INSTITUTIONAL ALTERNATIVES FOR REGULATING FINANCIAL REPORTING

Charles T. HORNGREN *

Within the context of the current approach to the regulation of financial reporting, Professor Horngren focuses upon the standard-setting process. He first examines the SEC–FASB approach and discusses criticisms which have been made by the business community. Positing that the setting of accounting standards has not been accurately depicted by any model of the policy-making process, Horngren suggests a series of factors that accounting researchers should investigate in order to construct a more accurate model. He concludes that while alternatives exist to the current arrangement, the SEC–FASB model is viable because it is responsive to criticisms, and combines the expertise of the private sector with the oversight of the SEC.

1. Introduction

When David Solomons asked me to prepare an article for this conference, he suggested that it might be called "Institutional Alternatives for Regulating Financial Reporting." He said: "The best way for me to indicate what we are looking for here is to formulate a number of questions. How might the Securities and Exchange Commission (SEC) approach its statutory duty to regulate financial reporting [1]? By a hands-off policy and reliance on the market? By encouraging self-regulation? By emphasis on disclosure, leaving registrants free to choose their own measurement rules? By delegation to a private sector body? This session will not deal with the regulation of the accounting profession."

My article offers a general response to these questions. My focus will be on the setting of standards for financial reporting rather than standards for auditing or standards for a practitioner within the accounting profession. My scope is narrowed, but it still covers a broad area.

There are many fundamental questions about the SEC and the Financial Accounting Standards Board (FASB) [2] that underlie the question of institu-

* Edmund W. Littlefield Professor of Accounting, Graduate School of Business, Stanford University.
tional alternatives for regulating financial reporting. Except indirectly, this article will not encompass the following: (1) Why does regulation exist? (2) What are the relative roles of efficiency and equity as criteria for setting accounting standards? (3) How should the regulators be judged? How can the social effects of regulation be evaluated [3]?

2. The existing arrangement

2.1. Nature of the standard-setting task

The literature on management control has various descriptions of how goals should be chosen, organizations should be structured, and systems should be designed to aid the management of processes [4]. In essence, most organizations have the task of creating or obtaining some product or service that fulfills customers' demands.

In our democratic society, there is a demand for an unusual product: accounting standards [5]. The customers are numerous and varied. Examples include bankers, financial analysts, public accountants, financial executives, chief executive officers, and stockholders. Consider the relationships shown in fig. 1.

In some organizations, such as a manufacturing company, the process [6] is well-specified, the environment [7] is easily controlled, and the relationship between inputs and outputs is predictable and easily measured. Moreover, the value of the output is easy to determine, and the quality of the output is easy to ascertain. In short, the world of a manufacturing company is often relatively simple [8].

In contrast, the production of financial accounting standards is fantastically complex. The inputs encompass information of all kinds, including research evidence and a spectrum of opinions. The environment is characterized by a high level of uncertainty, including the various likelihoods of acceptability, usefulness, and economic consequences. The value of the output is difficult to ascertain, and the quality of the output is inevitably questioned.

```
Inputs
(Information, opinions research) → Process
(Deliberations, predictions, decisions) → Outputs
(Financial accounting standards)

↑ Environment
```

Fig. 1
2.2. The existing arrangement

The complexity of setting financial accounting standards requires a richer model of the process and the environment than that just depicted. This audience knows the existing institutional arrangement for the production of financial accounting standards [9]. However, our individual descriptions of the arrangements and the processes would surely differ. Each of us would emphasize different aspects and critical relationships.

Fig. 2 portrays my perception of the existing arrangements [10]. To me, the relationships are similar to decentralized management in industry. Congress, via the Securities Act of 1933 [11], gave the SEC the primary responsibility for prescribing accounting standards (principles) [12]. In turn, the SEC had delegated a large part of the work to the private sector, in recent years principally to the Accounting Principles Board (APB) and its successor, the FASB.

As fig. 2 implies, the present institutional arrangement is a public sector–private sector relationship. The private sector has been delegated plenty of encouragement and decision-making power from the public sector – but the public sector is the boss [13].

This model directly addresses several commonly held myths about the current regulatory process:

Fig. 2. Diagram of institutional relationships for production of financial accounting standards.
Myth a. The private sector sets financial accounting standards [14]. Consider the following remark: "We must keep standard-setting in the private sector." It is not exclusively in the private sector now. A more accurate statement is: "We must preserve the role of the private sector in standard-setting, at least to the extent that it now exists.

Myth b. "The private sector sets financial accounting standards, and the SEC enforces the standards" [15]. The SEC plays a variety of roles in this entire picture, including enforcement [16]. But the private sector's role is overseen by the SEC [17].

Myth c. "The SEC and FASB are partners in setting financial accounting standards" [18]. They are not partners in the classical sense of each having an equal voice. The SEC is the managing partner [19].

2.3. Complaints about the existing arrangement

I am helped by analogies, even if they are strained. The SEC and the FASB are like the referees at the Super Bowl, who have an unusual objective. They try to minimize rather than maximize. That is, they want to minimize the hisses, catcalls, and brickbats. Have you ever seen referees get a standing ovation for a job well done? Similarly, the compliments for the SEC and FASB are rare, but the boos are frequent [20]. Their objective is often to minimize the boos. (However, the regulators simultaneously want to improve financial reporting [21]. Decision scientists might describe the regulators' problem as an example of goal programming.)

As a current trustee of the Financial Accounting Foundation (FAF), I have heard and read complaints about the Foundation and the Financial Accounting Standards Board. The messages are mixed, but consider some highlights.

(1) Many observers are especially disappointed about the lack of a more concrete conceptual framework and the inconsistent positions through a series of Board pronouncements [22]. Of course, similar complaints have been voiced since explicit regulation commenced fifty years ago [23].

(2) Members of Congress and their staffs have complained about the FASB since its inception [24]. These laments have varied, but a major criticism is that the private sector has too much power [25].

