

THE RISE OF "ECONOMIC CONSEQUENCES"

The impact of accounting reports on decision making may be the most challenging accounting issue of the 1970s.

by Stephen A. Zeff

Since the 1960s, the American accounting profession has been aware of the increasing influence of "outside forces" in the standard-setting process. Two parallel developments have marked this trend. First, individuals and groups that had rarely shown any interest in the setting of accounting standards began to intervene actively and powerfully in the process. Second, these parties began to invoke arguments other than those which have traditionally been employed in accounting discussions. The term "economic consequences" has been used to describe these novel kinds of arguments.

By "economic consequences" is meant the impact of accounting reports on the decision-making behavior of business, government, unions, investors and creditors. It is argued that the resulting behavior of these individuals and groups could be detrimental to the interests of other affected parties. And, the argument goes, accounting standard setters must take into consideration these allegedly detrimental consequences when deciding on accounting questions.* The recent debates involving foreign currency translation and the accounting for unsuccessful exploration activity in the petroleum industry have relied heavily on economic consequences argu-

ments, and the Financial Accounting Standards Board and the Securities and Exchange Commission have become extremely sensitive to the issue.¹

The economic consequences argument represents a veritable revolution in accounting thought. Until recently, accounting policy making was either assumed to be neutral in its effects or, if not neutral, it was not held out to the public as being responsible for those effects. Today, these assumptions are being severely questioned, and the subject of social and economic consequences "has become *the* central contemporary issue in accounting."² That the FASB has commissioned research papers on the economic consequences of selected standards and has held a conference devoted entirely to the subject³ underscores the current importance of this issue.

Accounting policy makers have been aware since at least the 1960s of the third-

¹ Several articles have been written on "economic consequences." See, e.g., Alfred Rappaport, "Economic Impact of Accounting Standards—Implications for the FASB," *JofA*, May 77, pp.89-98; Arthur R. Wyatt, "The Economic Impact of Financial Accounting Standards," *JofA*, Oct. 77, pp.92-94; and Robert J. Swieringa, "Consequences of Financial Accounting Standards," *Accounting Forum*, May 1977, pp.25-39.

² *Report of the Committee on the Social Consequences of Accounting Information* (Sarasota, Fla.: American Accounting Association, 1978), p.4.

³ *Conference on the Economic Consequences of Financial Accounting Standards* (Stamford, Conn.: FASB, 1978).

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* Ed. note: For the opinion of an accounting standard setter, see Oscar S. Gellein's article in *Statements in Quotes*, p. 75.

party intervention issue,⁴ while the issue of economic consequences has surfaced only in the 1970s. Indeed, much of the history of the Accounting Principles Board during the 1960s was one of endeavoring to understand and cope with the third-party forces which were intervening in the standard-setting process. In the end, the inability of the APB to deal effectively with these forces led to its demise and the establishment in 1973 of the FASB.

The true preoccupations of the intervening third parties have not always been made clear. When trying to understand the third-party arguments, one must remember that before the 1970s the accounting model employed by the American Institute of CPAs committee on accounting procedure (CAP) and the APB was, formally at least, confined to technical accounting considerations (sometimes called "accounting principles" or "conceptual questions") such as the measurement of assets, liabilities and income and the "fair presentation" of financial position and operations. The policy makers' sole concern was with the communication of financial information to actual and potential investors, for, indeed, their charter had been "granted" by the SEC, which itself had been charged by Congress to assure "full and fair disclosure" in reports to investors. Third-party intervenors, therefore, would have had an obvious incentive to appeal to the accounting model used by policy makers rather than raise the specter of an economic consequences model preferred by the third parties.

When corporate management began intervening in the standard-setting process to an increasing degree, therefore, its true position was probably disguised. An examination of management arguments suggests the following range of tactical rhetoric. Arguments were couched in terms of

1 The traditional accounting model, where management was genuinely concerned about unbiased and "theoretically sound" accounting measurements.

2 The traditional accounting model, where management was really seeking to advance

⁴In this article, I am chiefly concerned with third-party intervention in the standard setting for unregulated industries. Accounting policy makers in this country have been alive for several decades to the accounting implications of the rules and regulations of rate-making in the energy, transportation and communication industries. See, e.g., George O. May, *Financial Accounting: A Distillation of Experience* (New York: The Macmillan Company, 1943), chs. 7-8, and William A. Paton, "Accounting Policies of the Federal Power Commission—A Critique," *JofA*, June 44, pp. 432-60.

its self-interest in the economic consequences of the contents of published reports.

