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PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

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VOLUME ONE

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for the degree of Doctor of Philosophy.

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ABSTRACT

The present study contributes to an understanding of the professional accounting standards setting processes in the UK. These processes are in need of exploration and elaboration because they have an impact on wealth generation and allocation decisions; yet their complexity, and associated criticisms, suggest that their management is problematic. Earlier characterisations of these processes as strictly technical have recently given way to a partially political characterisation; this has increased their apparent complexity.

The study starts by reviewing previous research in accounting and economics. That research suggests that individuals possessing private accounting information have substantial economic incentives to seek to control the release of that information. These individuals will seek to participate in any process by which the information release process is regulated; professional accounting standards setting processes in the UK are just such a regulation process.

Previous research suggests that insights can be gained by adopting theoretical constructs from disciplines other than accounting and economics; but these constructs have been adopted so far in an unsatisfactory piecemeal manner. The present study contributes to the generation of new insight by proposing a framework which integrates the frameworks of political science, organisation theory and sociology of professions. The integration specifically excludes a framework based on the methods of natural scientists because these are founded on determinate criteria which are not available in the accounting environment.

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Previous research shows that only two empirical studies of the UK professional accounting standards setting processes have been published; in both cases the results were indeterminate and conclusions speculative. A substantial body of unexplored data is available in the form of letters of comment to the Accounting Standards Committee. The present study draws together the emergent interest in the political dimension of professional accounting standards setting processes; the integrated framework generated from disciplines other than accounting and economics; and the availability of data in the UK. This provides a basis for modelling the professional accounting standards setting processes as a political process.

In the empirical study, the professional accounting standards setting processes are characterised as a simple majority voting process in which the letters of comment are characterised as collections of votes on proposals put forward by the Accounting Standards Committee in an Exposure Draft. It is hypothesised that a simple majority of votes would be sufficient to determine the outcome for a proposal. The outcome is characterised as the change between an Exposure Draft and its related Statement of Standard Accounting Practice. The model develops two interesting measures, of "influence" and "sensitivity", which enable differences between classes of participants to be detected.

The results of statistical analysis, of data generated by content analysis of the letters of comment, demonstrate that the model is a reasonably good fit. We can make the statements that UK professional accounting standards setting processes are political in the sense that votes count; and that they demonstrate a significantly greater sensitivity to the votes of professional firms of accountants, and to the votes of representative bodies of accountants, than to the votes of companies. These results are interesting and further research needs to be conducted to establish any causal mechanism which may be operating. Several other suggestions for further research are made.

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PART I INTRODUCTION

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CHAPTER 1 INTRODUCTION

- 1.1 Introduction
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CHAPTER 1 INTRODUCTION

1.1 INTRODUCTION

Professional accounting standards, in the sense of standard practices rather than standards of competence or of ethics, come to public attention infrequently. As with many issues that only rarely come to public attention, the occasions are usually ones involving some controversy. For example, in 1931, standards of professional accounting practice were called into question in the trial, on charges of fraudulent accounting, of the chairman of the Royal Mail Steam Packet Company; after the 1964 collapse of Rolls Razor, its chairman, John Bloom, blamed the failure on misleading professional accounting practices; in 1973, the Government of the day appointed a committee to advise on how companies should account for inflation, a problem then being separately addressed by the profession's own Accounting Standards Committee and still being debated at the time of writing in 1983.

Professional accounting standards are important to the business community and to the rest of society. It is the standard of professional accounting which determines part of the information process on which depend many decisions made about the economy. Professional accounting standards contribute to the determination of which enterprises, public or private, report profits and which report losses. Changes in professional accounting standards can change the amount of profits or losses reported; and even change marginal cases from profit to loss, or vice versa.

These issues are important. The level of investment in individual enterprises can depend on the accounting information reflected in their accounts; business decisions about whether or not to close down, or start up, can depend in part on that information; the very theories which we construct to explain the behaviour of the corporate sector depends to some extent on accounting information. Changes in professional accounting

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standards can change those decisions and theories; they can change the rate at which wealth and welfare is created and they can change the distribution of existing wealth and welfare.

Professional accounting standards are said by some to be technical, and often highly technical. Debates about professional accounting standards are complex and the issues often beyond the understanding of the layman. Professional accounting standards are said by others to be political. Some proposals for changes in professional accounting standards are fiercely debated in the professional press; some proposals are ignored; and at least one UK professional accounting standard, the case of accounting for inflation, has received national television coverage. The involvement of Government in these debates is not unknown.

The present study of professional accounting standards setting processes in the UK is organised as follows

Firstly, the introductory material, which includes a description of the Accounting Standards Committee, is presented in the chapters which are collected together as Part I "Introduction".

Secondly, previous research is reviewed in the chapters which are collected together as Part II "Review of previous research in accounting and economics".

Thirdly, previous research suggests that a review of research frameworks in natural science, political science, organisation theory and sociology of professions is important. This is undertaken in the chapters collected together as Part III "Review of literature from disciplines other than accounting and economics".

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Fourthly, previous research suggests that new empirical work, which models the political dimension of the UK professional accounting standards setting process, would help to reduce some of its complexity. This is undertaken in the chapters collected together as Part IV "Evidence from the empirical study of UK data".

Finally, the study is concluded in Part V "Conclusions", following which are presented an extended bibliography and several appendices based on the empirical study.

1.2 PURPOSE OF THE STUDY

This study contributes to the construction of an explanation of how UK professional accounting standards are determined. This general context can be represented by the question

"What factors, when viewed together, might be used to explain the processes by which UK professional accounting standards are determined?"

More specifically, the purpose of the present study is to contribute to the development of that explanation by addressing two areas left open by previous research in the area.

Firstly, previous research suggests that the theoretical constructs of disciplines other than accounting and economics can offer new insights or analyses for the study of professional accounting standards setting processes in the UK. That previous research has not, however, attempted any broad review of the literature of those disciplines both to identify those constructs and to set them in their own contexts to ascertain their limitations. Rather, previous research has uncritically and selectively transferred constructs to the problem of professional accounting standards setting processes in an unsatisfactory piecemeal fashion. The present study both seeks to demonstrate that those other disciplines can offer a substantial and rich insight into the complexity of professional accounting standards setting processes; and to propose a framework which can integrate these theoretical constructs as a basis for future research. The review of these literatures is undertaken below in Part III "Review of literature from disciplines other than accounting and economics".

Secondly, previous research also suggests that a political dimension is important to any explanation of professional accounting standards setting processes. The empirical part of the present study tests that suggestion by adopting a simple, naive, voting characterisation of political choice and then asking the question "Do votes count?". For participants other than the Accounting Standards Committee itself, and for votes represented in letters of comment to the Accounting Standards Committee on Exposure Drafts, and for those issues selected, the present study seeks to demonstrate that votes do count. In other words, the UK professional accounting standards setting processes are demonstrably political. From this finding the study goes on to explore the relative sensitivity of the UK professional accounting standards setting processes to the votes, or preferences, of different classes of participants. The present study seeks to demonstrate that there is a differential sensitivity, with some groups' votes counting more than other groups. The tests and their results are set out below in Part IV "Evidence from the empirical study of the UK data".

1.3 CONTRIBUTIONS OF THE STUDY

The present study makes a number of contributions to the study of UK professional accounting standards setting processes. These contributions can be classified under three headings as follows.

Review of literature from disciplines other than accounting and economics

- 1 The complexity of the UK professional accounting standards setting processes is elaborated by documenting the different models which could be used as frameworks for their analysis.

The complexity of the models themselves is also elaborated. It is quite clear that professional accounting standards setting processes are not susceptible to simple explanations; to use the term "political" to describe the complexity is overly simplistic. The models are presented in Part III "Review of literature from disciplines other than accounting and economics".

- 2 The different frameworks from political science, organisation theory and sociology of professions are integrated into a single framework for the benefit of future research into professional accounting standards setting processes.

The integration adopts the professionalisation process framework as the primary framework within which political choice analysis operates as a sub-framework. Both an organisation framework and a committee structure framework offer themselves as alternative sub-sub-frameworks of analysis within political choice. The integrated framework is presented in Chapter 15 "Summary and conclusions drawn from reviews of literature from disciplines other than accounting and economics". The committee structure framework is especially interesting and is presented in Section 12.3 "Political institutions".

Evidence from the empirical study of UK data

- 1 The professional accounting standards setting processes are modelled using an abstract formulation of the political dimension based on a simple majority voting model.

This is the first algebraic model of the public comment stage of the professional accounting standards setting processes to be found in the literature. It is presented in Chapter 17 "A naive voting model".

- 2 Hypotheses are systematically tested over a broad range of issues.

A criticism of the previous research is that there has been a systematic bias to results based on the inflation accounting issue.

- 3 Rigorous analysis of an available, but hitherto substantially unexplored, body of data is conducted.

The letters of comment received by the Accounting Standards Committee are filed on public record. No research study has explored these data to the same extent as the present study.

- 4 Analysis is based on a novel definition of a proposal as an "irreducible statement of accounting definition or requirement".

Previous research suggests that subjectivity in classifying letters of comment is a problem. The definition adopted virtually eliminates the subjectivity in that area. It is presented in Section 18.2.2 "Proposal" of Chapter 18 "Research approach and method".

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5 Measures of "influence" and "sensitivity" are developed and tested which enable differences between classes of participants to be detected and quantified.

The algebraic model has enabled two measures to be defined which permit quantification of subtle features of the professional accounting standards setting processes. They are presented in Section 17.2.3 "Stage two: A probabilistic model of influence" and Section 17.2.4 "Stage three: A sensitivity extension of the probabilistic model of influence" both of Chapter 17 "A naive voting model".

6 Evidence has been generated that is consistent with the statement that the UK professional accounting standards setting processes are political.

The UK professional accounting standards setting processes have been demonstrated to be political in the sense that votes count. The preferences of participants have had a measurable impact on the outcome of the issues investigated. These results are presented in Chapter 19 "The data and their analysis".

7 Evidence has been generated that the UK professional accounting standards setting processes are significantly more sensitive to the preferences of professional firms of accountants and representative bodies of accountants than to the preferences of companies.

This finding is important in the sense that it suggests that future research studies should address the question of an underlying causal mechanism. The identification and elaboration of such a causal mechanism is a necessary condition for the demonstration of a "power" relation. The evidence is presented in Section 19.5.3 "Summary regression results" of Chapter 19 "The data and their analysis"; the argument linking "power" and causal mechanisms is discussed in Section 12.4 "Power" of Chapter 12 "Political choice processes".

8 A microcomputer programme was written which enables researchers to use microcomputers to create computer data files relatively speedily.

The programme will automatically write the data file and simultaneously create the format control statements required by the Statistical Package for Social Scientists (SPSS). The source listing for this microcomputer programme is set out at the end of the study in Appendix 10 "SPSSGEN: A programme written in BASIC to simplify creation of SPSS raw data files".

Review of previous research in accounting and economics

An extension of the review of the literature of social choice theory suggests that there might be conditions under which conflict minimisation is a meaningful surrogate for social welfare maximisation. In view of the fact that much criticism of the ASC suggests that it behaves in a conflict minimising manner, this idea is presented in Section 7.4.3 "Social welfare maximisation and a conflict minimisation hypothesis" and an initial exploration of those conditions is presented in Appendix 7.1 "A conflict minimisation hypothesis". The criticisms are reviewed in Section 3.10 "Criticisms of the Accounting Standards Committee".

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1.4 SCOPE AND LIMITATIONS

1.4.1 Introduction

The study is concerned with the professional accounting standards setting processes in the UK. These processes are focused on The Accounting Standards Committee (ASC) which is constituted as a committee of the six large UK professional accounting bodies. As such, the ASC does not set standards of accounting practice which originate from sources such as legislation, industrial and commercial organisations or any other groupings not formally organised within the UK accounting profession. The two main purposes of the study, set out above in Section 1.2 "Purposes of the study", differ in the degree to which they each focus on the ASC. The first abstracts away from the ASC and considers decision-making bodies generally; while the second focusses narrowly on one stage of the ASC's operation. Both are preceded by a review of the history and operation of the ASC; and by a review of the previous research by accountants and economists.

1.4.2 Scope

The ASC came into existence in 1970 and, apart from the need to consider an historical perspective, this study is not concerned with standards of accounting practice prior to that date. The ASC's activities are restricted to financial accounts intended to give a true and fair view of financial position and profit or loss. This implies that this study is only concerned with such financial statements as conform to that restriction. In general terms, this includes external financial reports of most corporate bodies in the UK, but does not include any internal, or management, accounting reports.

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Two important and general assumptions can be identified. Firstly, it is assumed that the existing body of literature concerning the analogous problem in the USA is capable of generating an analytic framework applicable to the UK. Secondly, it is assumed that the professional accounting standards setting processes are in some sense systematic and so capable of discovery and explanation. It is possible that the processes are strictly unsystematic.