(3) Chief executive officers and chief financial officers grumble about the personnel and the process. First, there are not enough representatives of business on the FAF board of trustees, on the FASB, and on the FASB staff; too few FASB members and staff are sympathetic to the problem of the real world [26]. And second, the FASB does not really listen to the written and oral suggestions from business [27]; the FASB's due process is a sham [28]; the FASB staff has too much power [29].

Of course, similar complaints about regulation have been voiced by business managers for many years. The tide rises and falls, and it is heavily affected by
the nature of the specific technical issues facing the FASB.

The repetition of history is sobering. As I wrote the above words, I was reminded of past criticisms of the APB. When the FASB was formed, the executive vice president of the American Institute of CPAs commented:

Can it be that the APB has been replaced not because of structural deficiencies but because of prevailing attitudes – attitudes within the public accounting profession and the attitude of business?

Is it possible that too many accountants and businessmen have been so determined to have their own way on matters of accounting principles that they preferred to bring down the structure rather than submit to an APB Opinion that impinged on their prerogatives [30]?

The managers' quest for power is unending and understandable. Managers perceive their stake in the output of the FASB as being larger than any other interested party [31].

3. Phenomena of political power

3.1. Model of conditions of power

Academicians prefer tidy, rational decisions. Nevertheless few FASB pronouncements turn out that way. Just as war is too important to be left to the generals, business executives, members of Congress, and many others believe that accounting is too important to be left to the technicians. There are struggles for power.

Moonitz and Sterling view "the problem as a power struggle between management and accountants. Managements want such things as diversity and flexibility, and accountants want to tell it like it is" [32].

If power is an important determinant of the output of the standard-setting process, accountants might benefit from studying fundamentals. What is power and how is it used? Here are two brief definitions:

*Power* – the ability of one social actor, A, to get another social actor B, to do something that B would not otherwise have done [33].

*Politics* – "activities taken ... to acquire, develop, and use power and other resources to obtain one's preferred outcomes in a situation where there is uncertainty or dissensus about choices" [34].

Jeffrey Pfeffer is a leading scholar in the area of power and organizations. Fig. 3 shows his model of the conditions producing the use of power and politics [35].

Although Pfeffer's model is related primarily to power within organizations [36], many of his ideas pertain to the setting of financial accounting standards. Consider *interdependence*, the first condition of the use of power [37]. When
the FASB issues a new Statement [38], it affects auditors, managers, and other interested parties. If there were no interdependence, there would be no cause for conflict or interaction among the parties.

The second condition of the use of power is inconsistent goals, called heterogeneous goals by Pfeffer [39]. When the FASB wants more lease and pension obligations recognized, many managers want just the opposite.

Heterogeneous beliefs about technology is the third condition of the use of power [40]. Some observers felt strongly that the economy would suffer dire consequences from the banning of the flow-through method for accounting for the investment tax credit [41]. Other observers disagreed [42].

Scarcity is the fourth condition of the use of power [43]. If a proposed accounting standard is perceived to affect the allocation of economic resources, effort will be expended to influence the decision. For example, managers of some insurance companies, petroleum companies, and conglomerates believed that substantial economic harm would result from proposed standards. Accordingly, these managers tried to wield power to affect the outcome [44]. As an audit partner remarked to me in the late 1970s, "Accounting doesn't advance on theory, only when somebody's money is at stake."

As fig. 3 indicates, together the four conditions produce conflict [45]. Will the conflict lead to the use of power, that is, politics? It depends on two other conditions. First, the issue or resource must be deemed important [46]. Second, the power must be dispersed [47]. Political activity occurs primarily when authority and power are dispersed in the social system [48]. In the case of standard-setting in a democratic society, these two conditions are always present. The issues are regarded as important and difficult, and the authority and power are not centralized.
When these conditions exist, the use of power is virtually certain. Moreover, Pfeffer claims that power is the only way to arrive at a decision:

Given conflicting and heterogeneous preferences and goals and beliefs about the relationship between actions and consequences, interdependence among the actors who possess conflicting preferences and beliefs, and a condition of scarcity so that not all participants can get their way, power is virtually the only way (except, perhaps, to use chance) to resolve the decision. There is no rational way to determine whose preferences are to prevail, or whose beliefs about technology should guide the decision. There may be norms, social customs, or tradition which dictate the choice, but these may be all efforts to legitimate the use of power to make its appearance less obtrusive. In situations of conflict, power is the mechanism, the currency by which the conflict gets resolved. Social power almost inevitably accompanies conditions of conflict, for power is the way by which such conflicts become resolved...

And when there is neither agreement on goals nor on technology, an unstructured, highly politicized form of decision-making is likely to occur [49].

3.2. Model of accounting policy-making

For the past fifteen years or more, I have been fascinated by the power plays in accounting policy-making. In particular, consider the maneuvers in conjunction with APB Opinions on income tax allocation [50], business combinations and goodwill [51] and proposed APB Opinions on marketable equity securities [52] and on the investment tax credit [53]. In addition, consider the FASB experiences with foreign currency translation [54], leases [55], petroleum [56], changing prices [57], and pensions [58]. Interest groups have pushed and pulled, trying to influence the final output of the standard-setting body. Above all, these antics have convinced me that our time-honored emphasis on conceptual frameworks and technical problems of measurement, although necessary, is inadequate. The FASB realizes this much better than did the APB, but its critics often see only part of the picture [59].

Many decision-making models have been described and advocated in economics, political science, organizational behavior, and other fields. Examples are the rational [60], bureaucratic [61], and market models [62]. But a model of political power may offer the most complete explanation of how financial accounting standards are set [63].

The process of setting accounting standards is often called policy-making. The process is a collection of activities by which individuals or groups in power choose general rules for action that may affect others within an organization or perhaps affect an entire society [64]. Raymond Chambers described policy-making as "'choosing which' when the choice is a matter of opinion or taste or some other personal or organizational criterion, and not simply a matter of technology" [65].