3 The economic consequences in which management was self-interested.

If one accepts Johnson's dictum that it requires a "lively imagination" to believe that management is genuinely concerned with fair presentation when choosing between accounting alternatives,⁵ it could be concluded that the first argument has seldom been employed in third-party interventions. In recent years, particularly since the early 1970s, management has become more candid in its dialogues with the FASB, insistently advancing the third argument and thus bringing economic consequences to the fore.

"... outside parties intervened in the standard-setting process by an appeal to criteria that transcended the traditional questions of accounting measurement and fair presentation. They were concerned instead with the economic consequences...."

Two factors tend to explain why economic consequences did not become a substantive issue before the 1970s. First, management and other interested parties predominantly used the second argument cited above, encouraging the standard-setting bodies to confine themselves to the traditional accounting model. Second, the CAP and APB, with few exceptions, were determined to resolve, or appear to resolve, standard-setting controversies in the context of traditional accounting.

Early Uses of Economic Consequences Arguments

Perhaps the first evidence of economic consequences reasoning in the pronouncements of American policy makers occurred as long ago as 1941. In Accounting Research Bulletin no. 11, *Corporate Accounting for Ordinary Stock Dividends*, the CAP, in accordance with "proper accounting and corporate policy," required that fair market value be used to record the issuance of stock dividends where such market value was substantially in excess of book value.⁶

Evidently, both the New York Stock Ex-

⁵ Charles E. Johnson, "Management's Role in External Accounting Measurements," in Robert K. Jaedicke, Yuji Ijiri and Oswald Nielsen (editors), *Research in Accounting Measurement* ([n.p.], AAA, 1966), p.91.
⁶ Accounting Research Bulletin no. 11, *Corporate Accounting for Ordinary Stock Dividends* (New York: American Institute of Accountants, 1941), pp.102-03.

change and a majority of the CAP regarded periodic stock dividends as "objectionable,"⁷ and the CAP acted to make it more difficult for corporations to sustain a series of such stock dividends out of their accumulated earnings. As far as this author is aware, the U.S. is still the only country in which an accounting pronouncement requires that stock dividends be capitalized at the fair market value of the issued shares,⁸ and this position was originally adopted in this country, at least in part, in order to produce an impact on the stock dividend policies of corporations.

A second evidence of economic consequences' entering into the debates surrounding the establishment of accounting standards, this time involving management representations, occurred in 1947-48. It was the height of the postwar inflation, and several corporations had adopted replacement cost depreciation in their published financial statements.⁹ Among the arguments employed in the debate involving the CAP were the possible implications for tax reform, the possible impact on wage bargaining and the need to counteract criticisms of profiteering by big business. Despite the pressures for accounting reform, the CAP reaffirmed its support of historical cost accounting for depreciation in ARB no. 33, *Depreciation and High Costs*, and in a letter issued in October 1948.

A clear use of the economic consequences argument occurred in 1958, when three subsidiaries of American Electric Power Company sued in the federal courts to enjoin the AICPA from allowing the CAP to issue a letter saying that the deferred tax credit account, as employed in the then-recently issued ARB no. 44 (Revised), *Declining-Balance Depreciation*, should be classified as a liability.¹⁰ The three public utility companies were concerned that the SEC, under authority granted by the Public Utility Holding Company Act, would not permit them to issue debt securities in view of the unfavora-

ble debt-to-equity ratios which the proposed reclassification would produce. The case reached the U.S. Supreme Court, where certiorari was denied. In the end, the clarifying letter was issued. Nonetheless, the SEC accommodated the public utility companies by consenting to exclude the deferred tax credit from both liabilities and stockholders' equity for purposes of decisions taken under the Public Utility Holding Company Act.¹¹

Shortly after the creation of the APB, the accounting treatment of the investment tax credit exploded on the scene. The three confrontations between the APB and the combined forces of industry and the administrations of Presidents Kennedy, Johnson and Nixon have already been amply discussed in the literature.¹² The government's argument was not that the accounting deferral of the investment tax credit was bad accounting but that it diluted the incentive effect of an instrument of fiscal policy.

