ACCOUNTING STANDARD SETTING AND ITS ECONOMIC CONSEQUENCES: WITH SPECIAL REFERENCE TO INFORMATION INDUCTANCE IN A COST-BENEFIT FRAMEWORK

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I. *Introduction*

What should be input factors in setting financial accounting standards? How can we develop a comprehensive framework for the formulation of accounting standards? What considerations should standard setting or rule making bodies incorporate into the process of making accounting policy? This paper discusses such questions which have been controversial and difficult to answer.

A few decades have passed since it was recognized that the objective of accounting was to provide information useful for making economic decisions by interested parties. Along with this, some technical criteria, such as relevance, verifiability, freedom from bias and quantifiability, have been also proposed for evaluating accounting information [e.g., see AAA, 1966]. Until recently, therefore, the choice among alternative accounting policies have been made on the basis of technical considerations. Such a technical accounting perspective has not, however, provided a conclusive frame of reference for standard setting. Why?

Several reasons may be enumerated for this failure (as will be stated later), and what is more important, a new perspective called "a veritable revolution in accounting thought" have arisen in the United States and have been applied in the domain of policy making [Zeff, 1978, p.56]. The main purposes of this paper are, in search of the answers to those questions put at the outset, (1) to give an outline of an economic consequences perspective in policy making with great emphasis on information inductance, (2) to present information inductance considerations in some cases, and (3) to examine the relationship between economic consequences and accounting standard setting.

II. *Accounting Standard Setting as a Social Choice*

It is safe to say that historically the setting of accounting standards have been based primarily on technical accounting considerations, such as which method produces the best matching of expenses and revenues or which principle provides the most realistic portrayal of the effects of transactions. In other words, it has been supposed that if accounting information meeting the technical tests are provided, all interested parties would be treated fairly.

But now things have changed greatly. Recognizing that the making of accounting

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policy needs to be viewed more broadly than simply and narrowly from a technical accounting perspective, standard setters have become aware of the economic and social consequences of the standards to be adopted. The term "economic consequences" here means the impact of accounting information on the behavior or decision making of firms, investors, governments, analysts, and so forth. Zeff [1978] described this newly developed view as follows:

> "Until recently, accounting policy making was either assumed to be neutral in its effects or, if not neutral, it was not held out to the public as being responsible for those effects. Today, these assumptions are being severely questioned." (p.56)

All decisions concerning accounting policy have economic consequences and, therefore, necessarily involve trade-offs among economic consequences and among constituencies in the financial reporting environment [Beaver, 1981, pp.16-18; AAA, 1978, p.24]. To put it another way, financial accounting standards can affect resource allocation and wealth distribution in the economy. In this sense the setting of accounting standards can be viewed essentially as a social choice. Hence the financial reporting system of each country may well be said to be the result of a form of social choice. The recent expanded view of standard setting to the effect that a policy making body should take into account the economic consequences of the policy to be established, comes from an increasing recognition of this.

Needless to say, the formulation of accounting standards may have adverse economic consequences or impose costs on some, while it may have favorable consequences or confer benefits to others.[1] The costs include the direct costs of production and publication of information by the firm, the costs of interpreting and evaluating information incurred by investors and other users, and such indirect costs as the unfavorable effects of information on the firm. The benefits include the relevance of information to the decision making by investors, a reduction of the cost for providing information, and the desired effects resulting from reactions of the firm or others because of the publication of the information. The economic consequences argument is based on the information economics approach which treats accounting information as an economic good and evaluates accounting information in a cost-benefit framework. In contrast, the classical and decision-usefulness approaches have not given explicit recognition to the costs of accounting information in a cost-benefit framework; they have focused solely on the benefits [AAA, 1977, p.21].

Some evidence of the restive tendency of the economic consequences argument can be enumerated. First of all, not a few theorists have persistently exhorted the importance of economic impact analysis with emphasis on the political or social choice dimension of accouting standard setting. It can be construed that a great number of empirical studies based on the efficient market hypothesis (EMH)[2] have been conducted in an effort to analyze the economic impact of accounting information on investors through the securities market.[3]

[1] Beaver [1981, pp. 15–17 and Ch. 2] enumerated, in his excellent book, as economic consequences of accounting policy the effects on the following: (1) wealth distribution, (2) aggregate risk incurred and risk allocation, (3) aggregate consumption and aggregate production, (4) resource allocation, (5) resources devoted to publicly available information, (6) resources devoted to regulation, and (7) resources devoted to private search for information.