Described another way, the model of accounting policy-making has two major features: technology and political action. The process of accounting
policy-making entails making value judgments. It involves applying the technology of the accounting discipline to controversial issues. In addition, it includes considering the issues in light of the political and educational problems of achieving general acceptance of the outputs.

3.3. Problem of social choice

The academic literature characterizes the accounting policy-making process as a problem of social choice [66]. The choice involves an assessment of the consequences of policy decisions on assorted constituencies such as managers, auditors, and investors. The policy decision is made after considering which configuration of consequences is most attractive. Tradeoffs are inevitably weighed among the interests of the affected groups.

The FASB has referred to its conceptual framework as a constitution, which clearly implies a social choice perspective [67]. The latter specifies the powers of various groups (constituencies). When preferences differ, the constitution says who will dominate. For example, the president may veto a bill and Congress may be able to override the veto. Similarly, the FASB may favor an accounting standard on petroleum accounting and the SEC may override the FASB [68]. However, note that the FASB cannot veto the SEC [69].

3.4. Importance of technology

The social choice decision is influenced by power and preference [70]. The critical element is the set of individuals or coalitions with sufficient power to force a choice. In any situation, if we can identify who has the power, we can frequently predict what choices will occur [71].

My plea to accounting researchers is to increase their investigation of the literature of organizations, collective choice, social welfare, political action, and social change [72]. In this way, all of us will eventually obtain more accurate models of the policy-making process in accounting.

Make no mistake. I favor research in accounting technology, including the development of objectives, a conceptual framework and how to account for specific issues such as leases and pensions. Still, such research is not enough. A major purpose of such research is to increase the likelihood of acceptability. As I see it, the more compelling the logic and empirical evidence, the greater the chance of gaining support from diverse interests.

3.5. Lessons from conceptual framework

For nearly fifty years, leaders in accounting policy-making have sought a conceptual framework [73]. After millions of dollars and ten years, the FASB seems to be reducing the intensity of this frustrating quest. Why? At the risk of
oversimplification, I submit that the perceived expected additional costs exceed the benefits.

Suppose a specific conceptual framework is developed. The likelihood of its acceptance within the Board and its general acceptance outside the Board is too small to warrant gigantic effort. Phrased differently, the issues are deemed important and the power is dispersed. Hence, in Pfeffer's words (as quoted earlier): "And when there is neither agreement on goals nor on technology, an unstructured, highly politicized form of decisionmaking is likely to occur" [74]. Given that political actions will be omnipresent and everlasting, our expectations must include a series of pronouncements that are laced with compromises and inconsistencies.

3.6. Roles of individuals and groups

I welcome recent attempts to model the political aspects of accounting policy-making [75]. Still, I fear that it is impossible to build a model that will accurately encompass all the relationships and dynamics of the continuing process. Nevertheless, this research is encouraging. Our understanding of the process of accounting policy-making is deeper in 1984 than in 1959 than in 1934. More of us now recognize that technical analysis helps, but it alone is insufficient for resolving policy issues.

Any analysis of the policy-making process should not overlook the dynamics of small groups. The key decisions usually reside in the hands of a board, a commission, or a committee. Each member has an individual technical conceptual framework and a way of dealing within the group. Some members are more influential than others. Sometimes one or two individuals can effectively block actions that are desired by a majority. On the other hand, sometimes a persuasive leader can achieve surprising results.

3.7. Role of the chief accountant

Researchers should give more attention to "points of leverage" in their models [76]. By points of leverage, Bauer means "a person, institution, issue, or subsystem that has the capacity to effect a substantial influence on the output of the system" [77].

The chief accountant of the SEC [78] is perhaps the most powerful individual continuing point of leverage in accounting policy-making. That leverage has been exerted differently by different chief accountants. Consider two.

In 1974, after intensive political actions by various groups, the APB gave up its attempt to require the use of market values for accounting for marketable securities [79]. Shortly thereafter I commented:

The failure of the APB to reach even an exposure draft stage for so obvious a candidate for fair value as marketable securities reinforces my pessimism about fair value as a goal over
the next ten to twenty or more years. After all, if the fair value idea cannot be implemented for that category of assets, there is little practical hope for more radical schemes [80].

That prediction has held up as far as audited financial reports are concerned. But I was wrong regarding disclosures. Four years later, despite forty years of opposition to departures from historical cost, the SEC required disclosures of replacement costs for inventories and plant and equipment [81]. As chief accountant, John C. Burton persuaded the SEC to mandate fair values. This was a revolutionary requirement.

Why do I mention these experiences? Because strong influential leaders can make a difference, especially if they are at points of leverage in the process. And timing counts too. For example, as chief accountant of the SEC, Andrew Barr had a well-known aversion to upward departures from historical costs. If Barr were sitting in Burton’s chair in 1976, I wonder if the replacement cost requirements would have been issued.

Similarly, if Burton had been sitting in Barr’s chair in 1971, I wonder if the results regarding marketable securities would have been different. Also keep in mind that the lobbying groups regarding replacement costs in 1976 were much more subdued than those regarding marketable securities in 1969–1971.

3.8. FASB and SEC leadership and general acceptance

Please do not misinterpret my focus on political action and general acceptance. The latter does not mean that votes of constituents must be counted on every issue. Majority acceptance is unnecessary for successful policy-making. Widespread support certainly eases the choice, but general acceptance can sometimes be attained even in the face of resistance by a large majority.

The FASB and the SEC must exert leadership. They cannot be merely reactive bodies. If they confine themselves to vote-counting, sooner or later society will replace them.

Leadership includes anticipating problems before others see them, tackling tough problems, and obtaining enough support from the key players to resolve the issues. The SEC, APB, and FASB have exerted leadership in many areas, including accounting for changing prices, interperiod income tax allocation, foreign currency translation, and leases. They have also led without much success in other areas. The investment tax credit is an example [82]. The jury is still out regarding pensions [83].