The review in Part III "Review of literature from disciplines other than accounting and economics" abstracts away from the ASC and adopts the characterisation of a generalised decision-making or choice-making entity. The differing perspectives used in these other disciplines for the analysis of choice are explored. The disciplines reviewed are

- 1 natural science, as represented by formal decision theory and measurement theory;
- 2 political science;
- 3 organisation theory; and
- 4 sociology of professions.

Conclusions are drawn from this exploration about the relative usefulness of each framework and possibilities for further research adopting their theoretical constructs.

The analysis in Part IV "Evidence from the empirical study of UK data" focusses narrowly on the ASC. The empirical study tests the proposition that the political dimension is important to an explanation of the UK professional accounting standards setting processes. This test is implemented by modelling the political dimension in terms of a naive voting model. The one-man, one-vote, simple-majority model is adopted. It is used as a basis for hypothesising relationships between the votes, or stated preferences, of participants and the outcome as reflected in accounting standards. More specifically, an Exposure Draft is characterised as a set of proposals on each of which votes are cast in the form of letters of comment to the ASC. The outcome of the process is characterised as the change between the

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Exposure Draft and the accounting standard. In other words, votes count to the extent that they are associated with a change in the ASC's position between Exposure Draft and accounting standard.

It follows from the above that the study makes no underlying assumptions about which proposals are, in some sense, important and which are not important. Such an assumption would be problematic in the sense that the importance criterion would be selected arbitrarily or, at least, subjectively. Three possible criteria are

- 1 the impact on the numbers disclosed in financial statements (a measurement criterion);
- 2 the impact on an individual's wealth (an economic consequences criterion); or
- 3 the number of other proposals which are dependent on the proposal being considered (an interdependency criterion).

By adopting an "equal importance" assumption, the present study develops a research method by which the relative importance imputed by the ASC can be determined. Arguably, this is a much more interesting approach. It is implemented by the use of a measure of the sensitivity of the professional accounting standards setting processes in the UK to participants' preferences.

Tests are conducted on a selection of issues, namely those based on exposure drafts published after mid-1977 but excluding the inflation accounting issue. The issues used are

- 1 accounting for associated companies;
- 2 accounting for investment properties;
- 3 accounting for foreign currencies;
- 4 group accounts; and
- 5 accounting for contingencies and events occurring after the balance sheet date.

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The results were computed at different levels of aggregation, namely

- 1 for all participants across all issues;
- 2 for all participants disaggregated by issue;
- 3 for all issues disaggregated by participant; and
- 4 disaggregated by both issue and participant.

The disaggregations across participant were based on the ASC's own classification into

companies; firms of accountants; representative bodies of accountants; other representative bodies; and others.

The data were generated by the technique of content analysis and implementation of the tests was undertaken on a large mainframe computer.

1.4.3 Limitations

As with all research, the present study has its limitations. The study does not address substantive accounting problems except insofar as they are the subject matter of specifically investigated issues. In particular, the study is not concerned with deducing normative frameworks which support any one particular accounting method as a basis of measurement of some perceived attribute of accounting entities. The subject of interest rests with the processes by which such measurements are legitimised by adoption in the Statements of Standard Accounting Practice published by the Councils of the six principal UK accountancy bodies.

The review of the literature presented in Part III "Review of literature from disciplines other than accounting and economics" is necessarily only a brief overview. No special expertise is claimed in any of these disciplines and so the conclusions are to be treated with caution. It is possible that, although care was exercised, substantive criticisms or new developments have been overlooked.

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Limitations of Part IV "Evidence from the empirical study of UK data" are more specific. The empirical study concentrates on only one stage of the UK professional accounting standards setting processes, that of soliciting public comment. The processes involve other stages, such as issue definition; agenda formulation; proposal definition by technical drafting and consultation; review of public comment and redrafting; and approval by governing bodies of ASC. Of all the stages only three systematically generate publicly available data. These are publication of the Exposure Draft; publication of the accounting standard; and filing of the letters of comment in the libraries of the six governing bodies of the ASC. The study is restricted to utilisation of these publicly available data.

The empirical study is based on issues on which the ASC chose to initiate a public process; there might be issues which were either ignored, suppressed or resolved privately. It is based on participation by individuals who chose to allow their comments to be made available publicly; there might be participants whose preferences were expressed privately.

The empirical study makes exploratory use of a naive voting model to represent the political dimension of professional accounting standards setting processes. Future research will demonstrate whether or not this is an efficient characterisation. It does not investigate the operation of the ASC itself. The participants whose preferences are being characterised as votes exclude the members of the ASC.

The limitations both of archival data sources and of content analysis flow through into the empirical study. In the case of archival sources, this applies to selectivity of archiving which is noted above as the possibility of participants not wishing their comments to be made available publicly. In the case of content analysis, this applies to subjectivity of interpretation. Subjectivity has been minimised by a novel definition of a

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"proposal" based on an irreducible statement of proposed accounting definition or practice. An Exposure Draft typically contains 20-50 such proposals.

The results of the empirical study are descriptive only of the data to hand. No attempt has been made to construct a normative or predictive model at this stage. Such possibilities are left open for future research studies.

More detailed discussion of the limitations of the empirical part of this study is provided below in each chapter of Part IV "Evidence from the empirical study of UK data".

1.5 THE RESEARCH PROBLEM

1.5.1 Professional accounting standards and the political dimension

In the field of external financial reporting by corporate management, there has been much interest in the role of the Accounting Standards Committee (ASC) in the UK and the Financial Accounting Standards Board (FASB) in the US. The stated role of each body is broadly to enhance the usefulness of external financial reports by reducing the variety of reporting practices ["Statement of intent", ICAEW 1970]. In the UK, this variety has been the cause of public criticism [Stamp & Marley 1970]. Both bodies have chosen the professional accounting standard as the instrument for the implementation of their objectives. The term "accounting standard" has now become sufficiently widespread in its application to these instruments, both in the UK and the US, that no confusion is caused by its use. However, they are standards in the sense of standard practices rather than standards of competence or of ethics.

Professional accounting standards are published by the standards setting bodies after public debate and have subsequent mandatory effect. Although detailed arrangements differ between the UK and the US, comparison with the US is important because it has an accounting profession which sets its own accounting and auditing standards with somewhat analogous institutional structures to those in the UK. There are distinctions between the UK and the US; for example, the business environments are different, both culturally and institutionally. In particular, the US government agency known as the Securities and Exchange Commission (SEC) has no direct equivalent in the UK. The SEC is charged by legislation with the responsibility for establishing accounting standards in the securities markets and, for the time being, it has chosen to delegate this responsibility to the FASB. The latter, although constitutionally autonomous, is dependent on the US accounting profession for its expertise and legitimation and

so is, in several respects, analogous to the UK's own ASC.

The accounting literature has long been characterised by a search for, or discussion of, better accounting practices and the external financial reporting practice of corporate management is the natural empirical domain of this literature; for example, Ijiri [1975], AAA [1966], Chambers [1966], Sprouse & Moonitz [1962], Edwards & Bell [1961], Moonitz [1961], Littleton [1953], Alexander [1950], Paton & Littleton [1940], Gilman [1939], MacNeal [1939], Sweeney [1936], Canning [1929], Hatfield [1927], Paton [1922] and Sprague [1907].

There is a noticeable trend in the more recent accounting literature toward discussion of what is often termed the political dimension of professional accounting standards; for example, Burggraaaf [1983], Solomons [1983; 1980 & 1978], Henderson & Peirson [1978], Kirk [1978], Standish [1978], Zeff [1978], Watts [1977], Armstrong [1976], Horngren [1976, 1973 & 1972], Moonitz [1974] and Gerboth [1973A; 1973B & 1972]. The history of this trend in the USA precedes that in the UK perhaps because the former has both a longer experience of published professional accounting standards and an institutionalised focus for the political dimension, that is, the SEC. Nevertheless, any study of professional accounting standards setting processes is now incomplete without some consideration of this political dimension.

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An explanation for the existence of the political dimension is to be found in the economic consequences literature in accounting, for example, Carter [1981], Hakansson [1981], Zeff [1978], Rappaport [1977] and Demski [1974]. The economic consequences argument can be summarised as follows:

Accounting information is used by various classes of individuals, such as investors, employees, central and local governments, trade creditors, bankers and other organisational participants. A change in the accounting information available to these classes of individuals may result in a change in either their own decisions; or the outcomes of existing financial contracts. Each has consequent wealth and welfare generation and redistribution effects. In either case, the self-interest of the individual participants is incentive for them to lobby for or against specific proposals to the extent that their interests are perceived to be affected.

1.5.2 The study of professional accounting standards setting processes

Hussein [1981, p.28] has argued that there are two fundamental approaches to investigating professional accounting standards setting processes, namely

- 1 the results approach, that is to treat as a black box the processes by which the professional accounting standards setting body seeks to satisfy objectives. This approach explores the outputs, that is the accounting standards, as instruments for satisfying objectives; and
- 2 the process approach, that is to explore the processes by which the professional accounting standards setting body seeks to satisfy objectives.

The present study adopts the second approach. In so doing it does not address the objectives themselves but assumes them to be held constant.

Many writers have adopted the first approach and the accounting literature is replete with examples. In pursuing their enquiries these writers often call upon criteria drawn from different disciplines. Examples include the following

- 1 do accounting standards increase information useful for making decisions? [Revsine 1973; Feltham 1972];
- 2 do accounting standards have any detectable effect on the market price of securities? [Watts & Zimmerman 1980; Gonedes &

Dopuch 1974];

- 3 do accounting standards have any effect on the day to day decisions of corporate management? [Horwitz & Kolodny 1981; Prakash & Rappaport 1975];
- 4 do accounting standards require the disclosure of information which is cost-effective to generate? [Benston 1981; 1980 & 1976]; and
- 5 do accounting standards conflict with existing legislation, such as the requirement to disclose a true and fair view in financial statements of UK companies [Jack 1978].

All these questions, and more, are reflected in the literature. As a result, a wealth of material is being generated which will benefit our understanding of the relationship between accounting information, accounting standards and assumed objectives.

It is also clear is that few writers have explored the black box of the professional accounting standards setting processes. Consequently, there is only a small body of literature which aims to investigate by this approach the effectiveness of accounting standards in meeting objectives.

In Part II "Review of previous research in accounting and economics", the present study considers that literature. For example, in the US, Carter [1981], Hussein [1981], Buckley [1980], Kelly-Newton [1980], Solomons [1978], Watts & Zimmerman [1978], Zeff [1978], Watts [1977], Moonitz [1974], Demski [1973], Gerboth [1973A] and Horngren [1973] each represent partial descriptions of the US process. A wide diversity of approach is apparent and this arguably reflects unstated assumptions about objectives.

In the UK literature, Hopwood [1982], Bromwich [1981 & 1980], ICAEW [1980], Westwick [1980], Hope [1979], ASC [1978], Barrett [1978], Slimmings [1978], Standish [1978], Edey [1977], and Lee [1975] again represent partial descriptions of the UK process. To a lesser degree, there is some European literature which may be of use in a comparative study for example, Bromwich & Hopwood (Eds) [1983], Klaassen [1980], Schoonderbeek et al [1980], Volten [1979] and Muis [1977].

The observation that only a small body of literature is concerned with the study of professional accounting standards setting processes is in need of some exploration and perhaps explanation. On the one hand, it could be that the processes are of no substantial interest, in the same way that the workings of computer hardware may be of no substantial interest to the users of computers. On the other hand, it could be that the processes are of interest but no researcher has investigated them due to lack of either resources or opportunity. This study assumes the latter to be the case. It seeks to explore the possibility that a greater understanding of how professional accounting standards setting processes generate specific outputs will enhance our understanding and critical awareness of those outputs themselves. Such work would necessarily complement the existing literature concerning the outputs of these processes. It would contribute to the construction of descriptive statements concerning the processes and be of help to those beneficiaries identified below in Section 1.5.5 "Beneficiaries of the study".

1.5.3 Definition of the problem

This study brings together the subject matter of the two preceding sections; namely a consideration of the political dimension in professional accounting standards and an exploration of the professional accounting standards setting processes in the UK.

The study contributes to an answer to the question

"What factors, when viewed together, might be used to explain the processes by which UK professional accounting standards are determined?"

More specifically, the problem is twofold.

Firstly, to explore the complexity of the political dimension of the professional accounting standards setting processes and propose a framework which can integrate the analyses of disciplines such as political science, organisation theory and sociology of professions for the benefit of future research studies.

Secondly, to test the proposition that the political dimension is important to any explanation of the UK professional accounting standards setting processes by modelling those processes as a simple voting process.

1.5.4 The importance of the problem

The problem of modelling and reducing the complexity of the processes by which UK professional accounting standards are determined is important for several reasons.

- 1 External financial reports of complex organisations appear to have an important role within society, yet that role is little understood [AAA 1977 and ASC 1975].

There is evidence that the UK accounting profession, through the ASC, has had a significant impact on UK external financial reports during the last decade. For example, the annual "Survey of published accounts", published by the Institute of Chartered Accountants in England and Wales (ICAEW), presents much of this evidence; some of which is summarised below in Section 3.5 "The 1970's".