[2] For a comprehensive discussion, see Gonedes and Dopuch [1974] and Dyckman, Downes and Magee [1975].

[3] It will be pointed out later that most EMH research studies are not sufficient for a cost-benefit analysis.

Furthermore, the American Accounting Association set up the Committee on the Social Consequences of Accounting Information and published a report as the outcome of deliberations in 1978.[4] The report said that the economic and social consequences perspective "has become the central contemporary issue in accounting." (p.4)

How about the FASB as a main policy making body in the U.S.? Faced with criticism from the accounting profession and financial community leveled at the FASB's operations and procedures, the Financial Accounting Foundation (FAF) recommended in 1977 that the FASB incorporate an economic impact analysis in significant exposure drafts.[5] Following this recommendation, the FASB has held a conference dealing entirely with the subject[6] and has commissioned research papers on the economic ramifications of certain accounting standards.[7] Evidence does not stop here. Moreover, the FASB's conceptual framework DM included "probable economic or social impact" among the other "qualities of useful information" than relevance, measurability, reliability and comparability [FASB, 1976, Ch.7]. And the FASB's *Statements of Concepts No.1 and 2*, though partly and inadequately, accept economic consequences considerations in a cost-benefit framework. Such evidence demonstrates that the economic consequences perspective has become accepted as a valid substantive policy issue [Zeff, 1978, p.61].

There are two principal reasons why the economic consequences perspective has surfaced.[8] One is the increasing influence or intervention of outside interested forces in the process of setting standards. Two background factors underlie this movement. First, the FASB (and the APB) has been taking up the issues which would have an enormous impact on the volatility or level of earnings of firms. Second, those outsiders have come increasingly to know that they can, and could influence the setting of standards. The other reason is the growing recognition that accounting policy making involves resource allocation and wealth distribution and that the goal of accounting is the maximization of social welfare. It is necessary, therefore, to analyze the effects of the accounting policy to be adopted on the goal, that is, the economic consequences.

III. *Goal of Accounting Standards*

The formulation of accounting policy requires a set of goals or objectives. The necessity for accounting policy is to achieve the set of goals selected. Accordingly, such goals would provide a criterion for policy decisions. The selection of a set of goals inherently involves value judgments. As May and Sundem [1976, p.748] aptly point out, however, it is an insoluable problem because value judgments are neither whether true or not nor whether right or not. The problem of selection of goals, therefore, must be solved by general agreement or acceptance. It follows that we should begin by setting the generally accepted

[4] *Report of the Committee on the Social Consequences of Accounting Information* (Sarasota, Florida: AAA, 1978).

[5] Financial Accounting Foundation Structure Committee, *The Structure of Establishing Financial Accounting Standards* (Stamford, Connecticut: FAF, 1977), p. 51.

[6] *Conference on the Economic Consequences of Financial Accounting Standards* (Stamford, Connecticut: FASB, 1978).

[7] Research Report, *Economic Consequences of Financial Accounting Standards*, July 1978; *The Economic Effects on Lessees of FASB Statement No. 13, Accounting for Leases*, July 1981.

[8] Zeff [1978, pp.61-63] detailed ten reasons for the rise of "economic consequences."

goal of financial accounting standards as the first step in a logical process of policy formulation.

Many attempts have been made to date to define the goals or objectives of accounting standards or financial statements. The definition that is the most famous and representative is as follows: "The basic objective of financial statements is to provide information useful for making economic decisions." [AICPA, 1973, p.13] However, this does not provide a basis or criterion for selecting among alternative policies. That is, it states *what* policy making bodies are to be concerned with, but it does not state *how* selections among alternative policies are to be made [May and Sundem, 1976, p. 748]. In addition, the prescribing of the concepts of capital and income, the bases of valuation, and the rules of disclosure is not sufficient in itself as a goal of accounting standards. Such theories or statements as made so far seem to have focused on specific objectives, for example, the preferences of management, stockholders, creditors, accountants, the interests of other groups in society. A major difficulty is, however, that each individual or group's preferences cannot be combined to form unique total preferences [Hendriksen, 1982, pp. 118-119].

