of specifying one or more methods of accounting in the light of the environment prevailing at the time of setting the standard, it would be desirable to specify a class of accounting methods of which a particular member is recommended as standard for a specific environment. Thus, for example, there would be no need for the FASB to choose between the historical cost and replacement cost accounting in general, it could have specified the economic conditions under which a particular accounting method would be the accounting standard. Given the amount ot time and effort necessary to develop new standards, a changed environment results in a tremendous waste when it necessitates search for a new standard. Choosing accounting standards for a class of specified environments may be a useful way to conserve on the standard setting efforts.

There is also the opposite problem of accounting standards which linger on books beyond time and environment for which they were chosen. Specification of the environment to which they are applicable, as we have suggested above, will help remove obsolete standards with less effort. Alternatively standards formulated to meet transient environmental phenomena could be formulated with specific sunset provisions to self distinct after a stated period of time. The standard setting body could, of course, reenact them in case their continuation is deemed desirable.

COMPOSITION OF STANDARD SETTING BODIES

If people behave to promote their economic interests, we should expect that the standard setting body will be criticized by those who see their interest as being hurt by their action. If the body does its job reasonably well, its every action will end up upsetting somebody or the other. If any single group makes the mistake of allowing itself a larger representation on the standards setting body, it will end up being the target of all blame and accusations by the aggrieved parties. FASB which in the U.S. started out insisting on a majority representation of public accountants has realized the mistake and has been settling down to a more equitable distribution of seats in recent years. In the international bodies such as IFAC, IASC, etc., such change has not yet occured. In bodies whose effectiveness depends largely on consensus, equal representation of numerous interests is more likely to yield effective results.

CONCLUDING REMARKS

Economics provides a new window on accounting issues. The perspective from this window does not make other, more familiar perspectives invalid or obsolete; it simply adds to our understanding of accounting. Recent years have seen much discussion of economic consequences of accounting standards. If we accept that accounting standards have knowable, or unknowable economic consequences, we are driven to the conclusion that once these standards are enforced, people will change their behavior and thus limit the effectiveness of such standards. What can a standard setting body do in a world full of economically motivated people? Tread slowly, carefully and very softly.

FOOTNOTES

1. See Financial Accounting Standards Board [1980] and Canadian Institute of Chartered Accountants [1980].
2. The theoretical foundation for such a purpose-oriented approach have been developed and presented by R. Mattessich [1964/1977, 1972, 1978].

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