FINANCIAL REPORTING: THE STATE OF STANDARD SETTING

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ABSTRACT

Three approaches to standard setting for financial reporting in the United States have been tried in the last forty-seven years. Those approaches have been marked by differences in authority, control, structure, and philosophy. The Financial Accounting Standards Board (FASB) is early in the second decade of its existence. It is a private body with a public interest under oversight of a public body, insofar as certain companies are concerned.

The FASB has not escaped the criticism heaped on its predecessors. That is not unexpected. Standard setters are not intended to be popular. They face too many conflicting forces. They are perceived by some as causing deprival of legitimate advantages and by others as being too slow in advancing the common good.

In the final analysis the FASB's success depends on its ability to persuade preparers of financial statements, auditors, and regulators that financial reporting has a role to fill—a common interest to serve—that requires order and discipline. That persuasive ability derives from technical competence and, equally important, from success in formulating an underlying conceptual structure and in coping with conflicting forces.

A conceptual anchor and acuity in dealing with change are essential for continuing success of the FASB.

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Formalized standard setting for financial reporting in the United States is about 45 years old. The third of three eras started in 1973 with the formation of the Financial Accounting Standards Board. The comments here focus mainly on the current era. They are intended to provide an overview of the process from the perspective of a standard setter. A bit of history is noted to point up changing philosophies and some of the reasons for the design of the current process. Some of the conflicting forces with which the standard setter must cope are identified. Finally, some factors bearing on the chances of continuing success of the Financial Accounting Standards Board are identified.

A standard setter's work results in either change or restraint of change. Although change has ever been a part of the human condition, people have not learned how to deal with it very well. Standpatters would have the standard setters confine their efforts to rearranging things as they are. Crusaders would have them undo basic things quite often. Evolutionists would be content to move in steps toward a goal, but would differ among themselves about the goal and how big the steps should be.

The principal forces bearing on the work of the standard setter grow out of the quest for order. Most people thirst for order. They will fight for it, but then often will fight the constraints that order imposes. Many people want to be free, and paradoxically want discipline for others to assure that freedom. The standard setter is ever caught up in that swirl of forces. It manifests itself often in terms of concerns about authoritative standards.

The term authoritative often rouses fears of heavy-handed restraint, loss of freedom, deadening uniformity, or caprice. Some observers are concerned that restraints imposed on companies prevent them from reporting the effects of differences in management philosophies. Others contend that restraints are needed to enable investors to make assessments of comparative returns and risks of companies. In short, freedom from restraint for one is viewed as a loss of freedom for the other.

After noting that everything a person does or thinks or believes expresses some accommodation between authority and freedom, MacIver [1954] observes that everyone in every way lives within a structure of authority that limits, sustains, and incorporates whatever freedom that may be owned. MacIver elaborates when he writes:

There is no freedom without order. There is no order without unity. There is no unity without authority. But the sense of unity must not degenerate into the demand for conformity, or freedom is again lost.

AUTHORITY

MacIver also assists in identifying three different kinds of authority:

- 1. Comprehensive authority. Authority that lays down rules and is backed by the power to enforce them—the ultimate political authority.
- Limited authority. Authority that lays down rules the violation of which may involve some penalty, loss of privilege or status or opportunity or economic position. This is the kind of authority possessed by many voluntary organizations.
- 3. Persuasive authority. Authority that makes no formal rules and is buttressed by no specific sanctions of any kind, but where it makes pronouncements within the appropriate area they carry weight. This is the sense in which authority is attributed to the expert, the sage, the celebrity, the social leader.

Those three kinds of authority have existed at different times in different degrees in the development of standards of financial reporting in the United States. If one marks the beginning of financial reporting in the United States as the last turn of a century, during the first thirty years standards evolved mainly under the influence of persuasive authority—the weight of expertise. That was a period when writers and speakers, both practitioners and academicians, exercised considerable influence over the course of financial reporting. One might say that it was a period in which the marketplace was allowed to furnish the order, or the discipline, subject to the recognized weight of expertise.

THREE ERAS OF STANDARD SETTING

The 1920s saw the beginning of unrest. The onset of the restiveness coincided with the rapid growth and dispersion of the capital market and widened participation of outside investors in that market. There were growing undercurrents of doubt as to whether financial reporting under persuasive authority enabled investors to make reasoned judgments. During that period the New York Stock Exchange became increasingly concerned about financial accounting principles. Even the Federal Reserve Board issued a pronouncement of financial reporting, though it dealt more with auditing procedures than accounting matters. The American Institute of Accountants (now AICPA) had not formalized a procedure for recommending standards, but a number of its influential members were writing and speaking extensively about accounting principles.

The economic crash of the early 1930s added impetus to a movement toward a different type of authority over financial reporting standards. Many investors suffered heavy losses. The collapse and ultimate liquidation of some companies caused the financial community to see and understand for the first time the extent of the diversities of financial accounting methods, among both companies within an industry and across industries. Pres-

sure to narrow the diversities began to rise. An AICPA committee, headed by George O. May, began discussions with the New York Stock Exchange.