As evident from the foregoing discussion, an alternative goal for the above statement of objectives is the maximization of social welfare in terms of economic consequences of accounting policy to be adopted[9] [Beaver, 1981; Hendriksen, 1982; May and Sundem, 1976; Prakash and Rappaport, 1976 & 1977]. This includes the optimal resource allocation (pareto optimality) and wealth distribution. It follows from this view on the goal that standard setters should take, in order to maximize social welfare, into consideration the favorable and unfavorable consequences to the firm and specific groups and individuals, and balance these favorable and unfavorable consequences. The basis for regulation by the FASB and the SEC of accounting information is that it may lead to the allocation of resources and distribution of wealth which is pareto superior to or better than that achieved by a free-market equilibrium allocation and distribution. That is, the FASB and the SEC can influence social welfare through the selection among accounting alternatives. It is no surprise, therefore, that the FASB is a political body and, consequently, that the process of selecting acceptable accounting alternatives is a political process. If the social welfare impact of accounting policy decisions were ignored, the basis for the existence of a regulatory body would disappear. That is why the FASB must consider explicitly political (i.e. social welfare) aspects [May and Sundem, 1976, pp.749-750].

IV. *Information Inductance*

The selection among alternative accounting policies has some effects, in varying degrees, on the behavior of individuals or organizational entities. First, accounting information can affect resource allocation and wealth distribution through the use of information. In other words, external financial reports can affect the decisions and actions of investors as intended recipients and other "free riders" or "piggybackers"— such as labors, competitors, consumers, financial analysts. The responses of these recipients influence the firm's operation or behavior, both directly and indirectly, in the result feed back into the economy.

[9] *FASB Statement of Concepts No. 2* [1980] states that a standard setting body should do its best to meet the needs of society as a whole (par. 133), although it does not explicitly say that the objective of accounting policy is to maximize social welfare.

For example, shareholders and other investors evaluate the company through the financial reports as a main information source and other information. And the evaluation would be, as empirical studies dealing with the relationship between security prices and accounting numbers tell us, reflected in security prices. Security price changes affect not only the present wealth of investors, but also they can have an impact on the company's resource allocation decisions because of their influence on the company's capital cost [Rappaport, 1977, p.90]. Additionally, many contracts and legal covenants are frequently expressed in terms of accounting numbers or financial ratios. The changes in accounting standards may have some effects on the meaning of these numbers or ratios, the new economic relationship will be, therefore, produced different from what was originally intended. To cite an example, expensing all research and development costs as incurred will affect the number of net profit and the debt-equity ratio.

Similar situations exist as to free riders. For example, financial analysts may change their opinion of the company's prospect. Labor unions may use the company's financial statements as a means of labor negotiations. Furthermore, competitors may change their plans or projects in consideration of the rival company's financial information or forecasts.

Considerable amount of research, which is called decision-usefulness approach or user-oriented approach, has so far concentrated on the economic consequences by the effects of accounting standards on information recipients, that is, through information use. EMH research is considered to be an important attempt to assess the economic impact of accounting standards on investors. Investors, however, consititute but one of many valid interested groups [Buckley, 1976, p.16; May and Sundem, 1976, p.753]. There are many other parties who are influenced by accounting standards. This is one of the critical defects associated with EMH models. Thus we should enlarge our scope of attention to all impacted individuals and groups.

The other major category than investors to be taken into consideration is firms (or management) as information producer or sender. The behavoir of information senders as well as information receivers is influenced by the accounting information the senders are required to communicate and which they believe might be used by receivers in ways desirable or undesirable. The process through which the sender's behavior is influenced by information is called "information inductance" [Prakash and Rappaport]. To examine information inductance is essential to economic consequences analysis in a cost-benefit framework. The principal concern in this paper is with information inductance, because this dimension of accounting policy making has been disregarded in a cost-benefit analysis as well as most EMH research undertaken to date.

Why does information inductance arise? Corporate management, information sender, tend to anticipate the possible consequences or feedback from the behavior of intended recipients and free riders resulted from information management will provide. Based on the anticipation, management might choose — before any information is communicated and, hence, even before any consequences arise—to alter the information or his own behavior. In the final analysis, management's anticipation of the feedback effects, whether reasonable or not, will affect the resource allocation decisions within the company and, hence, collectively result in real changes at the economy level. In summary the information sender's anticipation of the consequences or feedbacks on the sender himself will conduce to information inductance.