In 1965, the subject of segmental reporting emerged from a hearing of the Senate Subcommittee on Antitrust and Monopoly on the economic effects of conglomerate mergers. The aim of the senatorial inquiry was not to promote better accounting practices for investor use but to provide the subcommittee and other government policy makers with accounting data that would facilitate their assessment of the economic efficacy of conglomerate mergers. Company managements naturally looked on such disclosures as potentially detrimental to their merger ambitions. Pressure applied by this powerful subcommittee eventually forced the hand of the SEC to call for product-line disclosures in published financial reports. The repercussions of this initiative, which had its origin in a Senate hearing room, are still being felt.¹³

In 1967-69, the APB responded to an anguished objection by the startled Investment

⁷ George O. May, letter to J. S. Seidman, dated July 14, 1941 (deposited in the national office library of Price Waterhouse & Co. in New York), p.1.

⁸ Price Waterhouse International, *A Survey in 46 Countries: Accounting Principles and Reporting Practices* ([n.p.], PWI, 1975), table 145.

⁹ *Depreciation Policy When Price Levels Change* (New York: Controllership Foundation, Inc., 1948), ch. 14.

¹⁰ *The AICPA Injunction Case—Re: ARB [No.] 44 (Revised)*, Cases in Public Accounting Practice [no. 1] (Chicago, Ill.: Arthur Andersen & Co., 1960).

¹¹ *SEC Administrative Policy Re: Balance-Sheet Treatment of Deferred Income-Tax Credits*, Cases in Public Accounting Practice [nos. 5 and 6] (Chicago, Ill.: Arthur Andersen & Co., 1961), pp.35-59.

¹² See Maurice Moonitz, "Some Reflections on the Investment Credit Experience," *Journal of Accounting Research*, Spring 1966, pp.47-61; John L. Carey, *The Rise of the Accounting Profession: To Responsibility and Authority 1937-1969* (New York: AICPA, 1970), pp.98-104; and Stephen A. Zeff, *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* (Champaign, Ill.: Stipes Publishing Company, 1972), pp.178-80, 201-2, 219-21 and 326-27.

¹³ Charles W. Plum and Daniel W. Collins, "Business Segment Reporting," in James Don Edwards and Homer A. Black (editors), *The Modern Accountant's Handbook* (Homewood, Ill.: Dow Jones-Irwin, Inc., 1976), pp.469-511.

Bankers Association of America (today known as the Securities Industry Association) to a provision, once thought to be innocuous, in APB Opinion no. 10, *Omnibus Opinion-1966*, which imputed a debt discount to convertible debt and debt issued with stock warrants. The IBA was concerned about the impact of the accounting procedure on the market for such securities. In Opinion no. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*, the APB rescinded its action in regard to convertible debt while retaining the rest.¹⁴

From 1968 through 1971, the banking industry opposed the inclusion of bad-debt provisions and losses on the sales of securities in the net income of commercial banks. Bankers believed that the new measure would reflect unfavorably on the performance of banks. Eventually, through a concerted effort by the APB, the SEC and the bank regulatory agencies, generally accepted accounting principles were made applicable to banks.¹⁵

From 1968 through 1970, the APB struggled with the accounting for business combinations. It was flanked on the one side by the Federal Trade Commission and the Department of Justice, which favored the elimination of pooling-of-interests accounting in order to produce a slowing effect on the merger movement and on the other by merger-minded corporations that were fervent supporters of pooling-of-interests accounting. The APB, appearing almost as a pawn in a game of political chess, disenchanted many of its supporters as it abandoned positions of principle in favor of an embarrassing series of pressure-induced compromises.¹⁶

In 1971, the APB held public hearings on accounting for marketable equity securities, leases and the exploration and drilling costs of companies in the petroleum industry. In all three areas, powerful industry pressures thwarted the board from acting. The insurance industry was intensely concerned about the possible effects on its companies' stock prices of including the unrealized gains and

losses on portfolio holdings in their income statements.¹⁷ The leasing initiative was squelched after senators, representatives and even the secretary of transportation responded to a letter-writing campaign by making pointed inquiries of the SEC and APB. The letter writers raised the specter of injury that the board's proposed action would supposedly cause to consumers and to the viability of companies in several key industries.¹⁸ The petroleum industry was unable to unite on a solution to the controversy over full costing versus successful efforts costing, as it was alleged that a general imposition of the latter would adversely affect the fortunes of the small, independent exploration companies.¹⁹ Using its considerable political might, the industry succeeded in persuading the board to postpone consideration of the sensitive subject.²⁰

On each of the occasions enumerated above, outside parties intervened in the standard-setting process by an appeal to criteria that transcended the traditional questions of accounting measurement and fair

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presentation. They were concerned instead with the economic consequences of the accounting pronouncements.