4. Nine alternatives

Because I was asked to consider institutional alternatives, this final section will comment on the nine competing choices in Table 1. Obviously any set could have many variations. These choices represent alternatives within the
Some institutional alternatives for regulation

<table>
<thead>
<tr>
<th>Alternatives</th>
<th>Major producer of formal financial accounting standards</th>
<th>Major holder of power</th>
<th>Assessment of feasibility or likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Private sector</td>
<td>FASB or other non-AICPA body</td>
<td>Negligible</td>
</tr>
<tr>
<td>2</td>
<td>Private sector</td>
<td>AICPA</td>
<td>Negligible</td>
</tr>
<tr>
<td>3</td>
<td>Private sector</td>
<td>Free market</td>
<td>Negligible</td>
</tr>
<tr>
<td>4</td>
<td>Public sector</td>
<td>SEC</td>
<td>High</td>
</tr>
<tr>
<td>5</td>
<td>Public sector</td>
<td>Agency of Congress Like CASB</td>
<td>Low</td>
</tr>
<tr>
<td>6</td>
<td>Public sector</td>
<td>Comptroller-General or other individual</td>
<td>Infeasible</td>
</tr>
<tr>
<td>7</td>
<td>Public-private sector</td>
<td>SEC-AICPA</td>
<td>Negligible</td>
</tr>
<tr>
<td>8</td>
<td>Public-private sector</td>
<td>Private sector accounting court and public sector judicial system</td>
<td>Negligible</td>
</tr>
<tr>
<td>9</td>
<td>Public-private sector</td>
<td>SEC-FASB</td>
<td>Exists now</td>
</tr>
</tbody>
</table>

The spectrum of possibilities. My evaluations are heavily affected by my perceptions of how power would reside among constituencies.

The first three alternatives would remove power from the public sector. Deregulation by the government would entail the abolition of the SEC powers without substituting some other government powers. Although such actions would engender applause by many interested parties, I assess a tiny probability (easily less than .10) of their occurrence during our professional lives.

Each of the first three alternatives has appeal to various interest groups. Consider the first alternative. The FASB would probably welcome enhancement of its power. The SEC would not be there to influence the Board’s agenda, to constrain its options, or to veto its solutions.

The second alternative would result in the American Institute of Certified Public Accountants (AICPA) [84] having more power than it ever had during the APB days. Many practitioners would be happy because regulation would be conducted by the body of professionals who best understand the technical and practical aspects of the job. The generals would be in charge.

The third alternative would return to the earlier years of this century. There would be no formal regulation whatsoever. Accounting practices would be governed by market forces. There would be hurrahs from many interested parties, especially the followers of Milton Friedman. However, among the three alternatives, this has the lowest probability of happening. Why? Because the
practitioners in general demand some form of regulation [85]. Without rules to be cited, auditors might face ever tougher competition and stormier discussions with clients. Many auditors prefer to tell a client that the rulebook states that you must account for the transaction in a specified way. On balance, some regulation reduces confrontations and makes professional life easier rather than harder.

Alternatives four, five, and six would remove power from the private sector. The collective probability of such actions is much greater than the collective probability of the opposite actions (the removal of power from the public sector). Why? Mainly because alternative four, power residing solely in the SEC, has been discussed again and again since 1934 [86]. The Commission itself or Congress already has the power to take such actions if either is sufficiently unhappy with the existing institutional arrangements [87]. Moreover, suppose Congress is also sufficiently unhappy with the SEC. Then alternative five, the creation of an agency of Congress like the Cost Accounting Standards Board (CASB) [88], has more than a negligible probability.

The sixth alternative is to have a single person, such as the Comptroller General [89] or the SEC chief accountant [90], as the sole authority. This alternative might be pleasing to some holders of these positions, but not to others. For instance, several well-known professors would be glad to hold such a position. In any event, I have labeled this alternative as infeasible. Why? Because as long as we have a democratic society we will have no king of accounting.

The final three alternatives are public–private sector arrangements. Alternative seven would return to the SEC–AICPA days of the Committee on Accounting Procedure (CAP) [91] and the APB. In total, those lasted for almost thirty years, but they were finally found wanting for reasons well-documented elsewhere [92]. Consequently, I assess a negligible probability to restoring that mode.

Alternative eight would create an accounting court [93]. There are variations of this idea. For example, the body of financial accounting standards might be largely developed by case law [94]. There would be an appeals process. The courts in the public sector would always be a last resort. I assess a negligible probability to this alternative. Why? Mainly because those parties now in power would probably strongly resist such a radical rearrangement and transfer of authority to too few persons.

The ninth alternative, the existing SEC–FASB arrangement, has a high likelihood of surviving in its basic form for a long time. Indeed, I think it is more likely than the fourth alternative, regulation by the SEC alone. Such an intangible asset should last at least forty years. Given our democracy and the political power model, the existing arrangement has many appealing qualities. For example, all interested constituencies have ample opportunities to express their opinions.
If the existing institutional arrangement is changed dramatically, an exclusive public sector arrangement is the most likely next step. At least three categories of predictions have been made, as shown in table 2.

The performance of government regulation of accounting standards by foreign governments and by some U.S. federal agencies is unimpressive to some and disturbing to many. For example, adherence to the rigid accounting rule of the Interstate Commerce Commission inhibited desirable changes in railroad accounting for many years.

The best performance by the public sector that I anticipate is "not much difference." The extremes of enlightened governance or hobbling control are less probable. However, the prospect of hobbling seems higher. Consider what might occur: government agencies might get less direct support from the private sector. An active private body (such as the FASB) would probably wither. An understaffed public body would have to resolve more accounting issues directly. Progressive change would probably diminish. Consequently, I do not favor a complete government takeover of setting financial accounting standards.

5. Conclusion

Expectations sometimes lead to satisfying surprise and sometimes lead to sad disappointment. The level of the pleasure or pain is a function of the level of expectations. High expectations and inherent complexity often conflict. Do we expect too much? Do our expectations of a tidy conceptual framework and a well-knit series of standards square with reality?