2 The professional accounting standards setting processes have been characterised as a policy-making social choice mechanism [May & Sundem 1976].

Bauer [1968] argues that policy-making processes can be characterised as a single, complex, social process in which an intellectual process is embedded. As such, they exhibit characteristics attributed to professional occupations, to political decision making, to ambiguous organisational choice processes and to scientific enquiry. Reduction of the apparent complexity would render professional accounting standards setting processes more susceptible to effective management. There is evidence that the UK professional accounting standards setting processes have proved to be difficult to manage [Leach & Stamp (Eds) 1981].

3 Following Arrow [1963 & 1951], Riker [1980] argues that social choice is only possible if individual preferences are severely constrained.

A study of the institutional structure of social choice mechanisms is important to our understanding of both how choices are made under such constraints and the nature of those constraints. Evidence of the preference constraint structure in UK professional accounting standards setting processes is not yet available.

1.5.5 Beneficiaries of the study

Amongst those who will benefit from this study will be researchers and others who wish to gain a deeper understanding of debates in accounting [Leach & Stamp (Eds) 1981]. These will include policy-makers at government level who will wish to monitor the effectiveness of professional self-regulation in general and professional accounting standards setting in particular. There will be members of the UK accounting profession, which may have embarked on a formal professional accounting standards programme unwillingly [Zeff 1972, p.40] and which appears to be divided about the continued desirability of the programme [Accountancy Age, 6 March 1981, p.1]. Last, but not least, there will be the past, present and future participants in the professional accounting standards setting processes, whose understanding of the processes may well be imperfect [Hyde 1983].

1.5.6 Research approach and method

The study adopts complementary research methods as a means of supplementing the contribution of each individual method. The methods are identified below in summary form

- 1 Review of previous research, which has been conducted primarily in the fields of accounting and of economics.
- 2 Review of literature from disciplines, other than accounting and economics, of
 - (a) scientific decision;
 - (b) political science;
 - (c) organisation theory; and
 - (d) sociology of professions.
- 3 Content analysis, using a naive voting model framework, of
 - (a) draft accounting standards;
 - (b) letters of submission on those drafts; and
 - (c) the final accounting standards.

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The outcome of the literature review is the generation of alternative frameworks from disciplines other than accounting and economics. These frameworks complement those developed in the review of the previous research in accounting and economics and provide alternatives within which to explain and interpret the evidence from the empirical part of the study. The alternatives are integrated into a single framework for the benefit of future research studies.

With the exception of the inflation accounting issue, all of the issues that have been publicly addressed by the ASC during the period since mid-1977 are investigated. Data gathering is performed by content analysis of documents which provide evidence of one stage of the professional accounting standards setting processes in the UK. Bauer [1968] emphasises the importance of taking a broad view of the processes and their context, and then of identifying a particular stage, or leverage point, for closer study. The stage selected for investigation is that of the public comment on Exposure Drafts. There are two main arguments in support of this selection.

- 1 visibility of this stage. Chapter 3 "The Accounting Standards Committee" below shows that many of the stages in the UK professional accounting standards setting processes are not visible in the sense that much work is conducted as committee work. The public comment stage is the most visible stage of all; and
- 2 availability of data. As a matter of policy, the ASC files the letters of comment which it has received on each Exposure Draft. This filing is on public view in the library of the Institute of Chartered Accountants in England and Wales. The data has been virtually unexplored and so such an exploration would, of itself, be an important contribution.

Data analysis concentrates on an investigation of the relationship between the stated preferences of participants and the outcome of the process. In particular, there are developed two measures of the strength of association between these stated preferences and the change from the original proposal to the final accounting standard. These measures, called "influence" and "sensitivity", enable distinctions to be made between the

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various classes of individual participants to assess their impact on the UK professional accounting standards setting processes.

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CHAPTER 2 OUTLINE OF THE STUDY AND SUMMARY OF PREVIOUS RESEARCH

- 2.1 Outline of the study**
- 2.2 Summary of previous research**
- 2.3 Conclusions drawn from previous research**

CHAPTER 2 OUTLINE OF THE STUDY AND SUMMARY OF PREVIOUS RESEARCH

2.1 OUTLINE OF THE STUDY

2.1.1 Introduction

The study starts with the premise that professional accounting standards setting processes in the UK are little understood. Yet professional accounting standards setting processes appear to play an important role in the information processes upon which wealth generation and distribution decisions are made. The effects of these decisions are known as the "economic consequences" of professional accounting standards setting processes. They give rise to a political dimension reflecting the underlying conflict of interests inherent in any wealth distribution decision. It is clearly important to develop our understanding of these processes in order that they can be managed effectively.

In the UK, the professional accounting standards setting processes are focussed on the Accounting Standards Committee of the six major professional accountancy bodies. The historical context which led to the creation of the ASC and the history of the ASC itself lends support to the above explanation of a political dimension. The history is one of debate, controversy and difference of opinion between many different elements of the business community. The focus of debate being the particular accounting practices adopted, or to be adopted, by companies and other economic agents. The function of the ASC is, then, to reduce that conflict by standardising accounting practice. The context and function are not unique to the UK accounting profession. Accountancy professions throughout the developed nations are experiencing the same phenomena and, even within the UK, the engineering profession experienced a similar phenomenon when it created the Engineering Standards Committee in 1901; that committee is now constituted as the British Standards

Institution. The review of the historical context and comparison is set out in Chapter 3 "The Accounting Standards Committee".

2.1.2 Review of previous research in accounting and economics

As yet, there exists no substantial body of research which addresses, directly, the UK professional accounting standards setting processes. It is observed, in Section 3.8 "International comparisons", that the ASC is not unique as a mechanism by which a national accounting profession seeks to narrow areas of difference and variety in practice by publishing authoritative statements. This study draws on a body of research that has been conducted, in particular, in the USA. For example, Bromwich [1981], discussing the role of research in the process of setting UK professional accounting standards, also acknowledges the debt due to US research.

The review of previous research starts by describing the development of the literature as from a technical orientation, through an economic theory orientation to a relatively recent interest in the political dimension. The chapters in Part II "Review of previous research in accounting and economics" follow the sequence of the development of the literature.

In view of the importance attached by US studies to the economic dimension, Chapter 6 "Information economics" and Chapter 7 "Other economic processes" explore the extent to which economic theory can explain professional accounting standards setting processes. After that review, the research studies which explicitly address the political dimension are reviewed in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes".

Chapter 5 "Professional accounting standards, the political dimension and economic consequences" demonstrates the underlying reasons for the importance of both professional accounting standards and the processes by which they are determined. It is shown that characterisations of the professional accounting standards setting processes have recently changed from a purely "technical" description to a newly emerging political description. Changes in professional accounting standards have economic consequences to which can be attributed wealth and welfare generation and redistribution effects. The evidence for this is discussed. The problem of where the benefits or redistributions fall is the issue which gives rise to a political dimension in the sense that individuals will seek to influence the incidence of the costs and benefits.

Recognition of a political dimension in the research literature is a relatively recent phenomenon dating back to the early 1970's in the US literature and, arguably, not appearing in the UK literature until the early 1980's. This political orientation leads into a body of literature which adopts a policy-making characterisation of professional accounting standards setting processes with an implied objective of social welfare maximisation.

Chapter 6 "Information economics" sets out some of the mechanisms by which economic consequences are generated.

Information economics is concerned with, on the one hand, the analysis of the impact of information on markets, and on the other hand, the analysis of the conditions for a market in which information itself is traded. In the present study these two frameworks are labelled "supply-side" and "demand-side" respectively to distinguish between the underlying assumptions being made about the information generation process. These two frameworks are then compared.

In concentrating on a field of economic theory, the chapter explores some common economic assumptions. In particular, the Pareto-optimality criterion is seen to be fundamental as a goal in which it is not possible to increase the utility of any one person without decreasing that of one or more others; and the economic agent is assumed to behave as if he is rational, self-interested and expected-utility maximising.

A review of information economics is important in the context of the present study because it adds insight into incentives which might influence the behaviour of individuals in processes by which the flow of accounting information is regulated.

Chapter 7 "Other economic processes" sets out additional mechanisms by which economic consequences are generated. Three separate subsets of this literature are reviewed.

- 1 Rational choice theory is concerned with the analysis of information and its use by an individual. The focus of interest is the maximisation of expected utility for an individual. This literature suggests that a multi-person setting, where preferences are heterogeneous, will not provide a unique solution to the problem of selection of preferred accounting information.
- 2 Agency theory is concerned with the analysis of both the role of management as agent of the owners of the firm; and with the information requirements of both agents and owners. This literature suggests that management has incentives to enter into contracts to publish audited accounting information. Further that, having entered into such contracts, management has incentives to prefer specific classes of accounting information over others.
- 3 Social choice theory is concerned with the analysis of conditions under which heterogeneous preferences might be aggregated to generate stable choices. This literature suggests that stable choices are only possible when individual preferences are constrained in some way. The structure of constraints on preferences provides an important focus for the present study. Further, the criterion embedded in social choices can be modelled as maximisation of social welfare.

Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes" reviews empirical studies in which the political dimension is the primary focus of interest. The context is characterised as one of heterogeneous interest groups, collectively known as the constituency. An important feature of the studies reviewed is shown to be their interest in the nature and preferences of the constituency.

The study of the political dimension in professional accounting standards setting processes is shown to be at an early stage of development. Promise is held out for the use of some theoretical constructs from disciplines other than accounting and economics and potential applicability of US studies to the UK is demonstrated.

In summary, Part II "Review of previous research in accounting and economics" shows that the problem of investigating UK professional accounting standards setting processes has been substantially illuminated by the changing perspective of previous research studies. The description of the UK ASC provided in Chapter 3 "The Accounting Standards Committee" encompasses not only an accounting activity of specific technical matters being resolved by a profession's own committee of experts, but also an accounting activity with economic, political and professional dimensions.

The economic rationale for participation is not sufficient to explain the resultant choices of professional accounting standards. Firstly, the aggregation of individual preferences is indeterminate and, secondly, there exists no unique social preference function by which that indeterminacy can be resolved. It follows that an exploration of factors which might be used to explain the processes by which UK professional accounting standards are determined can be characterised as an investigation of a social choice process in which non-economic criteria play an

important part. An important focus for the present study is the structure of constraints on preferences. Such is the rationale for the existence of a political dimension to professional accounting standards setting processes.

The empirical studies have provided a valuable introduction to the political dimension, but a substantial contribution to theory construction is, as yet, undeveloped. In particular, the contributions of other disciplines, from which some explanatory concepts have been adopted, have been inadequately explored. Rather, isolated concepts have been introduced with limited discussion of their origins. The present study seeks to redress that defect in the review of literature from disciplines other than accounting and economics.

2.1.3 Review of literature from disciplines other than accounting and economics

Scientific choice processes

Two analyses lead to a consideration of the literature of scientific choice processes in Chapter 11 "Scientific choice processes". Firstly, in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes", is found the distinction between scientific and political styles of decision making; and the argument that professional accounting standards setting processes are both scientific and political. Secondly, in Chapter 12 "Political choice processes", is found the distinction between rational policy, organisational process and bureaucratic politics as three different models of political decision making; and the argument that the rational policy model is the rational selection of an alternative from among a number of alternatives in order to maximise the objectives, or criteria, of a "decision unit". This latter is the scientific choice model.

In the review it is shown that the literature on scientific choice processes is well developed. It is founded on a basic assumption concerning the nature of preferences, or criteria, namely that there exists a unique and determinable criterion. This assumption makes problematic its application to social sciences in general, and to professional accounting standards setting processes in particular. So then, formal decision theoretic choice processes are seen to be insufficient to explain professional accounting standards setting choice processes because of ambiguity of choice criterion inherent in the heterogeneous preference structure of the social environment.

Political choice processes

A consideration of the literature of political choice processes in Chapter 12 "Political choice processes" stems from the increasing recognition being given to the political dimension in the literature on the professional accounting standards setting processes. Although this increasing recognition is clear, the accounting literature is limited in as much as it does not address the nature of models implied by such a characterisation. One or two constructs, such as "power" and "coalition formation", have been identified but only in isolation from their underlying frameworks. The review of political choice processes seeks to redress the resulting imbalance.

For the purposes of the review, the political science literature is characterised as being subdivided into three separately identifiable schools, namely those on decision making, political institutions and power respectively. Political choice processes are seen to offer an interesting duality of approach to social choice. On the one hand preference structures are assumed to be given and then an analysis of constitutional rules and procedures throws light on the nature of social equilibria. On the other hand, analysis of models of choice found in the organisational choice process literature throws light on the

dynamic nature of preference structures.

Organisational choice processes

Two analyses lead to a consideration of the literature of organisational choice processes in Chapter 13 "Organisational choice processes". Firstly, in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes", is found the characterisation of the US professional accounting standards setting processes as being, in part, an organisational choice process. Secondly, in Chapter 12 "Political choice processes", is found the argument that the organisational process model is implied in much political analysis. Additionally, authors such as Hopwood [1983 & 1978], Cooper, Hayes & Wolf [1981] and Hofstede [1981] argue for an organisational perspective for the study of accounting.