“Economic consequences” have been invoked with even greater intensity in the short life of the FASB. Such questions as accounting for research and development costs, self-insurance and catastrophe reserves, development stage companies, foreign currency fluctuations, leases, the restructuring of troubled

¹⁷ Charles T. Horngren, “The Marketing of Accounting Standards,” *JofA*, Oct.73, pp.63-64.

¹⁸ Leonard M. Savoie, “Accounting Attitudes,” in Robert R. Sterling (editor), *Institutional Issues in Public Accounting* (Lawrence, Kan.: Scholars Book Co., 1974), p.326.

¹⁹ See the testimony and submissions in *APB Public Hearing on Accounting and Reporting Practices in the Petroleum Industry*, Cases in Public Accounting Practice [no.] 10 (Chicago, Ill.: Arthur Andersen & Co., 1972).

²⁰ Savoie, p.326.

¹⁴ Zeff, pp.202, 211.

¹⁵ Carey, p.134; Maurice Moonitz, *Obtaining Agreement on Standards in the Accounting Profession*, Studies in Accounting Research no. 8 (Sarasota, Fla.: AAA, 1974), pp.38-39; Zeff, pp.210-11.

¹⁶ Robert Chatov, *Corporate Financial Reporting: Public or Private Control?* (New York: The Free Press, 1975), pp. 212-22; and Zeff, pp.212-16.

debt,²¹ domestic inflation and relative price changes, and the exploration and drilling costs of companies in the petroleum industry have provoked widespread debate over their economic consequences.²² The list is both extensive and impressive, and accounting academics are busily investigating the empirical validity of claims that these and other accounting standards may be linked with the specified economic consequences.

The Standard-Setting Bodies Respond

What have been the reactions of the standard-setting bodies to the intervention by outside parties and the claim that accounting standards should or should not be changed in order to avoid unhealthy economic or social consequences? In the 1940s and 1950s, the CAP enhanced its liaison with interested third parties through a wider circulation of exposure drafts and subcommittee reports. From 1958 to 1971, through appointments to key committees, joint discussions and sym-

²¹ At the FASB's public hearing, some bankers warned of the dire economic consequences of requiring banks to write down their receivables following restructurings. Walter Wriston, chairman of Citicorp, asserted that the restructuring of New York City's obligations might just not have occurred if the banks would have been required to write down the carrying value of their receivables. Walter B. Wriston, *Transcript of Public Hearing on FASB discussion memorandum, Accounting by Debtors and Creditors When Debt Is Restructured* (1977-vol. 1-part 2), pp.69-70. Yet the FASB, in its lengthy "Basis for Conclusions" in Statement no. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (in which the feared write-downs were not required), did not refer to bankers' claims about the economic consequences of requiring significant write-downs. Does that omission imply that the FASB paid no attention to those assertions? Did the FASB conduct any empirical research (as it did concerning the economic consequences claims raised in connection with Statement no. 7, *Accounting and Reporting by Development Stage Enterprises*) to determine whether there was adequate ground to sustain such claims?

²² See, e.g., Joseph M. Burns, *Accounting Standards and International Finance: With Special Reference to Multinationals* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1976); Committee on the Social Consequences of Accounting Information, pp.9-12; Rappaport, pp.90, 92; FASB, *Conference on the Economic Consequences of Financial Accounting Standards*; U.S. Department of Energy, comments before the Securities and Exchange Commission, "Accounting Practices—Oil and Gas Producers—Financial Accounting Standards," unpublished memorandum, dated April 3, 1978.

Evidence attesting to the attention given by the FASB to economic consequences issues may be found in the "Basis for Conclusions" sections of the applicable statements. In addition to companies and industry groups, government departments (such as the Department of Commerce, in Statement no. 7, and the Departments of Energy and Justice, in Statement no. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*) were actively involved in the discussion of economic consequences.

posiums, mass mailings of exposure drafts and formal public hearings, the Institute and the APB acted to bring interested organizations more closely into the standard-setting process. The hope was, one supposes, that these organizations would be satisfied that their views were given full consideration before the final issuance of opinions. These accommodations were, however, of a procedural sort, although it is possible that these outside views did have an impact on the substantive content of some of the resulting opinions. It would appear that the APB was at least somewhat influenced by economic consequences in its prolonged deliberations leading to the issuance of Opinions no. 16, *Business Combinations*, and no. 17, *Intangible Assets*.²³ During the public hearings in 1971 on marketable equity securities and the accounting practices of companies in the petroleum industry, management representatives on several occasions asserted economic consequences as relevant considerations. Yet members of the APB's subject-area committees neither asked for proof of those assertions nor, indeed, questioned their relevance to the setting of accounting standards.²⁴