What needs next to be examined is what effect information inductance has on the information sender's behavior. It is appropriate at this stage to state those effects in a general manner. It seems that three alternative courses of behavior are available to the information sender. The first choice is to modify merely the description of the performance or transactions. If generally accepted accounting principles explicitly permit some latitude in describing them or do not set forth any specific criterion, then management will exercise a permitted freedom so that the consequences anticipated will be the most favorable for him. And the matter ends there. Assumed the first choice is not available, the second is to modify his de facto behavior, that is, to change in part the conditions or contents of the behavior or transactions. The purpose of such an action is to make the behavior's consequences the most favorable within the newly imposed or changed requirements. The third choice is to give up the originally intended behavior or abandon the planned project. In this case, accounting policy feeds back into the information sender's behavior in the strongest manner.

V. *Some Cases of Information Inductance prior to the Creation of the FASB*

As will be shown later, economic consequences arguments have been invoked with even greater intensity since the creation of the FASB. Nevertheless it seems that there were some specific cases before then where information inductance was taken, though partially and informally, into account in setting accounting standards.

The earliest case, as far as the author knows, appears to be accounting for capital reduction, particularly accounting for the premium on redemptions of preferred stock issues. In the mid 1930s redemptions of preferred stock began to increase in number and, hence, the treatment of the premium on preferred stock reacquired was a problem of critical importance. Of a variety of methods as used in practice for recording the redemption premium, two were rather predominant. One was deducting all the redemption premium from capital surplus (additional paid-in capital) as a whole (hereafter referred to as capital surplus deduction method). This method was also called "entity equity theory," which permitted all stock premiums to be recorded in one account whether resulted from common stock issues or preferred stock issues. The other was deducting all the redemption premium from retained earnings to the extent that such premium exceeds capital surplus applicable to the retired shares (hereafter referred to as retained earnings deduction method). It was also called "issue equity theory," which required to classify and record seperately paid-in capital according to the kind or right of shares issued. Retained earnings deduction method was espoused, in chronological order, by AAA's *Tentative Statement* [1936], Paton and Littleton [1940], Scovill [1940], Smith [1941], *ASR No. 45* [1943] and Newlove and Garner [1951]. On the other hand, capital surplus deduction method was supported by Berle [1931], May [1941], Broad [1942] and Sunley and Carter [1944]. What needs to be emphasized here is that the primitive version of information inductance perspective provided one of the valid rationales for the supporters of capital surplus deduction method. It was found clearly in May and Broad's views.

May [1941], known as utilitarian, stated as follows:

> "Would justice or any *social purpose* be served by imposing an accounting role restricting the legal right and requiring that the

premium on the retirement should be charged against (earned) surplus? Would not the sole practical *consequence* of such a rule be either an injustice to the remaining preferred stockholders or the prevention of a desirable transaction?" (p.129; italics and parenthesis added)

Broad [1942] observed in his article as follows:

> "Thus it does not seem that any sufficient *social purpose* could be promoted by this proposed accounting extension of legal requirements. On the other hand, the reverse could quite conceivably be the case. Situations have arisen where a requirement that the premium on shares retired, or the excess of cost over capital and the pro-rata of the capital surplus, be charged to earned surplus would be of sufficient importance to prevent the consummation of a transaction which in all other respects would be beneficial to stockholders. I can conceive of as many cases where the rule would prevent a sound transaction as where it would prevent an unsound one."[10] (pp.29-30; italics added)

What is common to both May and Broad's observations is that if retained earnings deduction method is imposed, corporate management's anticipation of adverse effects on remaining stockholders and, therefore, the company itself will lead him to prevent the redemption transaction which is beneficial to stockholders and socially desirable. Here we can find the sprout of information inductance as early as about 40 years ago.

Next, one of some exceptions to the lack of attention to economic consequences would appear to exist in the *APB Opinions No.16* and *17*[11] dealing with business combinations and goodwill. Some evidence on the process arriving at the formal opinions indicates that the APB was at least somewhat influenced by information inductance considerations. The story goes this. It was a matter of common knowledge among accountants that the criteria for distinguishing between poolings of interests and purchases as set forth in *ARB No.48*[12] had all but eroded in the 1960s. Thus the Federal Trade Commission and the Department of Justice favored the elimination of pooling of interests from the antitrust viewpoint, arguing that permissive accounting standards contributed substantially to the great merger boom. On the other side, merger-minded corporations fervently underpinned the retention of pooling of interests. In a position sandwiched in between the two sides Kripke, an eminent lawyer and a member of the AICPA's Advisory Committee for APB Research Studies, recognized abuses of pooling, but maintained that under certain conditions pooling was useful and ought to be continued. The basis for his proposal was that to prohibit pooling "could have staggering effects in slowing down the current trend for acquisitions, particularly among conglomerate companies." [1968, p.92] This is the veritable recognition of undesirable effects upon the economy by the prevention of acquisitions through information inductance.