A series of Federal securities acts were soon enacted. The Securities and Exchange Commission eventually was formed to administer the Acts and was empowered, among other things, to establish accounting principles appropriate for public companies. The Commission had comprehensive authority in MacIver's terms. The Commission soon entered into discussions with the AICPA about the role the Institute could play in this process. The Commission agreed that the AICPA should play a significant role in the development of generally accepted accounting principles, and in recent years has confirmed a significant role for the Financial Accounting Standards Board, the successor to the Accounting Principles Board of the AICPA.

COMMITTEE ON ACCOUNTING PROCEDURE

The AICPA soon organized itself to discharge the responsibility agreed upon with the Commission. The Committee on Accounting Procedure (CAP) was restructured and prepared itself to issue pronouncements aimed at narrowing the alternatives allowed under generally accepted accounting principles. The authority of the Committee was centered in the weight of its expertise, buttressed by the comprehensive authority of the Securities and Exchange Commission. AICPA members were expected to enforce the CAP pronouncements, but there was no AICPA by-law that imposed sanctions on its members.

Early in its existence, the CAP addressed the question of whether initially an attempt should be made to develop a coordinated conceptual foundation to undergird its pronouncements. That approach was rejected. Instead, it was perceived that coordinated concepts would emerge from the process of dealing with situations. Some may have believed that instincts were sufficient to identify good accounting—to furnish a basis for deciding that one accounting method is better than another. Others may have believed that accounting principles were immutable and only had to be discovered. Whether a belief in the power of instincts—a smell test—or the immutability of accounting truths, the course adopted assumed that good accounting would crowd out bad accounting. Presumably, the marketplace would provide the discipline.

As the CAP sought to nudge along the advancement of generally accepted accounting principles and to narrow alternatives, dissatisfaction with the pace and effectiveness of the process multiplied. By the late 1950s, after about 20 years of experience with a thrust characterized by authority based on the weight of expertise and a belief that good accounting would triumph over bad accounting, even George O. May, the architect of the

plan, had decided that a structure of coordinated concepts was necessary [Grady, 1962].

ACCOUNTING PRINCIPLES BOARD

The new approach put into operation in 1959 by the AICPA consisted of the Accounting Principles Board (APB) which was committed to an effort to search out the postulates and principles underlying financial reporting and an expanded research arm of the APB. The experience and professional standing of the members of the APB were not too different from that of the CAP, except for the addition of a few accountants from industry. True to its charge the APB set about to identify the pertinent postulates and principles. Two research studies soon were completed [Moonitz, 1962; Sprouse and Moonitz, 1962]. The APB assessed the studies and concluded that though they were well done and might prove helpful, they were too radical for adoption. For all practical purposes, the effort to base accounting standards on postulates and principles was abandoned. The APB continued the process of dealing with situations without a formulation of coordinated concepts. The hope remained, however, that a way would be found to develop those notions.

Quite early in the life of the APB an incident occurred that led to a change in the nature of its authority. An early Opinion on the accounting for the investment tax credit was viewed by some companies and some accounting firms as solely a recommendation and, accordingly, as not the only accounting principle that was generally accepted. The Securities and Exchange Commission acquiesced. The weight of expertise was not sufficient to impose a restraint on financial reporting.

The AICPA soon sought to strengthen the authority of the APB. Its bylaws were changed to recognize an APB Opinion as the exclusive accepted principle on the subject addressed and to impose ethical sanctions on members if they disregarded the Opinion. The authority of the APB shifted from that based on persuasion to derived limited authority, as identified by MacIver.

The APB dealt with some hard subjects during its fourteen-year life and met muscular opposition almost every time.

Users of financial statements claimed that the APB was yielding to pressures exerted by the clients of its members. Preparers of financial statements argued that the APB was arbitrary and did not listen to suggestions. Auditors of financial statements contended that its Opinions were either too "cook-bookish" or too flexible. There were stirrings in Congress that the APB was not serving the public interest well. All of those contentions crystallized into a few perceived causes of the difficulties:

- Members of the APB had conflicts of interests because its pronouncements impinged on the financial reporting of clients of members.
- Misunderstanding of purposes of financial reporting led to a floundering—a loss of sense of direction.
- Members could not be effective as standard setters because they were giving only part of their time to the effort.
- Influence over standard setting was out of balance—auditors' influence was too great.

FINANCIAL ACCOUNTING STANDARDS BOARD

By 1972 the crescendo of criticism caused the AICPA to study again the standard setting process. This time two study groups were formed to propose (a) objectives of financial statements and (b) changes in the structure of standard setting. Those study groups, respectively, were called the Trueblood study group and the Wheat committee after their chairmen. Members were appointed to the groups from accounting practitioners, representatives of companies issuing financial reports, academe, the financial community, and the AICPA.