Since it was the APB's inability to cope with the pressures brought by outside organizations that hastened its demise, it is worth noting that the FASB includes the Financial Executives Institute (FEI) among its co-sponsors. In my opinion, the incorporation of the FEI in the formal structure of the Financial Accounting Foundation (FAF, the FASB's parent) is one of the most significant advantages which the FASB possesses in relation to its predecessor.²⁵

The procedural machinery established for the FASB is even more elaborate than that which existed in the final years of the APB. The object of these additional procedures has been to expand and intensify the interaction between the board and interested outside parties, notably companies, industry associa-

²³ Wyatt, pp.92-93.

²⁴ *Proceedings of Hearing on Accounting for Equity Securities*, Accounting Principles Board (New York: AICPA, 1971), section A—Transcript; and *APB Public Hearing on Accounting and Reporting Practices in the Petroleum Industry*.

²⁵ The inclusion of the FEI could arguably become the undoing of the FASB. If the FEI were to lose confidence in the board, it is possible that many of the companies which now contribute to the Financial Accounting Foundation might decline to continue doing so, provoking a financial crisis that could threaten the board's viability.

tions and government departments and agencies. A task force drawn from a broad spectrum of interested groups is appointed prior to the preparation of each discussion memorandum. The DM itself is much bulkier than the modest document the APB had issued before its public hearings; it contains a neutral discussion of the entire gamut of policy issues that bear on the resolution of the controversy before the board. A Financial Accounting Standards Advisory Council (FASAC), composed of representatives of a wide array of interested groups, was appointed to be a sounding board for the FASB. The board itself has been composed of members drawn from accounting practice, the universities, companies and government—again, so that it would be responsive, and would appear to be responsive, to the concerns of those “constituencies.” In an effort to persuade skeptics of the merit of its recommendations, the board includes in its statements a lengthy explanation of the criteria, arguments and empirical considerations it used to fashion the recommended standards.

Following criticism from within the profession of the board’s operations and procedures, the FAF conducted a study in 1977 of the entire FASB operation. Among the FAF’s many recommendations were proposals that the board expand its formal and informal contacts with interested groups and that it include an economic impact analysis in important exposure drafts. On this latter point, the FAF’s structure committee concluded: “The Board need not be unduly influenced by the possibility of an economic impact, but it should consider both the possible costs and the expected benefits of a proposal.”²⁶ In addition, the structure committee recommended actions that would strengthen the roles of the task forces and the FASAC.²⁷ In 1978, under pressure from Congress, the board began to conduct virtually all its formal meetings (including those of the FASAC) “in the sunshine.”

The history of the APB and the FASB is one of a succession of procedural steps taken to bring the boards’ deliberations into closer proximity to the opinions and concerns of interested third parties. As in the case of the APB, it is possible that an effect of these more elaborate procedures has been a change

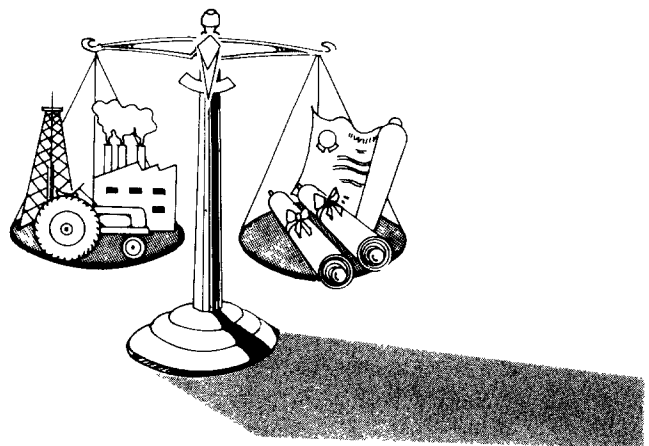
in the substance of the FASB’s conclusions and recommendations.