[10] Furthermore see the Broad's statement in the following open forum: AAA, Open Forum—Comments on the Capital Principle (*Accounting Review*, January 1942, pp. 47-48).

[11] *APB Opinion No. 16*, "Business Combinations," August 1970; *APB Opinion No. 17*, "Intangible Assets," August 1970.

[12] *ARB No. 48* "Business Combinations," January 1957.

In February, 1970, in an effort to break the deadlock, the APB circulated a formal exposure draft[13] which favored pooling when a 3 to 1 size test — "each combining company is not less than one-third the size of each other combining company," — was met together with other tests which were stricter than those set forth in *ARB No.48*. The proposed criteria immediately came under the outright attack from the merger-minded business world. According to Zeff's investigations [1972, pp.214-215], the Board received approximately 860 letters of comment, some 90 percent of which opposed the proposed criteria. In June, the 3 to 1 test was modified to 9 to 1. One reason for the relaxation by the Board was "the realization on the part of some members that a 3-to-1 size test would have a substantial impact on the way in which companies account for merger transactions — i.e., many more mergers would be shown as "purchases" instead of as "polings" [Zeff, 1972, pp.215-216]. Nevertheless, even the 9 to 1 size test could not obtain the agreement by a two-third majority of members, which was the absolute requirement for approval of drafts. In the last analysis *APB Opinion No.16* dropped the size test entirely.

It is rather evident that the ultimate policy making was affected by perceived adverse consequences that a stronger position on opposition to pooling would have a very damaging effect upon the merger-minded American firms and on the capital accumulation process, while it would give an advantage to foreign companies in bidding for American firms. The economic impact consideration, however, was essentially based on conjectures about the expected pattern of information inductance. Furthermore, it was rough and partial, because information inductance was considered only associated with the third choice of inductance's effects noted earlier, and the other two expected alternative choices must be included in an adequate economic impact analysis. It seems to be such a conjectured and partial economic impact argument that helped speed the demise of the APB.

VI. *Specific Information Inductance Arguments Facing the FASB*

As stated earlier, the FASB has accepted economic consequences perspective as a substantive policy issue. It appears that on the whole economic impact arguments or cost-benefit relationships have been often invoked to resist or criticize the existing or newly proposed accounting standards. It is doubtful, nevertheless, that the FASB has factored those arguments into the process of setting accounting standards. Let's outline those arguments in several accounting areas in terms of information inductance, which have been put forward against the FASB.

First, *FASB Statement No. 2, Accounting for Research and Develpoment Costs*, which requires that all R & D costs be expensed as incurred, has been said to alter the behavior of management and the incentives of management to undertake certain projects, so that it could reduce the ability of the firm to reap the benefits of innovative activities. It would constitute a threat to technological progress, especially by smaller companies that contemplate seeking access to the capital market [Beaver, 1981, p.51; Solomons, 1978, p.68]. Even greater weight is placed on the "competitive disadvantage" aspect.

The next topic is accounting for inflation or changing prices. The FASB issued *Statement No.33, Financial Reporting and Changing Prices*, in 1979 which requires certain large,

[13] For the exposure draft, see the Appendix C in Burton [1970].

publicly held corporations to disclose supplemental information about the effects of changing prices, including a measurement of income from continuing operations determined on the basis of constant dollar accounting and on the basis of current cost accounting.[14] Each method of accounting would affect different companies differently, making some look more prosperous than they are under present methods. What is more important is that the *Statement* would affect the behavior of management as information sender and, therefore, would change the allocation of resources within the copmany and in the economy. For example, forcing constant dollar accounting would favor the reported earnings of higher-leveraged companies to the ones with less leverage. This will lead corporate management to increase debt and thus report higher earnings per share.

Thirdly, more and more companies have leased substantial amounts of property as an alternative to ownership because of the financial, operating and risk advantages of lease arrangements. Heretofore the common wisdom of using leases was that leases represented off-the-balance-sheet financing. To put it a little badly, this enabled companies to hide their lease obligations and thus achieve far greater debt capacity and better credit ratings than would be available if these commitments were disclosed [Axelson, 1975, p.44]. The FASB promulgated *Statement No.13, Accounting for Leases*, in 1976 which requires all lessees to capitalize the lease arrangement which meets one or more of certain four criteria. As a result, even more leases have been forced to be capitalized in the balance sheet. These new requirements would affect the tendency of companies to use lease arrangements as an alternative to ownership and would lessen those aforesaid advantages.