The Wheat committee, noting the aforementioned criticisms, sought to make the standard setting body more of a public interest group, as free of perceived conflicts of interests as possible. Further, it recommended a Board comprising full-time, paid members who had broken their ties with former employers. The committee sought a process in which all parties interested in financial reporting would have an opportunity to be heard, but still a Board with as much authority as it is possible for a voluntary organization to have—authority that is derivative, stemming from ethical sanctions on auditors and buttressed by the compulsory authority of the Securities and Exchange Commission.

The Trueblood study group identified the purposes of financial statements with the decisions made by owners and creditors, existing and potential, as to where to place resources available for investments or loan. The group also expressed views about certain aspects of financial statements that it thought especially pertinent to investor/creditor decisions.

The Wheat committee recommendations led to an AICPA action to form the Financial Accounting Foundation, a not-for-profit organization, which in turn, established the Financial Accounting Standards Board (FASB) along the lines recommended by the committee. The Trueblood study group recommendations became the starting point for building a conceptual framework by the FASB. The Trueblood group provided a purpose and the beginning of a focus for financial reporting by emphasizing its role in connection with the investor/creditor decision process.

Now eleven years of the third era have passed. Highlights of the three eras are as follows:

Committee on Accounting Procedure (CAP)

22 years—1937–1959

This was an era characterized by the belief that good accounting would emerge and crowd out bad accounting as professionals studied and recommended preferred accounting. The authority was based essentially on the weight of expertise.

Accounting Principles Board (APB)

14 years—1959-1973

This was an era of search for postulates and principles, and discard of those found; nevertheless an era in which continuing efforts were made to identify coordinated concepts. Those efforts, however, did not come to fruition in the 14–year life of the APB. Its Statement No. 4 (1970), however, provided a necessary starting point for development of coordinated concepts. By articulating accounting principles then generally accepted, it brought to light the inconsistencies and the holes that needed to be filled. The authority of the APB, as noted, shifted from weight of expertise to limited authority, but remained derivative.

Financial Accounting Standards Board (FASB)

11 years-1973 to date

This current era is marked by separation from the AICPA and freedom from dominant influence by any group interested in financial reporting and by the building of a structure of coordinated concepts that is expected eventually to undergird existing standards and to provide direction for future standards. It is an era in which due process and openness are keynotes.

The authority is much like the authority of the APB during the later years of its existence. That kind of authority was buttressed further in 1973, however, by Accounting Series Release No. 150 of the Securities and Exchange Commission which identified the FASB as the private sector standard-setting body whose pronouncements would be recognized as constituting substantial authoritative support for the standard promulgated. Further, it stated that contrary standards would not have that kind of support.

PHILOSOPHICAL AND ATTITUDINAL CONSIDERATIONS

Forty-seven years of standard setting spanning three eras, characterized by differences in both structure and technique, has brought to light some central notions essential for the success of private-sector standard setting:

- Societal role of financial reporting. There must be a consensus among standard setters and their constituents of the principal role of financial reporting in society's affairs.
- The mission of the standard setters. Standard setters must have a clear perception of their mission vis-à-vis the societal role of financial reporting, and must be committed to it.
- Coordinated concepts. The mission cannot be fulfilled without a conceptual underpinning that provides direction and the means for deciding whether one solution of a financial accounting problem is better than another—the unity required for order.
- A political process. Standard setters must be mindful of their responsibilities as regulators in a private-sector political process.

Those four matters and notions about them interweave to form a philosophic foundation necessary for success of standard setters, whatever its structure and whether private or public. That philosophic foundation and the attitudes of the standard setter manifested by it are as necessary for success in standard setting as a well structured process and highly developed technical skills. The structure of the FASB has been finely tuned—there are no obvious holes or flaws. Its authority over financial reporting, direct only to the extent of the weight of its expertise and otherwise indirect through sanctions imposed by auditors and the SEC, is about as extensive as is possible for a private-sector body. Indeed, it is difficult to see how its authority could be extended short of making it a public-sector body and thereby giving it comprehensive authority. The nature of the FASB's authority is not a problem nor is its technical competence.

Improvements in the process are more likely to come from attention to and sharpening of the notions previously identified with the philosophic foundation for private-sector standard setting and attitudinal considerations for the standard setter.

Societal Role of Financial Reporting

Of what use is financial reporting in the affairs of society? Is it intended to provide the data used in compiling and measuring aggregate measures helpful in determining economic policy? It probably is not competent to do that, but it may be incidentally helpful to that end. Is it designed to report on the accountability of an enterprise to its owners and creditors? It probably is competent to do that, depending on the range of things for which an enterprise is to be held accountable, but if that were its focus, it probably would miss the opportunity to serve a broader and therefore a

more important role. Identification of role only in abstract terms is not enough.