The review shows that the literature on organisational choice processes is both well developed and undergoing a process of change to models which attempt to cope with ambiguity of outcome and of preference. Such models offer considerable promise for the investigation of the professional accounting standards setting processes.

Organisational choice processes are seen to be insufficient to explain professional accounting standards setting processes completely because of the ambiguity both of choice criteria and of causal relationship. A partial explanation may be available in as much as the choice opportunity is an occasion in which preference structures themselves may be changed; the outcome being a new preference structure rather than a new action, or any one or both of these.

Professionalisation processes

Three analyses lead to a consideration of the literature of professionalisation processes in Chapter 14 "Professionalisation processes". Firstly, in the Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes", is found the argument that professionalisation processes encourage professions to strive to keep technical, or scientific, decisions away from intervention by outsiders. Such decisions are said to be subject to intervention by veto. Secondly, in Chapter 12 "Political choice processes", is found the argument that the concept of morality has permeated much political analysis. The subsequent review suggests that the concept is implied in partial structurings of preferences such as is the case in the process of professionalisation. Thirdly, in Chapter 13 "Organisational choice processes", is found the argument that four such choice processes can be distinguished. Of these, the "judgemental" choice process is seen to be linked to the professionalisation literature to the extent that judgements are made by individuals in the roles of professionals in organisations.

The review explores the framework implied by the notion of professionalisation. Professional accounting standards setting processes are in part an integral component of the professionalisation process attributable to many occupational groups. The literature of the sociology of professions helps understand that process. Professionalisation processes are seen to impose a strong structuring on the preferences of the members of a profession and on the preferences of individuals outside the profession.

In summary, Part III "Review of literature from disciplines other than accounting and economics" shows that there are different frameworks from which it is possible to investigate the UK professional accounting standards setting processes. Further, the literature does not present any rational basis by which any one such framework may be selected in preference to any other. In the concluding sections, an integration of these frameworks is proposed within which future research studies might usefully be conducted. The proposal puts forward the professionalisation process framework as the primary framework within which the political choice sub-framework is embedded. The political choice framework is itself divided into two sub-sub-frameworks, namely the Shepsle committee structure framework and the organisational process framework.

2.1.4 Evidence from the empirical study of UK data

The empirical part of the present study focusses narrowly on a single element within the framework proposed in the concluding sections of Part III "Review of literature from disciplines other than accounting and economics". The study contributes to the trend of increasing recognition being given to the political dimension by developing a formal model of one stage of the professional accounting standards setting processes. As such, it can be viewed as a contribution to an elaboration of the Shepsle committee structure analysis. This is in the sense that the study is a description of an equilibrium outcome of a committee in operation. Alternatively, it can be viewed as an elaboration of the organisational process framework in the sense that it is a description of one of the stages of a multi-staged process.

The model presented is based on a political choice process, namely, that of the simple majority voting system. This is used as a framework for the empirical investigation. The model follows from the adoption of a naive political framework in which the professional accounting standards setting processes are characterised by a simple majority, one-man one-vote, voting model. Within this model, primary hypotheses are deduced which are concerned with the relationship between the stated preferences of participants and the outcome of the professional accounting standards setting processes. In summary these are

- H₁ there exists a relationship between the probability of a CHANGE and the direction of the absolute majority vote (AMV) on any particular proposal; and
- H₂ there exists a relationship between the probability of a CHANGE and the size of the absolute majority vote (AMV) on any particular proposal; and
- H₃ there exists a relationship between the class to which a participant belongs and the response of the professional accounting standards setting processes to that participant's preferences.

At a very elementary level, the model addresses the questions

"Are the UK professional accounting standards setting processes in any sense political?"; "Do votes count?"; and "If so, how?".

The presentation of the model seeks to achieve a rigorous analysis and an algebraic formulation is adopted. This is supplemented by tables, graphs and verbal statements of the central points. Two contributions of the model are the development of the concepts of "influence" and "sensitivity" each of which, necessarily, are given precise meanings within the context of this particular model. The research approach and method sections describe how the testing of the hypotheses developed in the naive voting model has been implemented. In particular, working definitions of the variables issue, proposal, CHANGE, and Absolute Majority Vote (AMV) are presented; and the criteria for the selection of data are discussed. The underlying technique for data generation was that of content analysis the steps used are set out in some detail.

The primary hypotheses are tested by implementing a series of tests each based on a separate null hypothesis. These tests ensure an orderly and systematic approach to the subsequent data analysis. The treatment of outliers in the data is discussed and it is seen that some of the outliers offer opportunities for further research.

A brief note is provided describing the implementation of data generation, the use of a pilot study and implementation of analysis on a large mainframe computer with an "unfriendly" operating system. The role of microcomputers in this study is described.

The results sections set out the results obtained from the application of the model to data obtained from the UK professional accounting standards setting processes.

The data base is described first in terms of elementary aggregate statistics such as total numbers of data cases; of ORIGINAL and AMENDMENT proposals; of written comments on Exposure Drafts; and of votes cast. Each of these being broken down by Issue and Exposure Draft.

Also are set out in some detail the contingency tables which describe the data. In very general terms, tests address the questions "Do votes count?" and "If so, how?". The detailed formulation of the tests is set out in the research approach and method sections. The results distinguish between ORIGINAL and AMENDMENT proposals.

The contingency tables are followed by scattergraph and linear regression results, but only to the extent that the contingency tables themselves suggest the existence of a significant relationship. The regression results, in very general terms, ask the question "If votes count, do they have an increasing linear influence?".

Each of the above results is presented for the data base as a complete set. A more interesting analysis follows in which the data are disaggregated across differing classes. These results, in very general terms, ask the question "Are there any differences between classes of participant?". The results for these tests are presented conveniently in summary tables. The main disaggregation classes are

by Issue: accounting for associated companies; accounting for investment properties; accounting for foreign currency translations; group accounts; and accounting for contingencies and events occurring after the balance sheet date (IAS14); and

by Group: companies; professional firms of accountants; representative bodies of accountants; other representative bodies; and others

The results are interesting. Votes do count; and they have an increasing linear influence. There are small differences between the influence of any class of participants; but there are significant differences between the sensitivity of the UK professional accounting standards setting processes to marginal changes in the absolute majority vote of some classes of participants. In particular, the measure of sensitivity is some three times greater for professional firms of accountants and representative bodies of accountants than for companies.

2.2 SUMMARY OF PREVIOUS RESEARCH IN ACCOUNTING AND ECONOMICS

2.2.1 Introduction

As yet, there exists no substantial body of research which addresses the factors which might be used to explain the processes by which UK professional accounting standards are determined. This study draws on a body of research that has been conducted in the USA, and a small, but growing, body of UK literature addressing the UK processes directly.

2.2.2 The political dimension and economic consequences

Over the period from the early 1970's to the early 1980's, the US research studies which are concerned with professional accounting standards setting processes have moved away from a conventional, technical, characterisation of those processes. That characterisation concerned the resolution of technical issues using well established criteria which apply to accounting information per se. The processes are coming to be seen as possessing a political dimension and that dimension is explained, at least, as being generated by the economic consequences of a change in professional accounting practice. A change in the measurement or disclosure of accounting information results in economic agents changing their decisions. This has consequent wealth and welfare generation and redistribution effects.

Thus a new perspective is evident in these studies. The professional accounting standards setting processes have been characterised as

- 1 an accounting policy-making process; and
- 2 a political process; and
- 3 a diffusion of innovation process; and
- 4 a social choice process.

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Professional accounting standards setting processes are acknowledged as possessing not only a technical dimension but also a political dimension. The technical dimension can be said to focus on the rational selection of accounting practices based on the established body of knowledge available to accountants. As such the technical dimension is analogous to scientific enquiry whereby new practices or knowledge are sought within the framework of existing theoretical understanding, implied or otherwise.

The political dimension can be said to focus on the selection of accounting practices based on the preferences of individuals. The general processes, by which individual preferences are translated into selections, are the subject of interest to researchers in a number of disciplines within the social sciences.

The underlying importance of professional accounting standards setting processes is attributable to the economic consequences of changes in professional accounting standards. These changes generate economic consequences which have subsequent wealth and welfare generation and redistribution effects and which in some cases can be significant. Individuals have preferences concerning where the benefits or redistributions are to fall. The expression of these preferences in a forum which had hitherto been regarded as an exclusively technical forum caused some debate in the US accounting profession. In the UK accounting profession, there is evidence that these preferences may well underly the technical debate.

Given that wealth and welfare generation and redistribution properties exist, then professional accounting standards setting processes can be characterised as a policy-making process in which it is impossible to meet individual preferences by using solely technical criteria. Intentional wealth and welfare redistributions might be made using professional accounting standards setting processes as processes of social engineering in which the adoption of a new professional standard accounting practice is characterised as a diffusion of innovation process.

2.2.3 Underlying economic processes

The information economics literature, which is essentially analytic in nature, suggests that the very subject matter of professional accounting standards setting processes, namely corporate information, is a resource the possession of which enables economic agents to realise gains at the expense of others. That is, it has inherent economic consequences. It is concerned both with the effects of changes in the information set on the underlying capital and product markets; and with the possible properties of a market for information itself.

In the first case, individuals are seen to stand to gain significantly from the possession of private information. In the absence of regulation, some sort of audited, financial statements would be expected because accounting information is generated privately. Speculative gains can be realised by subsequent publication of the information in a form in which it is credible. There is evidence of such published accounting information in unregulated markets in the form of audited financial statements. The trading activities of individuals with private information are essentially highly de-stabilising, and any resultant equilibria are not likely to be Pareto-optimal. Such an analysis is generating a reconsideration of the nature of general equilibrium economics.

In the second case, the properties of a market for information are explored in order to determine its possible equilibrium properties and, in particular, the conditions under which such a market would be Pareto-optimal.

These two analyses are seen to be mutually inconsistent, the primary distinction being the extent to which information is assumed not to possess consumption externalities and so support a clear demand for information as a tradeable good. Under the existing institutional structure, accounting information clearly possesses externalities and so the characterisation of a market for information is of little relevance to the present study.

Comparison of market and non-market based information allocation processes suggests that there is no rational economic basis for selecting between processes. Some are Pareto-optimal, others only approximate Pareto-optimality and, in each, some sort of constitutional safeguard is required to protect the "public interest". The economic analysis leaves unanswered the problem of identifying the public interest.

A review of the proposals for differing institutional arrangements for selecting professional accounting standards highlights the fundamental distinction between the two information economic perspectives. Some institutional arrangements assume the existence of consumption externalities and attempt to overcome the related problem of "market failure" by adopting non-market solutions. These arrangements include expert opinion, voting schemes and taxation regimes. On the other hand, other institutional arrangements assume that consumption externalities can be eliminated by appropriate changes to the system of property rights. These latter arrangements are essentially free market solutions. From the variety of different possible institutional arrangements can be drawn two observations

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- 1 the "expert opinion" arrangement most closely matches the UK professional accounting standards setting processes; and
- 2 the different arrangements possess different properties and objectives. Future studies might be able to address themselves to the problem of discovering to what extent the UK professional accounting standards setting processes reflect any or all of those properties and objectives.

Previous research, other than information economics, has been considered under the headings of rational choice theory; agency theory; and social choice theory.

An understanding of these other economic processes underlying the incidence of the economic consequences of changes in professional accounting standards is important. It facilitates an understanding of the factors which determine the preferences of individuals and so their participation in the professional accounting standards setting processes.

The rational choice theoretic research is essentially analytic in nature. It has demonstrated, on the basis of a reasonable individual expected utility maximisation criterion, that it is not possible to construct any set of professional accounting standards selection criteria which would guarantee maximisation of an individual's expected utility without that set of criteria, in some way, taking account of that individual's preferences. This result has been criticised on the grounds that its assumptions are unnecessarily restrictive. If the even more restrictive assumption is made that the individual's preference function is additively separable, then it is sufficient to select professional accounting standards sequentially without considering the effects of interaction with existing professional standards. Recognition of heterogeneity of preferences in a multi-person context immediately establishes a conflict between individuals, or classes of individuals, with no subsequent agreement on the desirability of any given accounting information set.

The agency theoretic research is also analytic in nature, but empirical work has been conducted based on the analytic framework. Management's own wealth is seen to be dependent upon professional accounting standards through such factors as non-pecuniary benefits and remuneration contracts which are based on the firm's income. In particular, managements are characterised as having incentives to enter into contracts to publish audited accounting information. Having entered into these contracts, management then has incentives to either support or oppose proposals to change professional accounting standards. These incentives are dependent on characteristics of the firms. It is an open question whether or not the agency framework can adequately predict managements' position in relation to specific proposals. In the case of inflation accounting, the behaviour of management in the US professional accounting standards setting processes has been shown to be consistent with agency theoretic predictions but a replication in the UK failed to generate unambiguous evidence.