The setting of financial accounting standards occurs in a democratic society. We should use a model of power and politics when we appraise our institutional arrangement. I desire improvements as much as the next accountant. But one person's improvement is frequently the other person's impairment.

My major point is that countless uncertainties and the problems of measurement and disclosure will still be there—regardless of whether accounting standards are set by the private sector, the public sector, or both. We should
not expect notably more "accuracy" or more "truth" merely because a more active role in setting standards is taken by one sector or another.

Judgments about measurement and disclosure are usually best made after give-and-take among informed persons. To serve the public interest, the SEC and the FASB have employed long processes of research and opinion-gathering. This takes time, much more time than many individuals prefer. Nevertheless, short-cuts are dangerous, especially in a democratic society.

In summary, the cooperative public-private method of setting financial accounting standards is probably the best way to obtain continued improvements. The federal authorities have the best of both imperfect worlds. The SEC has the major power. It has minimal resources, but it has an eager, well-financed private sector body that investigates almost all the topics chosen by federal authorities.

Some superb technical minds are being voluntarily provided to the SEC at no direct cost. Moreover, there is no evidence that the FASB has lacked integrity or subverted the public interest, however defined. Finally, the strong oversight (indeed, active participation) of the SEC and other government bodies in the standard-setting process can continue and, if necessary, be strengthened.

We will continue to muddle through. Let us not wring our hands too much at the state of our art after fifty years. To many, our conceptual framework is non-existent, flimsy, or wrong. But at least financial reporting in the United States is the most highly developed in the world. Let us proceed by improving measurements and disclosures without too much fretting about our manifold imperfections.

Keep in mind that we are not confronted with sending a man or woman to the moon. Compared to that technical feat, the setting of financial accounting standards is much more complex. As Albert Einstein remarked, "Mathematics is hard enough, but political science is far too difficult for me."

Notes

[2] The Financial Accounting Standards Board was formed concurrently with the Financial Accounting Foundation (FAF) and the Financial Accounting Standards Advisory Council (FASAC) in 1972. These were formed as the result of recommendations of a seven-man study group appointed by the American Institute of Certified Public Accountants (AICPA) Board of Directors.
Regulating financial reporting

(see infra note 84 for information about the AICPA) to study the process of establishing accounting principles and to make recommendations for improving the process as a result of the Wheat Study Group’s recommendations.

1. The FAF was established, separate from all existing professional bodies, with a Board of Trustees nominated by organizations having special expertise and continuing interest in financial accounting and reporting matters, and consisting of five certified public accountants in public practice, two financial executives, one accounting educator and one financial analyst. The principal duties of the Trustees are to appoint members of the FASB and the FASAC, a public advisory body; to raise funds to support these organizations; and to review periodically the basic structure of the standard setting organization.

2. The FASB was given all authority, functions and power of the AICPA and the FAF’s Trustees for establishing and improving standards of financial accounting and reporting and the conduct of all activities relating thereto. The FASB has seven full-time, salaried members independent of all other professional and business affiliations, four of whom are certified public accountants drawn from, or principally experienced in, public practice, while the remaining three, who might, but need not, be certified public accountants, are well-versed in problems of financial accounting and reporting.

3. A Financial Accounting Standards Advisory Council was appointed from the public to work closely with the FASB in an advisory capacity as to accounting and reporting matters, with members drawn from a variety of disciplines with no particular occupation predominating.

In July of 1973, the AICPA designated the FASB as the successor to the Accounting Principles Board (APB) in establishing accounting principles for purposes of Rule 203 of the AICPA’s Code of Professional Ethics. Rule 203 provides that no accountant who is a member of the AICPA may opine that financial statements are fairly presented in conformity with generally accepted accounting principles if such statements depart from an FASB pronouncement or an effective pronouncement of its predecessor standard-setting bodies, the APB and the Committee on Accounting Procedures, unless the accountant can demonstrate that due to unusual circumstances the financial statements would otherwise be misleading.

In December 1973, the SEC reaffirmed its administrative practice and policy of looking to the accounting profession’s authoritative standard-setting body for initiative in establishing and improving accounting principles and standards. In SEC Accounting Series Release No. 150, (Dec. 20, 1973), the SEC stated that principles, standards and practices issued by the FASB and its predecessors were presumptively required to be applied in financial statements filed with the SEC and that financial statements applying principles contrary to these accounting principles would be unacceptable in the absence of an SEC determination to the contrary.


[3] “Accounting disclosure policy affects the distribution of income, making it imperative to


[6] A process is a collection of decisions or activities that should be aimed at some ends. C. Horngren, Cost Accounting: A Managerial Emphasis 6 (5th ed. 1982) [hereinafter cited as Horngren]. The decision process is illustrated in id. at 4–7 (see especially Exhibit 1-1).

[7] The environment is the set of uncontrollable factors that affect the success of a process. Horngren, supra note 6, at 6.


[12] In the Securities Act and the Exchange Act, Congress directed the SEC to protect the public from false and misleading information by requiring publicly-owned corporations to disclose financial and other information in a manner which accurately depicts the results of corporate activities. Congress gave the SEC broad authority to establish accounting and reporting standards as part of its mandate to administer and enforce the provisions of the federal securities laws. Soon after its creation, the SEC decided by a three to two vote not to exercise its authority to set accounting standards.

Instead, the SEC decided to rely on accounting standards established in the private sector as being protective of the public interest, so long as such standards have “substantial authoritative support.” During the ensuing forty years, the AICPA has created three bodies to provide such support through authoritative pronouncements. A collection of flexible, alternative accounting standards—called generally accepted accounting principles—has evolved in the private sector to satisfy the SEC’s “substantial authoritative support” test.

The SEC issued a policy statement—Accounting Series Rel. No. 150—in 1973 which specifically endorses the FASB as the only private body where standards will be recognized by the SEC as satisfying the requirements of the federal securities laws. Staff Study, supra note 1, at 17–18. See SEC Accounting Series Rel. No. 150, Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards (Dec. 20, 1973).