To conclude that financial reporting's role is to assist those who make decisions concerning the capital market is a starting point, but only that. That abstration requires a focus for effective standard setting. What decision makers? What kinds of decisions? How does one go about answering those questions? The decision makers and the kinds of decisions they make are diverse—so diverse that to attempt to serve all of them would take financial reporting outside of the bounds of its competence. The choice therefore necessarily depends on the limits of expertise of financial reporting. For example, financial reporting is not especially adept at identifying and aggregating data that would be useful to economic policy makers who make decisions based on macro-economic data. If financial reporting were aimed in that direction or were to be designed to meet fuzzy goals of being helpful to all economic decision makers, it will surely fail to be maximally helpful to those decision makers that it is uniquely competent to assist.

The substance of financial reporting concerns investments, returns of and on investments, and risks that the timing and amount of returns will differ from that sought. Investors' and creditors' decisions have a direct concern with those matters. Employees' and customers' concerns about those matters are indirect, but nonetheless are real and substantive. Both the Trueblood group and the FASB addressed the aforementioned questions and both concluded that to focus on the decision makers with direct concerns about investments (assets), returns of and on (income) investments, and risks, i.e., on investors and creditors (or investors collectively) also would serve those with indirect concerns. Both bodies concluded that investor and credit decisions included decisions to invest or convert or disinvest and to lend or not lend or to call, as well as any other kind of investing or lending decision.

Investor and creditor decisions concern choices among alternatives. Their preferences vary as to the mix of prospective returns and risks. Some seek high prospective returns and are prepared to accept high risks. Others seek to limit their risks and are satisfied with low prospective returns. The role of financial reporting is to assist investors in making those choices. The societal role thus is seen to be one of serving the capital market, both public and private, as it works to allocate resources among resource seekers. Resource seekers are in the market to obtain capital at the lowest cost commensurate with prospective returns and risks offered. Resources providers are in the market to obtain the highest return commensurate with their preference for risk taking. Financial reporting seeks to present returns and risks of companies without bias, neither obscuring the risks nor exaggerating them. For then it will be evenhanded to resource providers and

fair to resource seekers—and will have served the public interest by doing all that it can to contribute to a healthy capital market.

Mission of the Standard Setters

The mission flows directly from the role of financial reporting. It has two parts: fulfilling the role in the most efficient and effective way and leading constituencies in the common effort to enhance an understanding of the part that financial reporting plays in the workings of the capital market.

The capital market is complex and has many parts. One is inclined to think of organized markets in identifying the capital market. But it is broader than that. It encompasses all of the transactions between resource seekers and resource providers whether carried out in organized markets or not. Much capital is allocated outside of organized public markets. Standard setters must continually study capital markets, public and private, and the kinds of decisions that are made in them.

They then must formulate their views about the ways in which financial accounting can assist in the decision process. They formulate their views about role and mission as a part of a political process in which resources seekers and resource providers are entitled to have their views heard. Standard setters need a feedback of others' views about their views. There is therefore a common educational objective for all parties. The standard setters, as a part of their mission, must lead in fulfilling that objective. Unless standard setters, resource seekers, and resource providers move along together in their understanding of the capital market and how financial reporting can serve it, there will be controversy and debate about role and mission. Too much of that kind of controversy will thwart efforts to make financial reporting the important force that it can be in bringing about a maximally effective capital market.

There can be, and likely ever will be, controversy about how best to serve the mission and whether it is being served best. Different perceptions in those regards are inevitable. But the standard setters and those otherwise concerned with financial reporting should not have persisting rifts in views about what the role and mission are. The FASB has given significant resources to their identification. Perhaps it should have given more attention to education. In any event the time seems near when role and mission will be commonly understood and generally accepted.

Coordinated Concepts

Standard setters without coordinated concepts of financial reporting are like a ship in a storm without an anchor. There is a bobbing around and merciless buffeting—from which there is no haven. After 22 years of at-

tempting to deal with situations without a conceptual anchor, the CAP saw the need for the anchor. After 14 years of dealing with situations and continuing awareness of the need for a conceptual anchor, which simply did not come off, the APB was dissolved in the hopes that a new approach would be more effective.

The conditions most often identified with the problems of the APB were perceived conflicts of interests causing a waffling of positions and part-time effort where full-time effort was needed. In retrospect, those probably were not as significant as the absence of a structure of fundamental notions that would elevate the level at which debate begins and provide assurance of considerable consistency to the standards pronounced. The APB repetitively argued fundamentals. The same fundamentals were argued in taking up projects near the end of its tenure as were argued in connection with early projects. Even the most fundamental of fundamentals—assets, liabilities, revenue, expense—were never defined nor could the definitions be inferred from APB pronouncements. APB Statement No. 4 (1970) surveyed financial reporting at the time and concluded, for example, that some assets were assets solely because that standing was accorded them by generally accepted accounting principles.