Let's turn to the next topic which is of importance lately in the U.S. When interest rate rises sharply and economic conditions become depressed, some debtors have difficulty meeting their financial obligations. As a result, creditors tend to agree to restructure debt to permit the debtor either to defer or to reduce the interest or the principal obligation. Because of an increasing number of troubled debt restructurings, the FASB issued *Statement No.15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*, in 1977. The *Statement* mandated that if the carrying amount of the obligation immediately prior to restructuring is less than the total future cash flows required after restructuring, the difference be recorded at the date of restructure as a gain to the debtor and as a loss to the creditor. The FASB initially, before the issuance of the formal *Statement*, had proposed the criteria severer to creditors than the *Statement*. Creditors (particularly banks), therefore, opposed this proposed standard. Interest groups including creditors claimed that the FASB should take into consideration the changes in the behavior of the reporting company and resultant economic consequences. They would, in a general way, consist of as follows [Rappaport, 1977, p.90]: If banks as creditors were forced to reflect losses as a result of restructuring debt, (1) borrowing by higher risk customers (for example, small businesses) would be restricted, thereby limiting economic growth, (2) banks would hesitate to change or restructure debt terms, with the possibility that this might lead to a higher rate of business failure, or (3) to avoid restructuring, bank lending policies might be biased in favor of short term arrangements, thus having an adverse effect on long term markets.

As a result, the FASB suggested in the *Statement No.15* that no gain or loss be recognized by debtors and creditors when only a modification of terms is involved, unless the carrying

[14] Additionally, see *Accounting Series Release No. 271, Deletion of Requirement to Disclose Replacement Cost Information*, October 1979.

amount of the debt exceeds the total future cash payments specified by the new terms.

It is possible to analyze and claim the economic consequences, from the information inductance viewpoint, of accounting for the oil and gas producing companies, the translation of foreign currency and management's forecasts of earnings.

VII. *Relationship between Standard Setting and Economic Consequences*

Almost all accountants or theorists would accept the need for explicit recognition of the probable economic and social consequences of a new accounting standard. The problem seems to be whether economic consequences considerations should be incorporated into the setting of accounting standards or not.

Horngren's view [1973] provides a helpful basis for distinguishing between the two different standpoints. Based on the realization that "the setting of accounting standards is as much a product of political action as of flawless logic or empirical findings" and "getting acceptance is an exceedingly complicated process that requires skillful marketing in a political arena," he exhorted the FASB to get equipped for its marketing[15] as well as its production responsibilities. In the light of Horngren's exhortation, many views given by theorists or bodies of the relationship between accounting policy making and economic consequences considerations can be classified into the two broad groups. The first group are those that require economic consequences considerations to be incorporated into the production (i.e., the setting of accounting standards) as well as the marketing (i.e., the obtaining of acceptance by all affected parties of standards). The second are those that require them to be incorporated only into the marketing. Each group contains these theorists or bodies:

First group — Buckley, Hawkins, May and Sundem, Prakash, Rappaport
Second group — FASB, Solomons, Wyatt, Zeff

Hawkins [1975] is in the forefront of the first group. He insisted that the goal of the FASB charged with determininig accounting standards must be different from the goal of the accounting process itself[16] and that accounting standards should contribute to the social welfare of the nation. And he stated as follows:

> "In contrast, those in Congress and the Executive branch of the Federal Government who are charged with managing the nation's economy are more and more aware of the behavioral aspects of corporate reporting and its macro economic implications. Increasingly, I believe, these policy makers will demand—particularly in times of economic turmoil—that the decisions of those charged with determining what constitutes approved corporate reporting standards result in corporate reporting standards that will lead to individual economic behavior that is consis-

[15] Horngren says that the term "marketing" means "the art of getting packages of ideas accepted by all affected parties in a professional manner." (p. 61)

[16] According to Hawkins, "the accounting process is concerned with the technical performance of tasks related to the measurement and communication of relevant economic data." (p.9)