In brief then, under the existing institutional arrangements, public accounting information is essentially a supply-side phenomenon, with strong economic incentives for individuals to supply, but no economic incentives for individuals to demand. Having contracted to supply accounting information, managements have additional incentives to prefer some accounting information over other accounting information. In a multi-person, utility-maximising setting, there is no set of criteria by which a unique solution can be determined to the problem of choice among alternatives for accounting information.

The social choice theoretic research seeks to analyse the structure of choices which are made under these conditions of indeterminacy. Arrow first identified a minimum set of conditions under which this indeterminacy would hold and so implicitly identified the need for additional constraints. One such constraint, the "single-peakedness" of preferences, had already been identified. In general terms, Arrow's first condition, that all logically possible orderings of the alternative social states are admissible, is the one condition subject to violation by additional constraint. The inadmissibility of some alternative social states can be illustrated simply by drawing attention to the existence of laws prohibiting some alternative behaviours.

Embedded in the social choice theoretic research is the social welfare maximisation criterion. It can be argued that social welfare maximisation is related to social conflict minimisation and that evidence of increasing social conflict is prima facie evidence of non-optimality of social welfare. The equity (or fairness or justice) criterion can be equated with the conflict minimisation criterion and there is evidence that such a criterion is institutionalised in the UK Civil Service.

2.2.4 Empirical studies of the political dimension

There are some empirical studies of the political dimension in professional accounting standards setting processes. The dimension is political in the sense that preferences amongst individuals are not homogeneous and choices are made by some non-economic procedure designed to be responsive to those individual preferences.

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In the overtly political environment of US regulation, vested interests adopt accounting theories to advocate their positions before Congress, the SEC and the FASB. In general, the various interest groups that make up the constituency of the FASB approve of the role of the FASB as a policy-making body and participate in its processes willingly and positively. There is some heterogeneity of preferences within the constituency. There is also evidence of heterogeneity of preferences and of perceptions on four higher-order issues:

- 1 the Government should not have a significant role in the accounting standards setting processes;
- 2 accounting standards should be left primarily to the company and its auditor;
- 3 the quality of accountants' work should be a private-sector responsibility; and
- 4 accounting standards should be based on a conceptual framework and on economic reality.

There is a partial relationship between the written expression of preferences and the outcome of the process. The potential applicability of the US analytic framework to the UK is demonstrated; but the relationship between written preferences and final outcomes may not be as strong in the UK as in the US.

The US "Big Eight" professional accounting firms possess disproportionately great power as measured by voting strengths; but this is not unambiguously translated into winning coalitions as measured by voting patterns.

Characterising the professional accounting standards setting processes as an organisational decision-making process is useful, but additional considerations of conflict resolution and of sociology of professions are important. In the organisational characterisation, concepts of decision-making and conflict resolution, to be found in the literature of organisation theorists, are adopted. Extending this characterisation, the choice process is both political and scientific in nature. The professional dimension implies that scientific, or technical,

choices will be kept within a profession but will always be subject to external approval, modification or veto. The relationship between a political style and a scientific, or technical, style of policy-making process is discussed; the political and scientific styles are argued to be inseparable.

The usefulness, and validity, of a self-interest assumption applied to participants in the professional accounting standards setting processes is addressed. In particular, these studies have found that the evidence is consistent with such an assumption.

Some of the work has been in the nature of attitude survey. Emphasis has been placed on the nature and structure of the "constituency" of the professional accounting standards setting processes. For example, the US Financial Accounting Foundation (FAF) argued that the US constituency was inadequately understood. Subsequent studies investigated the preference structure in response to the FAF argument. The contribution to theory construction is limited because relationships between attitudes and behaviour are little understood. However, these studies are useful to the extent that they have provided evidence of the heterogeneity of preferences which underlie the political dimension. Further, some of the studies have established usefulness of the technique of content analysis as applied to the written comments on Exposure Drafts submitted to the accounting standards setting body.

2.3 CONCLUSIONS DRAWN FROM PREVIOUS RESEACH

The problem of investigating UK professional accounting standards setting processes is substantially illuminated by the changing perspective of previous research studies. A description of the UK ASC is provided below in Chapter 3 "The Accounting Standards Committee". It encompasses not only an accounting activity of specific technical matters being resolved by a profession's own committee of experts, but also an accounting activity with economic, political and professional dimensions. Clearly, some of those dimensions are reflected in the literature.

The economic dimension is the most strongly represented in the US literature; the political dimension less so. However, the professional dimension seems not to be represented. No US study has sought to investigate the way in which the accounting profession, as a profession, influences the accounting standards setting processes. The reason for this apparent lack of interest in the implications of the professional dimension is perhaps not difficult to identify. The US institutional arrangement changed in 1973 when the FASB, as an independent body, took over the processes of setting accounting standards from the US accounting profession. Prior to that date, there was no serious US research interest in accounting standards setting processes per se.

Of importance to the problem of investigating UK professional accounting standards setting processes is the understanding that there are private gains available to those who both hold private information and can control the subsequent publication of that information. The existence of these gains arguably provides sufficient incentive for individuals to hold preferences in favour of some classes of accounting information as against other classes. Clearly, it is possible to characterise management as holding private information and so they have incentives to seek to control its subsequent publication. A professional accounting standards setting programme will necessarily restrict the freedom

of management to exercise that control and so incentives exist for management to resist such a programme. Such is the economic rationale for participation in professional accounting standards setting processes.

The economic rationale for participation is not sufficient to explain the resultant choices of professional accounting standards. Firstly, the aggregation of individual preferences is indeterminate and, secondly, there exists no unique social preference function by which that indeterminacy can be resolved. It follows that the general problem of the present study can be characterised as an investigation of a social choice process in which non-economic criteria play an important part. Such is the rationale for the existence of a political dimension to professional accounting standards setting processes.

Given that there is no unique solution to the problem of choice amongst alternatives for accounting information, there is a natural and clear interest in the structure of the present, existing, solution. Consideration of the different institutional arrangements under which professional accounting standards might be selected suggests the following areas for further research specifically based on existing professional accounting standards setting processes:

- 1 to what extent do existing professional accounting standards setting processes incorporate the Pareto-optimality criterion?
- 2 to what extent do existing professional accounting standards setting processes overcome incentives to misrepresent preferences?
- 3 to what extent do existing professional accounting standards setting processes incorporate a power dominated objective?

The theoretical frameworks being developed in a predominantly US orientated literature have potential application to the UK professional accounting standards setting processes. Clearly then, an adequate explanation of the UK professional accounting standards setting processes must take into account the political nature of those processes.

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Empirical studies to date have provided a valuable introduction to the study of the political dimension in professional accounting standards setting processes, but a substantial contribution to theory construction is, as yet, undeveloped. In particular, the contributions of other disciplines, from which some explanatory concepts have been adopted, have been inadequately explored. Rather, isolated concepts have been introduced with little discussion of their origins. The present study seeks to redress that defect in Part IV "Review of literature from disciplines other than accounting and economics" in order to more fully appreciate their meaning and potential application to UK professional accounting standards setting processes.

Precedents set by US studies suggest that a fruitful empirical study based on UK data could be conducted by the use of content analysis of written comments on Exposure Drafts. Some preliminary work conducted on UK data has provided strong support for the usefulness of such an analysis. The present study addresses this task in Part IV "Evidence from the empirical study of UK data".

This area of research is yet in its infancy and some gaps are evident. For example, no researcher has attempted to systematically observe several stages of the UK professional accounting standards setting process; the only information we have to date comprises anecdotes from participants and bland procedural statements from official publications. No researcher has attempted to systematically test hypotheses over a broad range of accounting issues; the inflation accounting issue has provided a strong attraction and possibly introduced a systematic bias into the results to date. No researcher has convincingly studied the roles, or perceptions, of participants in the process. Finally, only two studies have used the bank of data available in the UK as letters of comment to the ASC. These letters are filed, on public record, at the Library of the

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Institute of Chartered Accountants in England & Wales. The two studies have addressed one issue each, one of which was inflation accounting.

Changes in professional accounting standards, such as the publication of Statements of Standard Accounting Practice by the UK professional accountancy bodies, have important wealth and welfare generation and redistribution properties. It follows that an understanding of how professional accounting standards decisions are made represents an important issue of social policy-making. The underlying economic processes are well understood. This contrasts with the underlying political processes, which are poorly understood and little researched by accountants.

Two questions arise naturally from the previous research

- 1 are the theoretical constructs, from disciplines other than accounting and economics, that have been identified in the previous research capable of contributing to a comprehensive explanation of professional accounting standards setting processes in the UK?
- 2 what is the relationship between the written statements of preference and the final outcome in the UK?

In order to begin to answer these questions, evidence of two types appears to be called for

- 1 evidence that the theoretical constructs from disciplines other than accounting and economics are adequately supported by the literature of these disciplines and have implications which are meaningful in the context of professional accounting standards setting processes in the UK;
- 2 empirical evidence of professional accounting standards setting processes in the UK.

A substantial investment is required in understanding the political processes. The present study is devoted to systematically gathering those two classes of evidence through the two-fold approach of

- 1 reviewing analyses from the literature of disciplines other than accounting and economics. This investment is undertaken and documented in Part III "Review of literature from disciplines other than accounting and economics"; and
- 2 generating empirical evidence from professional accounting

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standards setting processes in operation in the UK. This investment is undertaken and documented in Part IV "Evidence from the empirical study of UK data".

CHAPTER 3 THE ACCOUNTING STANDARDS COMMITTEE

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CHAPTER 3 THE ACCOUNTING STANDARDS COMMITTEE

3.1 INTRODUCTION

Mills [1961] argues that no social phenomenon can be usefully investigated without considering the historical perspective. In particular, he is concerned that many such phenomena are of such complexity that the outcomes can only be understood by fully appreciating that historical perspective. The sociological view of Mills is supported by the views of students of politics, such as Lindblom [1959], who argue that an understanding of the outcomes of political processes can only begin to be attempted once the historical development of events leading to that outcome has been determined. It is with the benefit of these wisdoms that this study starts by embarking on an historical review.

The nature and history of events leading up to the formation of the Accounting Standards Committee (ASC) in the UK is well documented in Leach & Stamp (Eds) [1981], Zeff [1972] and Stamp & Marley [1970]. Only a brief review is presented here.

3.2 EARLY HISTORY

The history of corporate accounting throughout the world and, in particular, in the UK is inseparably bound into the history of the development of corporations, or more generally, organisations, and their environments. A review of the early history of accounting is provided by, for example, Chatfield [1974] and Bird [1973, pp.15-28]. In the rapidly changing commercial environment of corporations two major dimensions of change can be identified.

Firstly, new classes of transactions have been introduced for which novel accounting treatments have been required. Examples include the advent of hire purchase agreements, the issue of shares on listed securities markets, forward contracts for sale or purchase of goods, long term construction contracts in high technology areas, indirect holdings of rights in other corporations either as majority or minority shareholders.

Secondly, new classes of persons interested in financial statements have evolved. Originally financial statements were the private records of the proprietor of the business adventure. With the advent of listed securities markets, new "proprietors" arose who retained only partial ownership and who perhaps exercised no executive functions at all. The advent of long term contracts implied that customers were interested in assessing the corporation's ability to supply and maintain its products over a long time horizon. The advent of organised labour and trade unions implied that employees were interested in a corporation's ability to pay an acceptable price for that labour. The advent of organised media implied that the public could be encouraged to be interested in corporate affairs if they were sufficiently spectacular or entertaining; in the following section it is shown that the collapse of household name corporations or the activities of high financiers in take-over battles have proved to be sufficient. These new groups of interested persons, that is,

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for example, non-executive proprietors, long-term contract customers, trade unions and the media, clearly have a right to, or are able to demand by threat of some sanction, financial information by way of accounting statements. The non-executive proprietors can withdraw their capital, the long-term contract customers can take their custom elsewhere, the trade unions can withdraw their labour and the media can undertake "investigative journalism". Each is able to demand some extent of financial information as part of the price for their continued participation in the organisation's well-being.

Of interest to accountants, however, is the interaction of these two dimensions of change, that is, new classes of transactions and new classes of interested persons, with their body of technical knowledge. Like any intellectual discipline, accounting knowledge is changed mostly by two agencies, firstly the agency of responsibility for production and secondly the agency of abstract reasoning. In the UK, corporate legislation has conventionally placed responsibility for production in the hands of corporate management. Responsibility for abstract reasoning in accounting has, until only very recently in England and somewhat earlier in Scotland and the USA, been neglected by the very institutions which for centuries Western Europe has charged with the development of virtually all abstract reasoning, namely the universities. Necessarily then, the institutional structure we find in the UK implies that the role of accounting innovator will be filled by corporate management, as producer of financial statements.

Implicit in the above description is the inference that, in the absence of any unifying agency, there is to be expected a wide variability in accounting practice as corporate managements innovate according to their own circumstances. The following sections show that expectation to be fulfilled.