[14] The Senate Staff Study on the Accounting Establishment insists that “the SEC has permitted, and even insisted upon, establishment of accounting standards ... by self-interested private parties. The result has been an extraordinary delegation of public authority and responsibility to narrow private interests.” Staff Study, supra note 1, at 17.

[15] This myth is presented in the Senate Staff Study. See Staff Study, supra note 1, at 173–83.

[16] In terms of enforcement, the SEC may, for example, seek injunctions against continuing violations of federal securities laws or the SEC's rules thereunder. See Securities Act § 20(b), 15 U.S.C. § 77t(b) (1982); Exchange Act § 21(d), 15 U.S.C. § 78u(d) (1982). In appropriate cases, such

[17] The SEC oversees the accounting profession's standard-setting bodies. For example, the SEC has issued over 200 Accounting Series Releases, some of which have conflicted with, or effectively amended or superseded standards set by the accounting profession's authoritative standard-setting bodies. Statement of Position, supra note 2, at 37. For example, in 1975 the SEC became concerned that gains from early extinguishments of debt, then required by APB Opinions to be reflected as ordinary income, were inflating earnings of some companies and urged the FASB to take prompt action indicating that it would do so if the FASB did not. The result was Statement of Financial Accounting Standards No. 4. Id.


[19] That the SEC is the managing partner is illustrated both by its veto power. Newman, supra note 13, at 135, and by recommending specific accounting issues requiring the development of standards by the FASB, id. at 135 n. 1. The FASB does not have an equal voice. See Horngren, The Marketing of Accounting Standards, J. Acct., Oct. 1973, at 61, 64 ("[I]n relation to the SEC, the APB is not a 'partner' but is a subordinate.") [hereinafter cited as Horngren, Marketing of Accounting Standards].

[20] A catalogue of the complaints about the SEC and the FASB is contained in the Staff Study, supra note 1. The Statement of Position, supra note 2, is the FASB's response to these various criticisms.

[21] The FASB's and SEC's recent history "has been marked by a number of significant efforts to improve financial accounting." Statement of Position, supra note 2, at 6.


[23] Professor Abraham Briloff recounts similar criticisms. In reference to the Committee on Accounting Procedure, established in 1940, Briloff notes that its efforts "over an 18-year period were primarily focused on the articulation of existing accounting practices and on pragmatic solutions to specific problems. Less concern was evidenced with the development of a coherent conceptual structure." Furthermore, the replacing of the Committee on Accounting Procedure with the APB in 1959 was conceded, in part, as a means to "the elaboration of a conceptual framework." However, once again "the emphasis was upon the pragmatic, and the conceptual effort took a secondary role." Statement by Abraham J. Briloff before the Subcomm. on Oversight and Investigation of the House Comm. on Interstate and Foreign Commerce (May 21, 1976), reprinted in Staff Study, supra note 1, at 1614.

[24] The complaints are summarized at length in Staff Study, supra note 1.

[25] A typical complaint is that the delegation of authority to "private interest groups" has benefited special interests at the expense of the public. Id. at 17-18.


[27] A group of financial executives voiced their view that the FASB "was not responsive to the needs of business, and was, in fact, ignoring input from the business community." Address by Marshall S. Armstrong, Third Ann. Sec. Reg. Inst. (1976), reprinted in Staff Study, supra note 1, at 1398, 1407 [hereinafter cited as Armstrong].
[29] Id.
[31] Business perceives a threat whenever a proposal could have an adverse effect on its own financial statements. Armstrong, supra note 27, at 14–16. Indeed, management perceives the "basic function of financial statements" to be as a "report on management's stewardship of corporate assets." Id. at 1408.
[34] J. Pfeffer, Power in Organizations 7 (1981) [hereinafter cited as Pfeffer]. Pfeffer continues:

If power is a force, a store of potential influence through which events can be affected, politics involves those activities or behaviors through which power is developed and used in organizational settings. Power is a property of the system at rest; politics is the study of power in action....

... [P]olitical activity is activity which is undertaken to overcome some resistance or opposition. Without opposition or contest within the organization, there is neither the need nor the expectation that one would observe political activity.

Id. Pfeffer distinguishes political activity from activity involved in decision-making that uses rational or bureaucratic procedures. See infra notes 60–61 & 63 and accompanying text.

[35] Supra note 34, at 69. The numbering of the conditions is added here. See generally id. at 67–96. Pfeffer's model demonstrates that the introduction of power is a "necessary and sufficient condition" for making a choice. The model indicates when and why power comes to be employed. Id. at 68. Pfeffer argues that when the conditions in the figure occur, the use of power is virtually inevitable and, furthermore, it is the only way to arrive at a decision. Id. at 70.
[36] The theme of Pfeffer's book is that power and politics are fundamental concepts for understanding behavior in organizations. Id. at 1–2.
[37] Pfeffer describes interdependence as

a situation in which what happens to one organizational actor affects what happens to others. ... Interdependence is an important condition because it ties the organizational participants together, in the sense that each is now concerned with what the other does and what the other obtains. In the absence of such interdependence, there would be no basis for conflict or for interaction among the participants.

Id. at 68–69.
[39] Heterogeneous goals are "goals which are inconsistent with each other." Pfeffer, supra note 34, at 69; see id. at 71–74.
[40] Heterogeneous beliefs about technology are inconsistent beliefs about "the relationship between decisions and outcomes." Id. at 69, 71–74.
[41] "Many accountants contended that profit from property can come only by using or selling it and that it should not be possible to show a profit by purchasing property. Therefore they
argued that the investment tax credit should be shown as a deferred credit rather than an immediate credit to tax expense and should be taken into income over the life of the asset." T. Fiflis, H. Kripke, & P. Foster, Accounting for Business Lawyers 747–48 (3d ed. 1984) [hereinafter cited as Fiflis, Kripke & Foster].