By the middle 1970s, however, it was decided that the FASB should add economic (and social) consequences to the substantive issues it normally addresses. The inclusion of “probable economic or social impact” among the other “qualities of useful information” in the board’s conceptual framework DM,²⁸ the board’s announcement of its interest in empirical studies of economic consequences²⁹ and the recommendation of the FAF structure committee that the board inform itself adequately on the “various impacts its pronouncements might have”³⁰ collectively confirm this new direction. The issue of economic consequences has, therefore, changed from one having only procedural implications for the standard-setting process to one which is now firmly a part of the standard setters’ substantive policy framework.

Economic Consequences As a Substantive Issue

Economic consequences have finally become accepted as a valid substantive policy issue for a number of reasons:

- The tenor of the times. The decade of the 1970s is clearly one in which American society is holding its institutions responsible for



the social, environmental and economic consequences of their actions, and the crystalized public opinion on this subject eventually became evident (and relevant) to those interested in the accounting standard-setting activity.

²⁶ Financial Accounting Foundation structure committee, *The Structure of Establishing Financial Accounting Standards* (Stamford, Conn.: FAF, 1977), p.51.

²⁷ *Ibid.*, pp.23-25.

²⁸ Financial Accounting Standards Board discussion memorandum, *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement* (Stamford, Conn.: FASB, 1976), par. 367.

²⁹ Financial Accounting Standards Board, *Status Report*, no. 45, February 7, 1977.

³⁰ Structure committee, p.31.

□ The sheer intractability of the accounting problems being addressed. Since the mid-1960s, the APB and the FASB have been taking up difficult accounting questions on which industry positions have been well entrenched. To some degree, companies that are sensitive to the way their performances are evaluated through the medium of reported earnings have permitted their decision-making behavior to be influenced by their perceptions of how such behavior will be seen through the prism of accounting earnings. Still other such companies have tailored their accounting practices to reflect their economic performances in the best light—and the managers are evidently loathe to change their decision-making behavior in order to accommodate newly imposed accounting standards. This would also be a concern to managers who are being paid under incentive compensation plans.³¹

□ The enormity of the impact. Several of the issues facing the APB and the FASB in recent years have portended such a high degree of impact on either the volatility or level of earnings and other key financial figures and ratios that the FASB can no longer discuss the proposed accounting treatments without encountering incessant arguments over the probable economic consequences. Particularly apt examples are accounting for foreign exchange fluctuations, domestic inflation and relative price changes and the exploration and drilling costs of companies in the petroleum industry.

□ The growth in the information economics-social choice, behavioral, income smoothing and decision usefulness literature in accounting. Recent writings in the information economics-social choice literature have provided a broad analytical framework within which the problems of economic consequences may be conceptualized. Beginning with Stedry,³² the literature on the behavioral implications of accounting numbers has grown significantly, drawing the attention of researchers and policy makers to the importance of considering the effects of accounting information. The literature on income smoothing has suggested the presence of a managerial motive for influencing the measurement of earnings trends. Finally, the decision usefulness literature, although it is

confined to the direct users of accounting information, has served to lessen the inclination of accountants to argue over the inherent “truth” of different accounting incomes and, instead, to focus on the use of information by those who receive accounting reports.³³

□ The insufficiency of the procedural reforms adopted by the APB and the FASB. Despite the succession of procedural steps which both boards have taken to provide outside parties with a forum for expressing their views, the claims of economic consequences—and the resulting criticisms of the boards’ pronouncements—have continued unabated. The conclusion has evidently been reached that procedural remedies alone will not meet the problem.

□ The Moss and Metcalf investigations. By the middle of 1976, it was known that Congressman John E. Moss (D-Calif.) and the late Senator Lee Metcalf (D-Mont.) were conducting investigations of the performance of the accounting profession, including its standard-setting activities, and it could reasonably have been inferred that the responsiveness of the standard-setting bodies to the economic and social effects of their decisions would be an issue.

□ The increasing importance to corporate managers of the earnings figure in capital-market transactions. Especially in the 1960s, when capital markets were intensely competitive and the merger movement was fast paced, the earnings figure came to be viewed as an important element of managerial strategy and tactics. This factor is of importance in today’s markets, as the pace of merger activity has once again quickened.

□ Accounting figures came to be viewed as an instrument of social control. The social control of American enterprise has been well known in the rate-regulated energy, transportation and communications fields, but in recent years the earnings figure has, to an increasing degree, been employed as a control device on a broader scale.³⁴ Examples are fiscal incentives (such as the investment tax credit and redefinitions of taxable income that diverge from accounting income) that

³¹ Alfred Rappaport, “Executive Incentives vs. Corporate Growth,” *Harvard Business Review*, July-August 1978, pp.81-88.