> tent with the nation's macro economic objectives. Viewed from this perspective, corporate reporting standards are an economic planning tool that can be used to reinforce the effectiveness of the other instruments used to achieve economic goals. This awareness on the part of economic planners brings accounting standards setting into the realm of political economics."(pp. 7-8)
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> "I believe if the Financial Accounting Standards Board accepts and acts consistently with the Trueblood recommendation—all of which flow from the primary objective of the accounting process to provide relevant, useful data for economic decisions—the Standards Board will have the same fatal flaw which led in large measure to the disintegration of the Accounting Principles Board. Namely, the APB found itself in conflict with national economic objectives because it did not recognize an obligation to help, in a responsible manner, the government to reach its goal. Also, the Principles Board made the mistake of clearing its proposals only with the SEC, which is not a planning body but a tool of the economic planners. This approach hastened the Board's demise. To avoid this fate, the Financial Accounting Standards Board must add one key proviso to the overall objective expressed in the Trueblood Committee report. With this addition, the Committee's primary objective as adopted by the Standards Board would be that corporate reporting standards should result in data that are useful for economic decisions provided that the standard is consistent with the nationl macro economic objectives and the economic programs designed to reach these goals." (pp.9-10)

It is natural that Hawkings should say the capitalization of R & D costs is appropriate.

May and Sundem [1976] noted that the two primary inputs to accounting policy decisions are (1) forecasts of the economic consequences to individuals of policy alternatives and (2) forecasts of individual preferences over those consequences (p.754). Underlying May and Sundem's observation is the realization that the goal or objective of accounting standards is the maximization of social welfare and that standard setting constitutes a social choice.

Rappaport [1977], an enthusiastic advocate of economic impact analysis, enumerated three strategic options that are currently available to the FASB: (1) the conceptual framework strategy, (2) the economic impact strategy, and (3) the mixed strategy. As to the conceptual framework strategy, he said, its disadvantages outweigh advantages. To show a few disadvantages, the strategy would be insensitive to the environment of corporate financial reporting. Additionally, it is based on the anachronistic view that accounting is essentially a field dedicated to the search for "true" income and "true" wealth. It is no doubt that the very act of choosing one framework rather than another is of itself a value judgment. On the other hand, a strategy based exclusively on economic impact analysis is dangerous. The strategy raises the social legitimacy of the FASB question, because if the FASB puts an exclusive emphasis on the strategy, there is always the possibility that those who will be adversely affected by FASB standards might resort to government intervention. In the last analysis, Rappaport recommended the FASB to adopt the mixed srtategy which represents a blend of the conceptual framework and economic impact approaches. It demands the continual development of a coherent framework that will provide guidelines for measurement and disclosure policy while at the same time assessing the economic consequences of the policy.

On the other side, those who are included in the second group acknowledge the need to conduct inquiries into the probable economic and social consequences of proposed standards while warn the FASB of the danger of making policy decisions rest principally on their consequences. For example, describing economic consequences as "the most challenging accouting issue of the 1970s," Zeff [1978] expressed his well-balanced opinion as follows:

> "To what degree should the FASB have regard for economic consequences? To say that any significant economic consequences should be studied by the board does not imply that account ing principles and fair presentation should be dismissed as the principal guiding factor in the board's determination. The FASB is respected as a body of accounting experts, and it should focus its attention where its expertise will be acknowledged. While some observers might opt for determining accounting standards only with regard to their consequences for economic and social welfare, the FASB would surely preside over its own demise if it were to adopt this course and making decisions primarily on other than accounting ground.
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> The board is thus faced with a dilemma which requires a delicate balancing of accounting and nonaccounting variables. Although its decisions should rest—and be seen to rest—chiefly on accounting considerations, it must also study—and be seen to study—the possible adverse economic and social consequences of its proposed actions." (p.63)

Wyatt [1977] also hesitates to make economic consequences considerations enter into the process of setting standards, he states that standard setters need to be aware of those consequences so that they may anticipate oppositions by interest parties and persuade such oppositions. He is moderate in concluding that "resolution of accounting matters must rest principally on technical analysis and conformance to agreed-on objectives of financial statements." (p.94)

It appears that a conflict between the first group and the second revolves around the neutrality of accounting. It has been said that accounting should, and does reflect economic reality or substance of the transactions and performance in financial statements. But the first group theorists realistically and a little frigidly deny such a proposition. Prakash and Rappaport [1977] declared as follows:

> "In this context, while one may plead for "economic reality" in accounting, every accounting description is, nonetheless, a description of some facet of economic reality as well as of manage-

> rial behavior, with no description having an exclusive franchise on truth. And, in virtue of this, no accounting choice is "neutral"; each involves potential wealth redistribution and effectively, therefore, social choice."[17] (p.37)