Coordinated concepts of financial reporting have three principal purposes. First, they provide the means for judging whether a standard is directed toward fulfilling the role identified for financial reporting—the means for judging whether one solution is better than another. Second, they bolster the chances that standards are internally consistent and therefore are evenhanded and fair. Finally, they assist in providing discipline, the restraints necessary to prevent proliferation of perceptions and resulting diversity of accounting methods for substantially similar circumstances. Standard setters' instincts alone are not adequate to maintain direction—to discriminate between a solution that better lends usefulness to a standard than another solution, and at the same time maintain consistency. Their instincts need conceptual guidance.

The parts of the conceptual framework completed by the FASB manifest those three purposes. The objectives build on the role of financial reporting and underlie the definitions of financial statement elements. Acceptance of the definitions provides the necessary discipline for order. Instead of arguing about the definitions, the FASB, as well as its constituents, now focuses attention on whether a matter in a given situation meets the conditions of a definition. That contributes to efficiency and furthers the chances of consistency.

Successful completion of the conceptual framework is critical for continuing success of the FASB. The FASB's efforts to deal with recognition criteria are disappointing. (Note: This is written in April 1984, only a few months after issuance of an Exposure Draft of a proposed concepts state-

ment on recognition and measurement in financial statements of business enterprises.) The proposed statement is misnamed in several respects. It says very little about measurement in financial statements. What is said is essentially an observation that a mixture of attributes measuring financial statement elements is expected to continue to be useful. No conceptual guidance is offered. The observation might better have been communicated in some form other than a statement of concepts.

Some helpful comments are made in the Exposure Draft about classification and aggregation in financial statements and the complementary nature of the statements, but that might better have been said in an addendum to concept Statements previously issued. Further, some thoughts are expressed about the relationship between earnings and comprehensive income, leading up to examples of the two classes of items that are included in comprehensive income but excluded from earnings. The second of those classes refers to certain other changes in net assets, principally certain holding gains and losses, such as some changes in market values and foreign currency adjustments. The unexplained use of *certain* and *some* disqualifies that section of the Exposure Draft from concepts Statement status.

The section of the Exposure Draft on recognition would be a helpful distillation of current recognition practices. The umbrella is broad enough to cover virtually all current practices, but not conceptually directed toward either narrowing those practices or preventing their proliferation. For example, the business world has long labored with various situations involving revenue recognition and with the problem of identifying the conditions of commitments that call for liability recognition. The Exposure Draft is not likely to furnish very much assistance in either of those respects. Recognition is the watershed issue in the conceptual framework in the sense that hierarchically it is the ultimate stage of conceptual concreteness. Without that kind of conceptual guidance, there is the risk of reversion to ad hoc rules in determining accounting methods. The conceptual framework cannot be said to be complete until it includes a statement on recognition more conceptually oriented than that proposed in the Exposure Draft of December 31, 1983.

A second matter that may be a stumbling block in developing a satisfactory conceptual framework concerns the identity of the concepts that have primacy.

CONCEPTUAL PRIMACY

A central issue pervades the FASB effort to construct a conceptual framework. It was one of the first issues tackled. It remains an issue, because both the issue, and the implications of the FASB position on it are still rather widely misunderstood.

As mentioned earlier coordinated concepts are needed to establish direction, to provide unity necessary for order. Order requires discipline. Every conceptual formulation in any field that fulfills its purpose of providing order attaches primacy to certain concepts. They are the concepts used to define other concepts. They prevent the systems from being openended and potentially circular. They are the concepts that are used to test for unity and maintenance of a consistent direction—they are the anchor. Conceptual primacy has nothing to do with the question of what information is most useful or of how it is measured. It refers only to the matter of definitional dependency.

Candidates for primacy in financial reporting are assets and liabilities, on the one hand, and revenues and expenses, on the other—the fount and the flow from the fount. Does the definition of the fount depend on the definition of the flow, or vice versa? In the very early years of financial reporting periodic valuations of assets were made to determine the betteroffness during a period, that is, the income for the period between valuations. That approach on its face, quite apart from whether value was historical cost or some other attribute, manifested primacy of assets and liabilities, especially assets.

But as companies and the nature of their assets become more complex, and as they looked more and more to capital markets for financing, periodic valuations of assets became less satisfactory as a way to measure income. Instead, ways were sought to measure the revenues and expenses of a period as a means of measuring income. An immediate consideration therefore was the treatment of long-lived assets with limited service lives. In the early years of the current century there was a lively, and prolonged debate as to whether depreciation was a periodic expense at all. Cost allocation became the problem of the day.