³² Andrew C. Stedry, *Budget Control and Cost Behavior* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1960).

³³ Committee on concepts and standards for external financial reports, *Statement on Accounting Theory and Theory Acceptance* (Sarasota, Fla.: AAA, 1977), pp. 5-29.

³⁴ DR Scott, though writing in a different context, nonetheless was prophetic in his prediction that accounting would increasingly be used as a means of social control. DR Scott, *Cultural Significance of Accounts* (New York: Henry Holt and Co., 1931), esp. ch. 14.

have an influence on debates surrounding financial reporting,³⁵ the price-control mechanism of Phase II in 1972-73³⁶ and the data base contemplated by the Energy Policy and Conservation Act of 1975.

□ The realization that outsiders could influence the outcome of accounting debates. Before the 1960s, accounting controversies were rarely reported in the financial press, and it was widely believed that accounting was a constant, if not a fixed parameter, in the management of business operations. With the publicity given to the accounting for the investment credit in 1962-63, to the fractious dialogue within the AICPA in 1963-64 over the authority of the APB and to other accounting disagreements involving the APB, managers and other outside parties have come to realize that accounting may be a variable after all—that the rules of accounting are not unyielding or even unbending.

□ The growing use of the third argument, advanced earlier in the article, in accounting debates. Mostly for the reasons enumerated above, outside parties began to discard the pretense that their objections to proposed changes in accounting standards were solely, or even primarily, a function of differences over the proper interpretation of accounting principles. True reasons came out into the open, and accounting policy makers could no longer ignore their implications.

It is significant that economic consequences have become an important issue at a time when accounting and finance academics have been arguing that the U.S. capital markets are efficient with respect to publicly available information and, moreover, that the market cannot be “fooled” by the use of different accounting methods to reflect the same economic reality.³⁷

The Dilemma Facing the FASB

What are the implications of the economic consequences movement for the FASB? It has become clear that political agencies (such as government departments and congressional committees) expect accounting standard setters to take explicitly into con-

sideration the possible adverse consequences of proposed accounting standards. This expectation appears to be strongest where the consequences are thought to be significant and widespread—and especially where they might impinge on economic and social policies being pursued by the government. In these instances, the FASB must show that it has studied the possible consequences but that the benefits from implementing the standards outweigh the possible adverse consequences. Where the claimed consequences have implications for economic or social policies of national importance, the FASB should not be surprised if a political resolution is imposed by outside forces.

To what degree should the FASB have regard for economic consequences? To say that any significant economic consequences should be studied by the board does not imply that accounting principles and fair presentation should be dismissed as the principal guiding factor in the board's determination. The FASB is respected as a body of accounting experts, and it should focus its attention where its expertise will be acknowledged. While some observers might opt for determining accounting standards only with regard to their consequences for economic and social welfare, the FASB would surely preside over its own demise if it were to adopt this course and make decisions primarily on other than accounting grounds.

The board is thus faced with a dilemma which requires a delicate balancing of accounting and nonaccounting variables. Although its decisions should rest—and be seen to rest—chiefly on accounting considerations, it must also study—and be seen to study—the possible adverse economic and social consequences of its proposed actions. In order to deal adequately with this latter function, the board may find it convenient to develop a staff of competent analysts from allied disciplines, notably economics.

Economic consequences bids fair to be the most challenging accounting issue of the 1970s. What is abundantly clear is that we have entered an era in which economic and social consequences may no longer be ignored as a substantive issue in the setting of accounting standards. The profession must respond to the changing tenor of the times while continuing to perform its essential role in the areas in which it possesses undoubted expertise. ■

³⁵ The “required tax conformity” issue of the early 1970s (see Zeff, pp.218-19) is another instance.

³⁶ Robert F. Lanzillotti, Mary T. Hamilton and R. Blaine Roberts, *Phase II in Review; the Price Commission Experience* (Washington, D.C.: Brookings Institution, 1975), pp.73-77; and C. Jackson Grayson, Jr., and Louis Neeb, *Confessions of a Price Controller* (Homewood, Ill.: Dow Jones-Irwin, Inc., 1974), pp. 71-76.

³⁷ See, e.g., William H. Beaver, “What Should Be the FASB's Objectives?” *JofA*, Aug.73, pp.49-56.