The second group's attitude toward the neutrality can be most clearly seen in the following words of Solomons [1978]:

> "One way of reducing the traffic accident rate would be for highway authorities to lower the average speed by arranging to have all speedometers consistently overstate speeds so that drivers would think they were driving faster than they actually were. Speedometers influence behavior. Why not influence it in a beneficent direction? ..... If it ever became accepted that accounting might be used to achieve other than purely measurement ends, faith in it would be destroyed just as faith in speedometers would be destroyed once it was realized that they were subject to falsification for the purpose of influencing driving habits." (pp.69-70)

Solomons emphasizes the importance of neutrality by pointing out the analogy between accounting and cartography (or speedometers). A map is not judged by the behavioral effects it produces, but by how well it represents the fact. *FASB Statement of Concepts No.2* makes the same statement as Solomons', because information that is not neutral loses credibility (par.107).

These two extremely different groups seem to argue somewhat on different planes. The "non-neutral" camp focuses on the resultant effect aspect of a trade-off among individual preferences by any policy choice, while the "neutral" camp implies "representational accuracy" as the concept of neutrality which is independent of, or indifferent to, its effects. Then how could we accomplish the neutrality in the sense of "representational accuracy" at all? Should accounting be independent of its effects? For example, the adoption of replacement cost basis of accounting, which is of itself a value judgment, reflects only the current facet of "economic reality" as well as the management's behavior. The adoption of the method of expensing all R & D costs as incurred have regard only to the uncertainty facet about the future benefits of R & D projects. There are, as a matter of fact, some cases where those projects produce actual benefits. Furthermore, provided accounting should be independent of its effects, the basis of EMH research, which analyze the effects of accounting information on investors, will not exist.

It is probable that the policy decision in accordance with a conceptual framework which aims at freedom from bias may result in biased trade-offs among individuals' interests. If we are to reach as higher level of freedom from bias as possible, we have to assess ex ante as well as ex post economic consequences of accounting standards, and then incorporate them into the process of standard setting in a reasonable manner.

One of the important differences between the first group and the second manifests itself

[17] The same as Prakash and Reppaport's observation can be seen in AAA's *Report on the Social Consequences of Accounting Information* [1978, p. 24].

in the responsibility of standard setters to take care of undesired consequences. If adverse effects upon firms, industries and the economy as a whole are anticipated or have been occurred, the first group thinks the FASB has a reasponsibility to withhold action or to gear its decisions to a concomitant remedy to cure the effects [Buckley, 1976, p.15], while the second thinks other agencies than the FASB have the responsibility to intervene to take care of the damage [FASB, 1980, par.110].

VIII. *Conclusion*

Provided that the goal or objective of accounting standards is the maximization of social welfare, we need to analyze the economic and social consequences of accounting standards. As far as the APB and the FASB have been concerned, economic consequences have been sporadically and informally evaluated only in certain instances. Particularly, less attention has been given to the concept of information inductance that the information sender's behavior is influenced by the information which he is required to communicate. What needs to be emphasized is that a cost-benefit analysis of financial reporting system will be sufficient only by combining information inductance with information use dimension of financial accounting data. Accounting standard setters had better incorporate economic consequences considerations including information inductance not only into their marketing of standards, but also, if necessary, into their production in a reasonable manner.

In concluding this paper, it appears appropriate to refer to several hurdles to be overcome in giving effect to economic impact analysis. The first hurdle is the difficulties obtaining valid and real evidence on economic consequences. When assessing ex ante those consequences, we have no choice but to resort to conjecture or perception. The second is the difficulties measuring those consequences. At present any working devices of quantifying them are not available. Faced with this problem, the FASB [1980] has declared its own standpoint as follows:

> "Despite the difficulties, the Board does not conclude that it should turn its back on the matter, for there are some things that it can do to safeguard the cost-effectiveness of its standards. .... Though it is unlikely that significantly improved means of measuring benefits will become available in the foreseeable future, it seems possible that better ways of quantifying the incremental costs of regulations of all kinds may gradually be developed, and the Board will watch any such developments carefully to see whether they can be applied to financial accouting standards."[18] (pars. 143-144)

The third and last hurdle is that even if all economic consequences could be quantified, it is difficult to determine what weight to give them in policy making.

It is our task to solve by all means these problems through applying information economics and other potent disciplines.

[18] For the evaluation of financial reporting systems, see Demski [1974].

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