[42] Other accountants, companies, and the Treasury argued that the flow-through method had been passed to help corporations. See id. at 748.

[43] "To the extent that resources are insufficient to meet the various demands of organizational participants, choices have to be made concerning the allocation of those resources. The greater the scarcity as compared to the demand, the greater the power and the effort that will be expended in resolving the decision." Pfeffer. supra note 34, at 69. Scarcity is a vital component of Pfeffer's model:

Interdependence ... and differences in goals and in perceptions of technology are not sufficient, by themselves, to produce conflict and the resulting use of power and politics to reach decisions. It is only when these conditions are coupled with resource scarcity that conflict and power arise in organizational settings.

Id. at 79.

[44] For a discussion of the activities of petroleum companies regarding proposed standards for oil and gas accounting and disclosure, see Fiflis, Kripke & Foster, supra note 41, at 232–40.

[45] "[D]isagreements about cause–effect relations and preferences lead to conflict and, potentially, the use of power to resolve the choice." Pfeffer, supra note 34, at 74. According to Pfeffer, goal discrepancies are widely recognized as preconditions for conflict. Id. at 74–79.

[46] Where a decision is perceived as less important, "power and politics may not be employed to resolve the decision because the issue is too trivial to merit the investment of political resources and effort." Id. at 70. Pfeffer explains:

The use of power requires time and effort. Moreover, power typically is not inexhaustible. Votes or favors called in on one issue may not be available for use in other decisions. Thus, the use of resources that provide power, and power itself, is husbanded. Just as there is no need to use power in the absence of scarcity, there is no desire to use power to affect decisions that are not perceived as being important or critical to the organization's operations.

Id. at 85.

[47] "When power is highly centralized, the centralized authority makes decisions using its own rules and values. The political contests that sometimes occur in organizations take place only because there is some dispersion of power and authority in the social system." Id. at 70. In terms of the actors in the system, Pfeffer argues that "when power is highly concentrated, the other participants in the system have little ability or motivation to engage in a contest for control which provokes the visible conflict and political activity observed when power is more equally distributed." Id. at 87.


[49] Id. at 70–71.


[52] For a discussion of the maneuvers in the case of marketable equity securities, see Horngren, Marketing of Accounting Standards, supra note 19, at 63–64.

[53] For a discussion of these maneuvers in the case of the investment tax credit, see Fiflis, Kripke & Foster, supra note 41, at 747–49.

[55] For a discussion of these maneuvers in the case of leasing, see Fiflis, Kripke & Foster, supra note 41, at 755-59.


[60] For a discussion of rational choice models, see generally Pfeffer, supra note 34, at 18-22. Rational choice models presume that consistent goals and objectives characterize organizations. Given a set of goals, decision-making alternatives must be chosen. The search for alternatives is conducted only until a satisfactory alternative is found. Once a set of alternatives is uncovered, they are assessed in terms of likely outcomes or consequences. Id. at 20.

A rational choice involves selecting that course of action or that alternative which maximizes the social actor's likelihood of attaining the highest value for achievement of the preferences or goals in the objective function. ... Decisions are related systematically to objectives; that decision is made which shows the most promise of enabling the social actor to maximize the attainment of objectives.

Id. at 20.

Pfeffer notes that “[i]n theories of public bureaucracies, the goals are presumed to be those that are part of the agency's mission and which enable it to fulfill its assigned role in society.” Id.

[61] For a discussion of bureaucratic models of decision-making, see generally id. at 22-24. In bureaucratic models “choices are made according to rules and processes which have been adaptive and effective in the past.” Id. at 22. “Decisions are not made as much as they evolve from the policies, procedures, and rules which constitute the organization and its memory.” Id. at 23. The difference between rational models, see supra note 60, and bureaucratic models is that organizations characterized by the latter “will typically have much less extensive information search and analysis activities, and rely more heavily on rules, precedent, and standard operating procedures. Less time and resources will be spent on decision making, and fewer alternatives will be considered before action taken.” Id. at 24.

[62] A market model may be likened to what Pfeffer calls a decision process model. See generally id. at 25-27. In such a model, “there are no overall organizational goals being maximized through choice, and no powerful actors with defined preferences who possess resources through which they seek to obtain those preferences.” Id. at 25. “Action occurs, but it is not primarily motivated by conscious choice and planning.” Id. at 27.

[63] For a discussion of political models of organizations, see generally id. at 27-29. Pfeffer explains that

Political models of choice further presume that when preferences conflict, the power of the various social actors determines the outcome of the decision process. ... Those interests, subunits, or individuals within the organization who possess the greatest power will receive the greatest rewards from the interplay of organizational politics. ... Power is used to overcome the resistance of others and obtain one's way in the organization.
Pfeffer provides a helpful comparison of rational and bureaucratic models on the one hand and political models on the other:

"Because political activity is focused around the acquisition and use of power, it can be distinguished from activity involved in making decisions which uses rational or bureaucratic procedures. In both rational and bureaucratic models of choice, there is no place for and no presumed effect of political activity. Decisions are made to best achieve the organization's goals, either by relying on the best information and options that have been uncovered, or by using rules and procedures which have evolved in the organization. Political activity, by contrast, implies the conscious effort to muster and use force to overcome opposition in a choice situation."

Thus, the FASB is a policy-making group.

A conceptual framework is a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. The objectives identify the goals and purposes of accounting. The fundamentals are the underlying concepts of accounting, concepts that guide the selection of events to be accounted for, the measurement of those events, and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting standards.

See generally Newman, supra note 13.

"When preferences conflict, the power of the various social actors determines the outcome of the decision process." Pfeffer, supra note 34, at 28.

"Those interests, subunits, or individuals within the organization who possess the greatest power, will receive the greatest rewards from the interplay of organizational politics." Those with power will be able to "overcome the resistance of others and obtain [their] way in the organization." Id.