Accounting educators played a significant role in the debate of those issues. Beginning in the mid 1930s the Executive Committee of the American Accounting Association took up the task of attempting to give some order to the fundamental structure of corporate accounting. That effort culminated in the publication in 1936 of a brief and tentative "Statement of Accounting Principles Underlying Corporate Financial Statements." The Executive Committee then commissioned W. A. Paton and A. C. Littleton, two members of the original Executive Committee, to prepare "a coherent, coordinated, consistent body of doctrine" expressing the standards by which corporation accounting may be judged [Paton and Littleton, 1940]. The monograph that resulted has had a profound effect on financial reporting in the United States.

Among other things, Paton and Littleton sought to lay to rest the question of whether there was a place in financial accounting for cost allocation as a part of periodic expense determination. Revenue and expense match-

ing was the central thrust of their argument. Perhaps for the purposes of this incomplete analysis it is fair to say that the following comprise the heart of the Paton and Littleton [1940] analysis:

The basic subject matter of accounting is therefore the measured consideration involved in exchange activities, especially those which are related to services acquired (cost, expense) and services rendered (revenue, income). [pp. 11 and 12]

By means of accounting we seek to provide these test readings by a periodic matching of the costs and revenues that have flowed past "the meter" in an interval of time. [p. 15]

With acquisition and disposition prices measuring both efforts to produce results and the results produced, the principal concern of accounting is the periodic matching of costs and revenues as a test reading by which to gauge the effect of the efforts expended. [p. 7]

This analysis, which makes revenue and cost matching the centerpiece, launched a continuing effort to identify the characteristics of good matching. The thought became pervasive, almost compulsive, and caused some to conclude that the test of good matching is nondistortion. Paton and Littleton did not make that argument, but others did. Presumably, so the argument goes, distortion is recognizable in and of itself. The flaw in the argument is that distortion has meaning only as a deviation from an accepted standard or norm. Without a norm distortion is a matter of perception and therefore is subjective. Paton and Littleton dealt with the norm, the standard against which distortion would be judged—the restraint on matching. Those restraints, however, often have been overlooked or laid aside.

The restraints noted by Paton and Littleton [1940] are encapsulated in the following excerpts:

Because accounts and financial statements relate to business enterprises rather than to owners, revenues and costs are defined in terms of changes in enterprise assets rather than as increases or decreases in proprietorship. [p. 7]

Accounting theory, therefore, should explain the concepts of revenue and expense in terms of enterprise asset changes rather than as increases or decreases in proprietors' or stockholders' equities. [p. 9]

There are these stages in the accounting treatment of cost, (1) initial recognition, measurement, and classification, (2) tracing subsequent internal movements and regroupings, (3) final matching with revenue in the present or some future fiscal period. [p. 25]

In short, Paton and Littleton note that cost incurrence is a condition precedent for matching and that expenses and revenues are explainable in terms of asset changes.

When the FASB in 1973 began construction of a conceptual framework, the issue of primacy was in the forefront. The FASB attempted definitions based on the primacy of assets and liabilities and another set based on the primacy of revenues and expenses [FASB, 1946]. Having made the attempts the FASB then expressed a preference for the primacy of assets and liabilities. Views in the financial community soon polarized. Adherents of revenue and expense primacy contended that adoption of the other view constituted rejection of Paton and Littleton and of matching, elevation of the importance of the balance sheet, a secondary position for the income statement, and adoption of current value as the attribute eventually to be used in measuring assets, and perhaps liabilities. Adherents of primacy of assets and liabilities denied all of those contentions. Even today, though, there seems to be an undercurrent of fears that the contentions of those adhering to the conceptual primacy of revenue and expense may come to pass. Educational efforts are needed.

One aspect of primacy is either not understood or not accepted. If assets and liabilities have primacy in determining periodic income by matching cost and revenue, items shown in the balance sheet must satisfy the definitions of assets and liabilities. That is the key to the unity necessary for order and, therefore, discipline. If revenue and expense have conceptual primacy in determining periodic expense by matching costs and revenue, items shown in the balance sheet are the things that fall out in matching. The unity and the resulting order and discipline necessarily then derive from the restraints on the matching that are not imposed by the nature of balance-sheet elements. Attempts to identify a good match based on the primacy of revenue and expense have been unsuccessful so far. There is a serious question as to whether revenue and expense can be defined independent of assets and liabilities. As pointed out previously, assets are the fount of revenue and their cost measures expense as the fount is "used up." The fount and that which flows are both assets. Can flow then be defined without reference, direct or implied, to assets?

Anthony [1983] recently has attempted to make revenue and expense the conceptual centerpiece.

- He defines revenue for a period as those additions to entity equity resulting from operating activities of the period that can be reliably measured.
- Expense is defined as a cost applicable to the current accounting period.
- Assets are defined as the forms in which an entity's capital exists.
 Assets consist of monetary items, unexpired costs, and investments.
- Liabilities are said to report the amounts of funds supplied by those external parties who do not receive equity rights in return.

Either entity equity or entity capital would appear to have conceptual primacy. Anthony defines capital as entity's wealth, that is, the resources it controls, which takes that term back to assets. Further analysis will be required to determine whether Anthony has been successful in giving primacy to revenue and expense.