3.3 RECENT HISTORY

Standards of accounting practice came to the attention of the British public in 1931 when the "Royal Mail" case received widespread publicity and became infamous. The Royal Mail Steam Packet Company was at that time audited by Price Waterhouse & Co and the chairman of the board of directors, Lord Kylsant, had over a number of years been taking advantage of the profession's attitude to the creation of secret reserves. The attitude of the day was that secret reserves, in which the amounts at which assets are disclosed are intentionally understated, gave companies hidden strength on which they could draw in times of temporary decline. The Royal Mail concealed losses, or lower than expected profits, by making transfers from secret reserves into its profit and loss account. The decline of the Royal Mail was somewhat worse than temporary and, after a Government enquiry, a charge of fraud was preferred. Details of the case are well covered in Hastings [1949] and here it is only necessary to point out that the public debate which this event generated caused the profession, in particular the Institute of Chartered Accountants in England and Wales (English Institute), considerable embarrassment.

In 1941 a Government committee set out to review the Companies Acts; a review which eventually resulted in the Companies Act 1948, the principal legislation on company regulation for at least the next quarter-century. During that review, it became clear to the English Institute that unless they acted to improve standards of reporting then this committee was likely to recommend substantial legislative control of professional accounting standards. Zeff [1972, pp.7-9] notes that concurrently there were moves for reform within the English Institute and these two major factors, that is, the covert threat of legislative control of the profession's technical domain and internal moves for reform, resulted in publication, in December 1942, of a series of "Recommendations on Accounting". This

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series, which was to reach 29 in number, was designed to recommend to English Institute members preferred accounting practice in such areas as accounting for tax reserve certificates, war damage, depreciation, stocks, rising price levels, form and presentation of accounts, consolidated accounts and events occurring after the balance sheet date. These were areas in which considerable ambiguity existed in the set of existing conventions and consequently a wide diversity of practice could be found in the contemporary external financial reports of corporate management. The complete list of these recommendations is reproduced as Appendix 3.1 at the end of this chapter. In a separate statement [ICAEW 1942] the English Institute's Council, that is, its governing body, made it clear that the series represented only best practice and was not considered mandatory on its members. In particular, it stated that "it is, of course, a matter for each individual member to consider his responsibility in regard to accounts presented by directors" (p.354).

At least one body of research examines the degree to which these recommendations were followed by corporate management in practice. The annual "Survey of published accounts", published by the English Institute from March 1970 reviews corporate reporting practices and includes these recommendations within its scope as part of the general background of literature against which practice is compared. The early issues of this survey, which commenced with the issue for 1968/69 [ICAEW 1970B], refers substantially to the "Recommendations" (by then known as "N" statements by virtue of their classification in the "Members Handbook" issued to English Institute members).

3.4 THE 1960's

The late 1950's and the 1960's in the UK saw an increased level of activity in corporate mergers and acquisitions. In addition there were a number of spectacular corporate crashes. These have been well documented elsewhere (for example, especially Stamp & Marley [1970]). It is important to appreciate the effects of these events on public opinion and in particular to be aware of the role of external financial reports in the formulation of that public opinion.

In 1958 British Aluminium was a company with a number of potential take-over "suitors". In addition, there were other take-over battles involving the London store of Harrods and, separately, the brewing organisation of Watneys. Each of these issues attracted considerable interest on the part of the media and, it must be inferred, the public. Public awareness of the activities of the business community or certainly these particular activities, was heightened and consequently for much of the next decade press comment on major financial issues was commonplace. Stamp & Marley [pp.11-19, 25-40, 48-56 and 68-71] chronicle the events of Pye in 1966, Courtaulds, GEC-AEI and Metal Industries in 1967, International Paints, Gallaher and Pergamon-News of the World each in 1968 and Pergamon-Leasco in 1969. The primary theme running through each of these issues was the behaviour of the London stock markets, the market traders and the advisors of the competing factions in the struggles for control of the companies in question. However, a secondary theme underlying these behaviours was, as Lord Kearton of Courtaulds highlighted in a press conference in June 1968 shortly after his public censuring at the hands of the City Panel on Take-overs and Mergers, the distinct lack of information concerning the companies involved. It is in this latter theme that the UK accounting profession, in particular the English Institute, came to the attention of the public. For it was alleged that where information was available it was invariably inaccurate or

misleading. The prime focus of attention was the profit forecast. It was used by AEI in its defence against GEC, used by Dufay in its attack on International Paints and used by Pergamon during its acquisition campaign for News of the World. These forecasts are, by their very nature as predictions in an uncertain world, liable to misunderstanding by the public and misuse by vested interests. Nevertheless the effect on public perceptions cannot be understated. The AEI forecast of £10 million profits for 1967 made in the tenth month of that year [Stamp & Marley 1970, p.69] was converted later into a reported loss of £4.5 million by the new management. The effect of this single event on public perceptions was exemplary.

More crucial to the criticisms of the profession were the public exposure of diversity of accounting practice, not only in profit forecasts but also in audited financial statements. Stamp & Marley (*ibid.*) point out that the 1966 accounts of Pye were less than fair in their treatment of losses written-off which were concealed by disaggregating the total and treating the components under separate classifications; that dubious accounting practices of Pergamon were revealed slowly and unwillingly to Leasco's accountant advisors, Touche Ross, in 1969; that Dufay deliberately delayed publication of poor trading results in 1968 [pp.27-28]; and that Rolls Razor, which crashed in 1964 [Zeff 1972, p.33] tried to blame its failure on the misleading practices of its auditors [Stamp & Marley 1970 p.71]. The outcome of these exposures was informed press comment. The Economist commented that "the system which has been exposed simply is not good enough" [30 August 1969]; and the Guardian commented

"that auditors are too ready to follow blindly the instructions of a Board....without facing squarely the question of whether the methods are the right ones for proper conduct of the business and the protection of shareholders' interests" [22 October 1969].

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It was a direct result of these reports, and others, reviewed in Zeff [1972, pp.33-40] that variability in external financial reports of corporate management became discredited in the public eye. In particular, a celebrated public exchange took place in the columns of the Times in September 1969 between Professor Edward Stamp then of Edinburgh University and Mr (later Sir) Ronald Leach as President of the English Institute. It is widely held [p.39] that this single exchange was the catalyst in what would otherwise have been a much slower reaction. At this time the UK Government department responsible, namely the Board of Trade, was to apply pressure [pp.39-40] to the English Institute to take action to improve standards of financial reporting or else risk being deprived of the initiative. The threat of Government intervention was again in the minds of the English Institute, some quarter of a century after the threat posed by the 1941 company law review.

On 12 December 1969 the English Institute published a "Statement of Intent" announcing the establishing of an Accounting Standards Steering Committee with a stated objective to ..

"narrow the areas of difference and variety in accounting practice by publishing authoritative statements on best accounting practice which will, wherever possible, be definitive" [ICAEW 1970A, p.2].

3.5 THE 1970's

The 1970's in the UK was the first decade in the life of the Accounting Standards Committee (ASC) (the name was changed in 1976). In that decade the ASC appears to have achieved much in attempting to meet its stated objectives. The committee started life at its first meeting in March 1970 as a committee of the English Institute and immediately a list of projects, set out below in Appendix 3.2 "The Accounting Standards Committee: Projects identified in 1970", was drawn up as potentially suitable material for the subject matter of accounting standards. Some of these subjects were already on the agenda of the English Institute's Technical Committee as topics for the "Accounting recommendations" series. In that sense, ASC was fortunate in being able to inherit an existing portfolio of work in hand. The accounting standards published to date, the exposure drafts and the other publications of the ASC are set out below in Appendices 3.3, 3.4, and 3.5 as an indication of the subjects on which it has deliberated. From the outset, the English Institute intended that it should not be alone in the UK initiative to publish accounting standards. The Institutes of Chartered Accountants of Scotland and in Ireland became participating members from April 1970 [Zeff 1972, p.40]. The Association of Certified Accountants and the Institute of Cost and Management Accountants both joined in 1971 ["Accounting standards 1980", ICAEW 1980A, p.1]. By 1976 the last of the six UK accountancy bodies, that is, the Chartered Institute of Public Finance and Accountancy, had decided to participate in the ASC.

In 1978 the ASC decided that it should embark on a review of its activities in order to determine whether or not changes were required in the light of experience. A discussion document was published under the title "Setting accounting standards: A consultative document" [ASC 1978] inviting public comment. Reviewers received this as a "status quo" document [Lafferty 1979, Stamp 1979 and Paterson & Smith 1979] so indicating the

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ASC's own perception of successful performance to date.

The method of operation of the ASC is discussed in more detail below. At this stage it is sufficient to note the procedure to be found in "Accounting Standards 1980" [ICAEW 1980A, pp.4-7]. A draft accounting standard is prepared by an ASC working party and then exposed to the public for comment during a fixed period after which a final accounting standard, incorporating any comments the ASC considers suitable, is published by the Councils of the six accountancy bodies. In this final form the accounting standard is mandatory on the members of the UK accounting profession.

Coincident with the launch of the ASC, the English Institute launched a research initiative in the publication of an annual survey of external financial reporting practices as evidenced in the published accounts of 300 major UK listed industrial firms. This initiative was numbered among those of Professor Stamp in Stamp & Marley [p.149]. The annual survey is now an established part of the literature under the title "Survey of published accounts" [for example, ICAEW 1980B]. The implied objective of the survey was, in substance, to offset the perceived unbalanced public view of external financial reporting gained during the 1960's as a result of the adverse press coverage. One effect of the series is that there exists a permanent record of the chronology of the effectiveness of the ASC in changing practice in the companies surveyed.

The series of accounting standards, entitled Statements of Standard Accounting Practice (SSAP), from SSAP1 to SSAP15 which were published in the decade of the 1970's has resulted, prima facie, in an improvement in external financial reporting practice. For example, SSAP2 "Disclosure of accounting policies" became effective for accounting periods commencing on or after 1 January 1972. "Survey of published accounts 1980" [ICAEW 1980B, p.151] records that in 1972/73 only 189 of the sample of 300

companies disclosed their accounting policies together in one annexed statement or note to the accounts. By 1979/80 294 of the sample of 300 companies had adopted the practice of systematic disclosure in one statement or note (ibid.). Further, "Survey of published accounts 1980" shows that all the 300 companies it reviews published audited statements of source and application of funds in that year, whereas "Survey of published accounts 1968/69" [ICAEW 1970B] shows that only one of those 300 companies published an audited statement of source and application of funds in that earlier year. In the earlier year a further 20 of the 300 companies published unaudited statements of sources and applications of funds. The accounting standard requiring publication of these statements was published in 1975. In the case of accounting for changing price levels, "Survey of published accounts 1980" shows that one of the 300 companies published supplementary current purchasing power (CPP) statements and 100 companies published supplementary current cost accounting (CCA) statements during that year, whereas "Survey of published accounts 1975" [ICAEW 1976] shows that 48 companies published supplementary CCA statements during that earlier year. The accounting standard requiring publication of supplementary CPP statements, PASSP7, was published in 1974. It was later withdrawn and an accounting standard requiring publication of supplementary CCA statements, SSAP16, was published in 1980.

3.6 THE 1980's

The ASC entered the 1980's with a continued programme of publishing (through its governing bodies) accounting standards with the aim of reducing variability in, and implicitly improving the quality of, external financial reporting. The accounting standards which have been published to 30 June 1983 are set out below in Appendix 3.3 "Statements of Standard Accounting Practice published".

In particular, March 1980 saw the publication of a SSAP16 "Current cost accounting", October 1981 saw ED29 "Accounting for leases and hire purchase contracts" and April 1983 saw SSAP20 "Accounting for foreign currency translations". Each of these three topics proved to be particularly controversial and are among those listed below in Appendix 3.1 "Recommendations on accounting principles published by the Institute of Chartered Accountants in England and Wales".

Additionally, a review of the standards setting processes started with the publication of "Setting accounting standards: A consultative document" [ASC 1978]. This review resulted in the amended constitution of July 1982 discussed below in Section 3.7 "Constitutional establishment and committee operation" and the publication of "Review of the standard setting process: A report by the Accounting Standards Committee" in June 1983. This latter report re-affirms the ASC's method of operation developed during the previous decade and sets out the policy for the future of the process. That policy is essentially the same as before but a distinguishing characteristic is the use of two new classes of document to be published at a level below that of a Statement of Standard Accounting Practice. The first such is a "Statement of Intent" in which the ASC will publish an outline of the solution it will propose in a latter Exposure Draft. The second such is a "Statement of Recommended Practice" in which the ASC will publish a preferred solution which will not have the mandatory effect of

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Statements of Standard Accounting Practice. The publication of the latter is to be restricted to "matters of major and fundamental importance affecting the generality of companies, and will therefore be few in number" [ASC 1983, p.5].

No clear rationalisations are presented for the adoption of these two new types of document, although their proposed functions are set out. In particular, a Statement of Intent "could be used to elicit public comment on a proposed course of action more promptly than a full-length discussion paper, whilst serving to reduce problems at the exposure draft stage" [ASC 1983, p.13]

Further, Statements of Recommended Accounting Practice will be concerned with

"issues...which, although of sufficient importance to require an authoritative pronouncement, do not meet all the criteria for an accounting standard....SORPs will generally deal with either (1) matters which, whilst being of widespread application, are not of fundamental importance, or (2) matters which are of limited application" [ASC 1983, p.19].