Examples of this literature include, Watts and Zimmerman, The Demand for and Supply of Accounting Theories: The Market for Excuses, 54 Acct. Rev. 273 (1979) [hereinafter cited as Watts
[73] See generally Pacter, supra note 22, at 76.

[74] Pfeffer, supra note 34, at 71.

[75] For a variety of proposals and criticisms, see May and Sundem, supra note 66; Watts & Zimmerman, supra note 72; Christenson, supra note 72.


[77] Id. at 21. See generally Gergen, Assessing the Leverage Points in the Process of Policy Formation, in Bauer, supra note 76, at 181.

[78] The SEC chief accountant is the person through whom the SEC "has maintained oversight of the Financial Accounting Standards Board and its predecessor standard-setting bodies," with respect to the relationship between the work of these bodies and the Commission's responsibility to ensure appropriate disclosure in financial statements filed pursuant to the federal securities laws. Letter from Roderick M. Hills, Chairman of the SEC, to Senator Lee Metcalf (April 30, 1976), reprinted in Staff Study, supra note 1, at 1457.

[79] See Horngren, Marketing of Accounting Standards, supra note 19, at 64.

[80] Id.


[82] See generally Fiflis, Kripke & Foster, supra note 41, at 783-89. For example, after a troubled history, both the APB and SEC agreed that the investment tax credit should be deferred when it was to be reinstated in 1971. Congress provided, however, that no taxpayer shall be required to use any particular method of accounting for the credit. Pub. L. No. 92-178, § 101(c), 85 Stat. 499 (1971). This frustrated any attempt to resolve the issue.

[83] See generally Fiflis, Kripke & Foster, supra note 41, at 815-67. Changes proposed by the FASB regarding accounting in this area are subject to controversy. See FASB, Preliminary Views, Employers' Accounting Pensions and Other Post-employment Benefits (1982).

[84] The American Institute of Certified Public Accountants (AICPA) is the major U.S. professional association in the private sector that regulates the quality of external auditors (CPAs) and prepares the Uniform CPA Examination. Horngren, supra note 6, at 940. For a thorough analysis of the AICPA and its activities, see Staff Study, supra note 1, at 70-130.

[85] See supra note 5.

[86] For example, one of the recommendations of the Senate Staff Study is that the SEC establish auditing standards and enforce standards of conduct for independent auditors. Staff Study, supra note 1, at 20-24.

[87] Congress, of course, may mandate that the SEC not delegate any authority to any other organizations, whereas the SEC, as the agency with which authority rests to promulgate securities regulations, may in whole or in part ignore the mandates of the private sector. The SEC is presently under no statutory compulsion to look to the accounting profession's standard setting body for establishing accounting standards. See Exchange Act § 3(b)(1), 15 U.S.C. § 78m(b)(1) (1982). The SEC could simply reverse Accounting Series Release No. 150.

[88] In 1970, the Cost Accounting Standards Board (CASB) was formed by the U.S. Congress to establish uniform cost accounting standards, which must be used by defense contractors and federal agencies in estimating, accumulating, and reporting costs in connection with negotiated contracts. Pub. L. 91-379, § 103, 84 Stat. 796 (codified as amended at 50 U.S.C. App. § 2168 (1982)). "Negotiated" means that the price is tied to costs rather than to competitive bidding. One
of the problems that led to the formation of this board was that of how costs should be allocated among contracts and among commercial and defense products.

The CASB was terminated in 1980 because its major mission had been accomplished. However, the CASB's rules, regulations, and standards have been included in the major federal government procurement regulations and will continue to have the full force and effect of law.

The purpose of standards is to obtain a "fair" price for both buyer and seller. That is, the standards focus on ways of using a "cost accounting pricing system" as a substitute for the "free market pricing system." Horngren, supra note 6, at 511–12.

[89] The Accounting and Auditing Act of 1950, ch. 946, 64 Stat. 834 (codified at 31 U.S.C. §§ 65–67 (1982)) provides that the "Comptroller General of the United States ... shall prescribe the principles, standards and related requirements for accounting to be observed by each executive agency...."

At the present time, the Comptroller General has no authority or responsibility to set accounting rules, principles or standards which must be followed by business or accounting firms. Letter from Elmer Staats, Comptroller General of the United States, to Senator Lee Metcalf (March 31, 1976), reprinted in Staff Study, supra note 1, at 1587.

[90] See supra note 78.

[91] The Committee on Accounting Procedure was established in 1938 by the AICPA to define recommended accounting practices. Its opinions were stated in a series of publications called "Accounting Research Bulletins" (ARBs). The Committee went out of existence in 1959, when its functions were assumed by a successor agency, the Accounting Principles Board. Conference Board, Report No. 762, Identifying Accounting Principles: the Process of Developing Financial Reporting Standards and Rules in the United States 16–17 (1979).

[92] See supra note 2.

[93] I was exposed to this idea when I attended my first annual meeting of the American Accounting Association in Madison in 1957. I listened to Leonard Spacek's address: Spacek, The Need for an Accounting Court, 33 Acct. Rev. 368 (1958) [hereinafter cited as Spacek]. Sterling, supra note 32, at 67, regards accountants as having a judicial role that deserves government backing. However, this need not entail "the government's writing a rule book of individual detailed practices." Sterling suggests government intervention that gives "power to the CPA to enforce his decisions without specifying the particular decision. This is the way that a judge operates." Id.

[94] Spacek states: "From a professional point of view, we need the case method of arriving at decisions on accounting principles. We need it so that not only the accounting profession, but also industry, government, teachers, and students will know the views that prevail in arriving at accepted principles, and why they prevail." Spacek, supra note 93, at 375.

Charles T. Horngren is the Edmund W. Littlefield Professor of Accounting at Stanford University. A former president of the American Accounting Association, he has received that association's Outstanding Accounting Educator Award as well as being the 1985 recipient of the American Institute of Certified Public Accountants' Outstanding Educator Award. An author himself, he is the Consulting Editor for the Prentice-Hall Series in Accounting.