The primacy issue raises the question of the nature and purpose of accrual accounting itself. Is accrual accounting intended to produce a statistical measure of income serving as an indicator of performance, normal operations, sustainable level of activity, distributable funds, or some other feature of enterprise activity? Or, is income, instead, intended to measure an increment of enterprise betteroffness, an enhancement of wealth, an increase in net assets? The primary issue must be resolved to decide once and for all whether income is simply a statistic that measures an averaged or normalized long-range indicator or, instead, whether it represents enhancement of wealth during a period.

Standard setters unable to bring about a conceptual structure for what they are charged to do are sure to fail in carrying out their mission. The FASB is well along with its construction—some building blocks, some cornerstones are in place. Development of a conceptual framework that gives direction to standard setting and appropriate discipline to financial reporting does not come easily or quickly. Patience on the part of constituents comprising the reporting and financial communities is needed and a great deal of education along the way is essential. Abandonment of the construction would threaten the viability of the FASB.

A POLITICAL PROCESS

Standard setting in the private sector today is designed as a political process. Its design is political in that constituents are assured an opportunity to be heard and, on important issues, to engage in a dialogue with the standard setters. They are assured too that no interest group has the power to dominate the process. The power to decide issues, however, rests with the FASB; the power to enforce rests with auditors and, for public companies, with the Securities and Exchange Commission.

That kind of political process brings into play a number of forces that bear on the work of standard setters. Those forces stem from resistance to change and conflicts between perceptions of long-run common interests and perceptions of short-run self interests.

The standard setter must learn to deal with those forces evenhandedly and fairly, without cynicism. If too big a step is attempted at one time, ground may be lost instead of gained because forces may be invoked to thwart progress. If the steps taken are too small, discontent with the efficacy of the standard setting process is sure to grow and thus threaten its con-

tinuance. There is a delicate balance here that requires both courage and reason on the part of the standard setter.

Criticisms of standard setting often focus on absence of neutrality and claims of attending adverse consequences of a changed standard, as well as on the resulting increase in costs of complying with the standard.

NEUTRALITY

The standard setter reaches for neutrality. The neutrality of a standard is not gauged by its blandness. Neutrality does not mean the absence of consequence. A standard without consequence is worse than redundant—it is sterile. The expected consequence, the consequence sought, is an improvement in the investor's assessments of relative returns and risks of enterprises selected for alternative investment opportunities. Those improved assessments may, in turn, trigger consequences manifested in changed securities prices of some companies, higher for some, lower for others. The financial reporting is neutral if it aids the investor to make more accurate assessments of enterprises' returns and risks. The standard setter can expect claims from enterprises of likely adverse consequences in the course of developing and proposing changes in accounting. Those claims usually fall into two classes:

- a claim that future cash flows of the company will be adversely affected; and
- a claim that harm will be done to the working of the general economy

CASH-FLOW CONSEQUENCES

Claimed consequences concerning enterprise cash flow effects, in turn, are of three types. First, in some situations it is claimed that disclosures made in connection with a changed standard will trigger actions by customers, creditors, taxing authorities, and regulators having an adverse effect on the enterprise's cash flows. Those claims are difficult to substantiate, but they trouble the standard setter who must in the final analysis decide whether the standard and its attendant disclosures would aid the investor in making better assessments of relative returns and risks.

Second, in other situations, the claim is made that the proposed standard will adversely affect the price of an enterprise's securities and thereby adversely affect enterprise future cash flows. The standard setter in this situation must judge (a) whether the claimed consequence is likely and (b) if it is likely, whether it is an expected consequence of the standard, that is, a reassessment by investors of relative returns and risks.

Third, in still other situations claims are made that enterprises, as a

result of a change in accounting standards, will change the structure of transactions to accomplish some other accounting result. For example, when the FASB proposed new standards of accounting for leases and foreign exchange it was claimed that new kinds of leases would be written to avoid capitalization and that foreign currency activities would be changed to avoid certain accounting results. There is some evidence showing that some of the claimed actions did ensue. Though seldom stated directly the criticism implies that the reaction was one that the enterprise did not want to take because of feared adverse cash flow effects. One inference that can be drawn is that enterprises do not believe that the securities market is efficient and that any adverse effect on internal cash flows of revised operating procedures will be more than offset by adverse effects on securities prices that otherwise would have occurred. An alternative inference is that the enterprise believes that the changed standard is a bad standard that would cause investors to make inaccurate assessments of relative returns and risks. Transactions are thus restructured to avoid bad accounting that otherwise would apply and to avoid unjustified adverse effects on securities prices. One can see that this is a jungle for standard setters but one with which they must cope.