Clearly, the impact of these changes to the UK professional accounting standards setting processes is the subject of a future research study.

3.7 CONSTITUTIONAL ESTABLISHMENT AND COMMITTEE OPERATION

The ASC is constituted as a committee which reports directly to the Councils of the six principal UK accountancy bodies, its governing bodies. The six bodies are The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland, The Institute of Chartered Accountants in Ireland, The Association of Certified Accountants, The Institute of Cost and Management Accountants and The Chartered Institute of Public Finance and Accountancy. It is financed by and responsible to these six bodies and, as such, is entirely a creature of the UK accounting profession. It is supported by a secretariat which is provided by the English Institute.

The constitution was substantially amended in July 1982. The earlier constitution, reproduced in "Accounting standards 1982" [ICAEW 1982, pp.22-24], provided for a total of 23 members each of whom was nominated by one of the six accounting bodies. The English Institute had the right to nominate 12 members. The new constitution provides for a total of 20 members. Of these, five are reserved for "users" of accounts (distinguished from "preparers") and each governing body has a right to at least one seat. The 1982 annual report of the English Institute states that

"the membership is now based on a 'balanced slate' approach, ensuring an appropriate mix of preparers, users and auditors of financial statements." [ICAEW 1983, p.5]

Members are expressly stated to participate as individuals and not as representatives of any organisation. When the ASC wishes to vote on the publication of an exposure draft the constitution requires two thirds majority and similarly when the ASC wishes to recommend the publication of a Statement of Standard Accounting Practice to the Councils. It is a feature of this constitutional arrangement that the ASC does not publish accounting standards. The ASC recommends that the profession's governing bodies publish them and it is the governing bodies which possess the disciplinary machinery by which the standards may be enforced on

their own members. Clearly then, accounting standards are not directly imposed on persons who are not members of the accounting profession except to the extent that the Courts of Law choose to adopt Statements of Standard Accounting Practice. They may choose to do so when interpreting the legislative requirement that the accounts of a limited company shall present a true and fair view of financial position and profit or loss. In a 1981 case, magistrates found the directors of Argyll Foods Ltd. guilty of a breach of that legislation. The directors were convicted of a failure to ensure that a true and fair view was being presented. In the evidence it was argued that the presentation was not in compliance with SSAP14 "Group accounts" [Accountancy, August 1981, p.19]. Accounting standards are, however, indirectly imposed on persons who are not members of the accounting profession. There are two main mechanisms by which this can take place. Firstly, the auditors of all limited companies and of many other organisations are expected by their professional body to ensure that accounting standards are followed by others. A qualified or reserved audit opinion is the sanction auditors can apply to ensure compliance. Secondly, there is a subtle mechanism of "economic consequences" by which the effects of accounting standards can be indirectly translated to a number of individuals. The "economic consequences" of accounting standards are discussed more fully below in Part II "Review of previous research in accounting and economics".

The series of Statements of Standard Accounting Practice is prefaced by an "Explanatory Foreword" ["Accounting standards 1980", ICAEW 1980A, pp. 117-118] which provides, inter alia, for three further constitutional provisions. Firstly, Statements of Standard Accounting Practice apply to "all financial accounts intended to give a true and fair view of financial position and profit or loss" [paragraph 1]. Secondly, departures from Statements of Standard Accounting Practice must occasionally be expected in exceptional or borderline cases [paragraph 10] in which cases departures should be disclosed and explained

[paragraph 2]. Thirdly, the governing bodies may enquire into apparent non-compliance by utilising their existing disciplinary procedures [paragraph 6]. Finance is not provided for in the written constitution of the ASC. As noted above, the committee is supported by the staff of the English Institute and to this extent costs are incurred and borne by each of the six accountancy bodies. The Watts Report [ASC 1981, pp.37-38] discusses finance and indicates that these costs are budgeted at the level of £200,000 for 1981. This excludes any research costs.

The procedure [ASC 1978, pp.5-6] for developing a Statement of Standard Accounting Practice commences with one or more limited research studies and there is an implied decision that a problem has been identified which warrants researching. This process of problem identification is embodied in a periodic approval by ASC of its long range programme and its associated structure of priorities [ICAEW 1980A, p.5]. Then a sub-committee is established which comprises six to nine representatives of interested parties and which prepares a preliminary draft of a proposed standard. The sub-committee is intended to be as representative and balanced as possible (*ibid.*). This draft is then circulated widely within the profession and initial meetings may be held with organisations potentially affected by these proposals. At this stage, considerable reliance is placed on the network of technical committees within the profession to provide additional input and it is implicit that feedback would be reflected in the draft document. Following this, publication of the Exposure Draft (ED) takes place with a fixed exposure period during which written public comment is invited on the proposals. Each Exposure Draft contains a statement that these written comments are "regarded as on public record unless confidentiality is requested by the commentator". Distribution of these Exposure Drafts is extensive, with the total number of copies approximating the total number of members of the UK accounting profession, that is, about 100,000. The written comments are

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collated, circulated amongst ASC members and considered by a panel of ASC which impliedly makes its consideration known to ASC for discussion. Any particular problems identified at this stage may result in further meetings with interested parties. At the final stage the draft Statement of Standard Accounting Practice is forwarded to the Councils of the governing bodies for their approval and subsequent publication along with a technical release indicating the background, any major differences between the Exposure Draft and the Statement of Standard Accounting Practice and explanations for any substantial comments which have not been reflected in the final accounting standard. Stress is placed [p.7] on the time elapsing between publication of the Exposure Draft and final publication of its associated Statement of Standard Accounting Practice as being dependent on a careful consideration of all the issues raised by the commentators during the exposure period.

The ASC has one further major constitutional device for eliciting the preferences of interested parties. Although not provided for in the written constitution, ASC has created a "consultative group" [ASC 1978, p.6] which meets at least three times a year and is comprised of some 24 bodies which together probably captures all the City of London Institutions in both government and private sectors.

Few writers have added to the above description of ASC's constitution and operation.

Westwick [1980] has added new insight in his story of the progress of the "inflation accounting" debate through the perceptions of an English Institute staff member. Westwick points out [p.356] that this particular issue came to the ASC's agenda by way of an English Institute Council request to ASC; a request which itself had been prompted by Sir Henry Benson in a letter to the President of the English Institute. Clearly, this is an important insight into the manner in which issues are

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adopted by the ASC. Further, a sub-committee of the English Institute's Technical Committee had been charged with responsibility for preparing a "current purchasing power" exposure draft. This represents an exclusion of choice at that sub-committee level and Westwick remarked that this "decision was perhaps not surprising in the light of publication of Stewardship in 1968". He is clearly implying that choices in 1971 had, to a large extent, been restricted by the publication of "Accounting for stewardship in a period of inflation" [ICAEW 1968], a choice made at least some three years earlier and during the presidency of Sir Edward Parker who was one of "the principal figures advocating the need for inflation accounting in the 1950's and 60's" [Westwick 1980, p.355]. Further insight comes from a passage in which Westwick says of the sub-committee preparing that exposure draft "as a new member of the secretariat I was in no position to suggest that the committee should reconsider its basic decision" [p.359]. There is a clear implication that the secretariat's ability to change decisions is limited. Nevertheless, Westwick did initiate work in three areas. These were the use of a sample of companies to field test the practicability of the proposals; an estimate of the effect of the proposals on reported profits; and the preparation of a working guide to aid implementation of the proposals. ED8 "Accounting for changes in the purchasing power of money" was published in January 1973.

Westwick also throws light on the nature of Government involvement in this issue. Government involvement had been requested by Sir Henry Benson in May 1971 [p.356] but the overtures of the profession came to no avail. Only in July 1973, at the end of the fixed period of exposure for the profession's own proposal, did the (then) Department of Trade and Industry decide to intervene by the establishment of a committee of enquiry, under the chairmanship of Mr. Francis Sandilands. The committee reported in September 1975 [Sandilands 1975] after hearing evidence from several sources, including the ASC. It

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recommended current cost accounting while specifically rejecting the ASC proposal for current purchasing power accounting. A further recommendation of this report was "that a Steering Group should be set up to supervise necessary detailed work in preparation for the introduction of Current Cost Accounting." [Sandilands 1975, pp.3-4]. Such a steering group was established in January 1976, under the chairmanship of Mr. (later Sir) Douglas Morpeth and financed jointly by the Government, the accounting profession (through the ASC) and industry. It was not until the accounting standard SSAP16 "Current cost accounting" had been published in March 1980 that direct Government involvement in this issue ceased with the winding up of that steering group.

The IASG immediately acted [Westwick 1980, pp. 362-363] to make its task manageable by

- 1 establishing working parties to consider different aspects of its responsibility;
- 2 continuing to use the field-test companies whose comments were incorporated into the earlier ASC proposal under the Westwick initiative;
- 3 deciding an early compromise to a perceived conflict between a Sandilands recommendation on the treatment of monetary items and the known views of the accounting profession; and
- 4 holding an international conference to explore the implications for international harmonisation.

The outcome of the IASG's work was the exposure draft ED18 "Current cost accounting", reprinted in "Accounting standards 1977" [ICAEW 1977, pp. 45-151], on which comments were received and analysed by normal ASC procedure. As a result of that analysis, the IASG published in May 1977 an outline of proposed changes aimed at meeting the (considerable) criticism of the exposure draft. Simultaneously, members of the English Institute requisitioned a special meeting of their Institute, on 6 July 1977, at which a vote decided that CCA should not be made compulsory. Such was the strength of opposition to the exposure draft. Westwick notes [p.365] that following this vote several meetings were held at a high level between the Stock Exchange, the CBI, the ASC and the IASG; and further, that "we were

fortunate at this critical juncture to have the statesmanlike qualities of Sir William Slimmings as chairman of the ASC" (p.36). The outcome of this phase of activity was the appointment of a sub-committee of ASC under the chairmanship of Mr. W. Hyde. This committee prepared for ASC interim recommendations on inflation accounting ["Hyde Guidelines", ASC 1977] which Westwick notes [p.366] were more acceptable to industry. He also notes that the Hyde Guidelines were entirely voluntary, simpler and shorter than either SSAP7 "Accounting for changes in the purchasing power of money" or ED18 "Current cost accounting" and perhaps more acceptable because "of the cumulative effect of the debate so far". The next phase of activity on which Westwick gives some insight is that of the preparation of the second exposure draft on the subject, ED24 "Current cost accounting", reprinted in "Accounting standards 1979", [ICAEW 1979, pp.98-125]: Here he remarks [p.366] that much of the time prior to publication in April 1979 was spent, not in revising the earlier draft, but in "considerable debate on the political desirability and timing of another exposure draft". The final section of Westwick's paper is devoted to a criticism of the process which he has described.

From the moment of the intervention of the Government, inflation accounting became an issue which focussed abnormal attention onto the activities of the ASC. As a result the description of the operation of the ASC and its steering group, the Inflation Accounting Steering Group (IASG), which Westwick [1980] provides should be cautiously viewed as not necessarily representative of a more "normal" pattern of operation. Nevertheless, a study of this issue is important in that it may aid an exploration of that operation at its limits.

Barrett [1978] provides insight, as a former member, into the operations of the ASC. Barrett presents a view of a hard-working committee meeting for a full day each month with peak work even carried out at weekend meetings. Sub-committee meetings are even

more regular, often being held weekly. More importantly, Barrett tells us that the voting record was more nearly unanimous than the constitution requires

"indeed on a great number of issues, there was critical unanimity and on others only two or three dissenters" [p.21].

Attendance also, was high, there being an average of 17 present of the 21 total membership (Barrett served before the ASC was expanded to 23 members by the admission of the Chartered Institute of Public Finance and Accountancy in 1976). He does point to a changing attendance and occasional reversal of decisions made at immediately preceding meetings; the implication being that decisions are sensitive to the attendance of "key" individual members. The changing attendance is attributed to the "very busy schedules" of members (ibid.). Barrett also describes frequent meetings with interest groups [p.23] in which other professional bodies views were heard, but not necessarily acceded.

In reviewing issues in which he was involved, Barrett notes that, in the context of SSAP12 "Accounting for depreciation"

"the British Property Federation simply refused to go along with (depreciation of investment properties)under such a procedure, very many companies holding investment properties would be condemned to permanent loss" (ibid.);

and that, in the context of SSAP11 "Accounting for deferred taxation"

"apart from the technical surrender in this debate one of its worst features is that we backed down under pressure and were publicly seen to have done so" [p.24].

Such passages give a clear insight into the conflict of interests which are focussed on ASC, the outcomes of some of the win or lose struggles and the attitude of the professional member to the integrity of the technically preferred solution.