EFFICIENT MARKET HYPOTHESIS

Research on the efficient market hypothesis (EMH) has implications for standard setting, especially in connection with the economic consequences of financial reporting. There is an impressive body of research indicating that securities markets have the power to search out information quickly, whatever the source, and impound it in securities prices. In certain situations the research shows that the market is not fooled by changes in accounting that are not accompanied by changes in enterprise cash flows. Some observers have concluded that standard setting is a misdirected effort that wastes resources. Others say the EMH research is very helpful in gaining an understanding of securities markets but does not invalidate the need for standard setting. Seligman [1983] has addressed the question: How close to reality is EMH?

Having now re-surveyed the basic case made for it in the business schools, and also looked at some recent findings that seem inconsistent with it, I find myself still answering that EMH is extremely useful for understanding the stock market—but doubting, that it's as close to reality as I had previously assumed. It seems fairly clear that some superior investors are out there beating the market systematically.

The standard setter seems forced to conclude that there is an unbearable risk in assuming that the mix of accounting measurements, disclosures, and displays in financial statements is a matter of indifference to parties

buying and selling securities. A standard setter should keep up with EMH research developments and encourage more of it. It promises to be helpful in assessing certain kinds of possible consequences of changes in accounting methods and in responding to claims of possible consequences. It shows promise, too, of helping the standard setter to choose, where the call is close, between a changed financial statement measurement and an added disclosure. That is a circumstance, for example, that seems to apply to pension accounting. The limitations of the assistance that EMH can provide, however, should not be overlooked. The standard setter needs the assistance before pronouncing.

Further, EMH does not purport to measure the magnitude of the effect on securities prices in relation to the magnitude of the effect of the new standard on financial statements. Nor has the research been especially helpful in explaining the reasons for the securities price effect. An adverse securities price effect for some companies following issuance of a standard that calls for a change in accounting may be the expected consequence of improved assessments of relative returns and risks by investors. Conversely, the absence, of a securities price effect may be an indication that the standard is redundant.

STATE OF ECONOMY CONSEQUENCES

The claims of adverse consequences on the state of the economy are often more far-fetched and depend almost entirely on the argument that an adverse effect on the operations of enterprises in an industry will have a rippling effect on the economy as a whole. Sometimes the argument is carried to the point of claiming a bigger ripple throughout the economy than the ripple for the industry. Over the years, for example, standard setters have heard from respondents to invitations to comment on various proposed standards that they would:

- jeopardize the credit market because of loss of public confidence in the banking system;
- 2. have an adverse effect on the U.S. balance of payments;
- 3. lessen the availability of capital by removing leasing companies from the capital market;
- 4. lessen the flow of capital by denying small companies the opportunity to be acquired;
- 5. bring about an overall increase in utility rates because of accounting induced changes in debt-equity ratios; or
- 6. cause a lessening of exploration for hydrocarbon deposits when more exploration is needed.

Those arguments and others like them seldom have been validated. Nonetheless, the standard setter must be mindful of the possibilities. At the same time the duty to mission cannot be overlooked or laid aside—of doing everything that can be done feasibly and prudently to make the decision process that allocates scarce resources more effective and more efficient. That is overriding for the standard setter.

COSTS AND BENEFITS

Preparers of financial statements often contend that the added cost of a proposed standard is not justified. Resource seekers incur significant out-of-pocket costs for reporting. The benefit to them as a group of improved reporting is a more efficient and effective capital market in which returns and risks of one resource seeker are displayed as fully and reliably as that of other resource seekers, and therefore the prospects of a fair cost to each for returns and risks proffered.

Resource providers incur out-of-pocket costs too, searching for data, compiling, and comparing it, and assessing relative returns and risks. The benefit to them as a group is a relevant and reliable basis for assessment, and the prospects of assuming an acceptable risk and receiving a commensurate return.

Both resource seekers and resource providers can incur other kinds of costs, often not measurable, but nonetheless real and potentially significant, if the financial reporting is redundant, misunderstood, or incomplete, or for some other reason causes investors to inaccurately assess risks and prospects of returns of companies. The standard setter should have no bias concerning the parties who should bear the cost or the proportions they should bear. He does not ignore the fact that the flow of data is from resource seeker to resource provider and that each increment of additional data reported may add to the costs of resource seekers. At the same time, the standard setter realizes that resource providers may incur added costs searching for that kind of data and in relying on estimates of it. The standard setter's obligation is to do all that can be done to support the conclusion that the overall incremental benefit of added data justifies the overall incremental cost—knowing that often neither the incidence nor the amount of either costs or benefits can be measured reliably.

As mentioned earlier success in standard setting takes an understanding of societal role of financial reporting, a commitment to a commonly understood mission of standard setting, a conceptual basis serving as an anchor and the source of discipline necessary for restraint in reporting, and an attitude conditioned by the forces of the political process by which standards evolve. Fixing the direction, staying on course, and determining the length of each stride are crucial considerations. Persistent efforts to widen

and deepen understanding are necessary to keep the process on course and apace—the need for public education is continuing and decisive.

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