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There are other publications by members, former members of the ASC, and others, for example, Gibbs [1981], Leach [1981], Morpeth [1981 & 1980], Slimmings [1981 & 1978], Watts [1981 & 1980], and Edey [1977]. None, however, were found in the progress of the present study which described the actual operation of the committee. Most were concerned with debating specific issues; past, current or future. Brief notes on some of them follow.

ICAEW [1980] is one issue in an annual series of the collected UK accounting standards which, in its introductory sections, presents a description of the UK accounting standard setting process. The document's brevity adds insight into the perceptions of its authors.

Slimmings [1978] is of value in that it gives an insight into how a member, this time a former chairman, of ASC views the professional accounting standard setting processes. The author gives a description of the administrative functions of the ASC and its supporting staff. It suffers from brevity and the limitations of a view of organisations as bureaucracies [for example Weber 1947].

Edey [1977] gives an insight into how another member of ASC views the professional accounting standard setting processes. The processes themselves are not discussed but only the characteristics of accounting standards themselves as if they were independent of any process by which they are generated. This, in itself, gives the insight referred to.

Lee [1975] is an historical narration of the background to the professional accounting standard setting processes of both the UK and the US. This narration is not as extensive as Zeff [1972] but does more clearly make comparison between the two environments.

3.8 INTERNATIONAL COMPARISONS

The ASC is not unique as a mechanism by which an accounting profession seeks to narrow areas of difference and variety in practice by publishing authoritative statements. Much comparative material is collected together in Sprouse [1983], Moonitz [1974] and Zeff [1972], and so only a brief review will be provided here.

As early as 1914, the US accounting profession was confronting the problem of variability of accounting practice and the subsequent criticism which that variability attracted from outside bodies [Zeff 1972, p.113]. A "Special Committee on the Development of Accounting Principles" was formed by the American Institute of Accountants (AIA), (renamed the American Institute of Certified Public Accounts in 1957) in 1933 [p.134]. This committee became the "Committee on Accounting Procedure" (CAP) in 1936 under the chairmanship of George O. May, then senior partner of Price Waterhouse & Co. During the period 1939 to 1959 the CAP published a series of 51 "Accounting Research Bulletins" which were designed to "narrow down the range of choices in accounting procedures" [Blough 1967, quoted in Zeff 1972, p.137]. Initially there was no provision for consultation by the CAP with either the AIA members or other outside parties, but as the members began to perceive that the bulletins were to have an impact on their practices so there grew a pressure for consultation [Zeff, p.146]. By the end of its term, the CAP was regularly issuing drafts of its bulletins for exposure to organisations and individuals.

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In 1959 the (then renamed) American Institute of Certified Public Accountants (AICPA) created the Accounting Principles Board (APB) as a successor to the Committee on Accounting Procedure. The APB was supported by an Accounting Research Division with the intention that statements on accounting practice published by the APB should be seen to be adequately supported by a substantial research effort. The lack of such a research effort was one of the main criticisms addressed at the CAP. During the period 1962 to 1973, the APB published a series of 31 "Opinions"; the first being delayed by the need to prepare a research study on basic postulates and principles. This research study, published as Moonitz [1961] and Sprouse & Moonitz [1962], was suggested by a special committee which was responsible for the establishment of the APB and which envisaged that

"the results of these (studies), as adopted by the Board, should serve as the foundation for the entire body of future pronouncements" (quoted in Zeff [1972, p.172]).

Additionally, professional accounting standards setting processes exist in Australia, New Zealand, Canada, South Africa, Germany, Holland, Mexico and Japan to name but a few. Many of these countries' professional bodies also participate in the International Accounting Standards Committee [Benson 1976].

The present study is organised as a UK orientated study rather than as an international comparative study. Accordingly, the richness of insight which could be gained from an extensive comparative study is left to a future research study. Nevertheless in the following Part II "Review of previous research in accounting and economics", the present study is able to take advantage of the US comparison by drawing on a growing body of research addressing the US professional accounting standards setting processes.

3.9 A UK COMPARISON: THE ENGINEERING STANDARDS COMMITTEE

In addition to the international comparison, it is possible to make a direct comparison within the UK. The ASC is not unique as a mechanism by which a UK profession seeks to narrow areas of difference and variety in practice by publishing authoritative statements.

In 1903 the Engineering Standards Committee published its first standard entitled "British standard sections" some two years after its first meeting on 26 April 1901 [Woodward 1972]. Parallels with the ASC are striking. There were strong incentives for standardisation operating within the engineering industry of the late 19th century, an industry which had seen a period of sustained growth for at least the preceding hundred years.

"we have too much individualism in this country.....no two professional men are agreed upon (the proper specification of product)....to meet the irregular unscientific requirements of (users)" (letter to The Times 1895, quoted in Woodward [1972, p.8]).

Once established, the Engineering Standards Committee commenced work through its "sectional committees" [Woodward 1972, p.9] on which were represented trade associations and government departments who would be affected by the standards. Flexibility was a hallmark of the committee's work, an early chairman noted that it was not an organisation "for stereotyping...we have arranged that our committees sit permanently for the purpose of considering improvements". The work of members is provided voluntarily and a major task is that of arriving at "a consensus between producers and users" [p.1]. Compulsion is seen as "ultimately self-defeating" and so compliance is essentially voluntary.

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Developments have since moved the Engineering Standards Committee, now the British Standards Institution (BSI), a considerable distance from the ASC. The BSI has some 4500 technical committees, received its own Royal Charter in 1929 and is financed by sales of standards documentation; by subscriptions of 15,000 member bodies and individuals; by government grant; and by fees for certification. In 1970 the total budget was £2.8m, of which some £1.1m was provided by Government grant [p.93].

Clearly, the Engineering Standards Committee provides a model against which development of the ASC can be compared. A thorough investigation would be the subject of a separate study and will not be attempted here. However, it is interesting to note that to date there is no evidence that the UK literature has identified the Engineering Standards Committee as a model for the ASC, attention to date being given more often to the US FASB.

In the following Chapter 14 "Professionalisation processes", the present study examines more closely some of the implications of the idea that standards setting processes are to be found within the framework of a profession such as the accounting and the engineering professions.

3.10 CRITICISMS OF THE ACCOUNTING STANDARDS COMMITTEE

There have been several criticisms of the ASC and its programme of accounting standards.

Lafferty [1979] catalogues a number of examples of UK reporting practices which, in some way or other do not follow the practices set out in Statements of Standard Accounting Practice. Lafferty strongly criticises the role of the auditor on the grounds of its inability to ensure enforcement of Statements of Standard Accounting Practice. He predicts that a Governmental body will be created to ensure enforcement [p.51]. Lafferty also argues that the ASC generates ambiguous Statements of Standard Accounting Practice which are designed to "avoid(s) embarrassing public confrontation". Further, he argues that the ASC's own membership is inadequate to ensure that the needs of users are fully represented. This latter point has been met to some extent by the 1982 constitutional changes referred to above in Section 3.7 "Constitutional establishment and committee operation".

Stamp was noted above in Section 3.4 "The 1960's" as being instrumental in the formation of opinion which precipitated the creation of the ASC. His continued criticism and review of the ASC and professional accounting standards setting processes is noteworthy [Stamp 1983, 1982, 1981A, 1981B, 1980A, 1980B, 1979A, 1979B, 1979C, 1973, Leach & Stamp (Eds) 1981]. In particular, Stamp [1981] addresses the enforcement issue and argues that the London Stock Exchange should take powers to fine directors of companies not following Statements of Standard Accounting Practice. Stamp [1981] also favours a solution adopted in Canada whereby professional accounting standards have been incorporated into legislation. Stamp [1980] argues that professional accounting standards setting processes are deficient in that they are not based on any clear conceptual framework; they do not adequately meet the needs of users; there is underlying conflict of interest; and they suppress variety of practice on which

legitimate innovation is based. This latter point is also made by Baxter [1981 & 1953]. Stamp [1979A] criticises the Watts' Report [ASC 1978] as being "an uncertain trumpet". Stamp argues that the ASC's own resources should be increased substantially and that an "agreed conceptual framework" should form the basis of its Statements of Standard Accounting Practice. Stamp [1979B] suggests that the English Institute has a "death wish" and that "the whole accounting standards programme is now bogged down in confusion, acrimony, and dissent" [p.203].

Weetman [1977] reviews progress of the ASC against the criteria set out in the original "Statement of Intent" [ICAEW 1970] and concludes that the ASC "has moved too far towards extreme rigidity, and future accounting standards must steer a middle course if they are to gain universal acceptance and respect" [p.176]. That conclusion was based on a brief survey of the comments of management to be found in the annual report and accounts of large listed companies.

Hope [1979] criticises the critics of the ASC. He argues that if the ASC's function is seen as policy-making in a democratic society then the interests of a wide variety of groups need to be taken into account. In such a setting, "purely conceptual, 'rational' approaches to the determination of accounting practice may lead accounting policy-makers to make decisions which produce results incompatible with the workings of a democratic social system" [p.564]. Hope argues that the ASC should adopt an "incremental" approach to its policy-making and incorporate some assessments of the economic impact of its proposals.

McCusker [1979] criticises the ASC for its "ad hoc and pragmatic approach to problem solving" [p.22]. Such an approach is said to produce "contradictions and inconsistencies" which are compounded by missing definitions of the purpose of the balance sheet; the meaning of profit; the implications of capital maintenance; and the accounting entity.

Paterson & Smith [1979] also addresses inconsistency in the accounting standards programme. For example, they point out that measurement of profit was defined on the basis of matching of revenues and expenses in the first proposal for a standard on deferred taxation, ED11, but that this was then changed, to include the measurement of profit on the basis of changes in balance sheet position, in the first accounting standard on the same issue, SSAP11. Paterson & Smith argue that some explicit objective should be adopted by the ASC to reduce the inconsistency. Further, they argue that a re-structuring of the committee itself would provide an opportunity for wider participation by other financial institutions who would also be able to play a role in monitoring and enforcing the application of Statements of Standard Accounting Practice.

Morris [1975] considered the impact of the ASC on accounting practice as reflected in the English Institute's annual "Survey of Published Accounts". Morris concluded that, although there was, in 1975, a measurable impact on the format of disclosure, there was no measurable additional disclosure. On this basis Morris suggests that "there is little evidence that investors are worse off for this, and much of the criticism...seems to have been ill thought out" [p.14].

Solomons [1983] argues that the intervention of the UK Government in the inflation accounting debate in 1974 is evidence of a political dimension to accounting standards. The argument continues that political bias in accounting is a bad thing because it produces an "erosion of confidence". Solomons suggests the adoption of US style solutions such as a conceptual framework; full-time ASC membership; and independence from its governing bodies.

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In summary, the ASC has not been without its critics. The points of criticism include inconsistency of practice; ambiguity of requirement; lack of definition; lack of explicit conceptual framework; conflict of interests; political interference; and lack of defined objectives; to name but a few. The existence and persistence of these criticisms is noteworthy and invites investigation and explanation. Such an observation provides the initial motivation for the present study, the purpose of which is to contribute both to that investigation and to an explanation.

3.11 SUMMARY

The historical, professional and international perspectives have been described in which the professional accounting standards setting processes in the UK, are to be found. Early external financial reports are argued to be originally influenced primarily by the needs of corporate management as responses to the changing commercial environment. However, the role of the State is seen to be important in times of extreme testing of the financial reporting system. In cases of State intervention, existing reporting practices, and so professional accounting standards, had been discredited in the public perception and the role of the State was arguably that of an external corrective mechanism.

The core machinery for an accounting standards programme was born in the English Institute in 1942 with the development of the first "Recommendations on accounting principles". These recommendations were formulated in committee and then published by the English Institute. There is no evidence of an outside consultative process, but such a process was introduced, with the birth of the ASC in 1970, as an attempt to take into account the views and perceptions of earlier critics.

The ASC is now an organ of the six principal UK accountancy bodies and during the period since 1970 has been responsible for a series of published professional accounting standards which appear to have had a significant impact on the external financial reports of UK companies. The ASC has a well defined constitutional structure based on a committee structure. Within this committee structure, issues are identified, selected for public debate and the professional accounting standards setting machinery set into motion. Specific issues may originate from different circumstances and the roles of individuals have been seen to be important in advocating both issues and solutions. Further, some issues generate more controversy in the public

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forum than others and at the extreme, there has been State intervention.

The ASC is not a unique body. Interest in standards of external financial reporting has permeated many major trading nations of the world sympathetic to Western European commercial value systems. Primary amongst these being the USA, Australia, and Canada. At the international level there exists an International Accounting Standards Committee and governmental organisations are also interested in the topic through the United Nations and the European Economic Community. Additionally, at least one other UK profession, the engineering profession, has used a similar institutional structure.

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APPENDIX 3.1 RECOMMENDATIONS ON ACCOUNTING PRINCIPLES PUBLISHED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

	<u>Date Issued</u>
1 Tax reserve certificates	12 December 1942
2 War damage contributions, premiums and claims	12 December 1942
3 The treatment of taxation in accounts	13 March 1943
4 The treatment in accounts of income tax deductible from dividends payable and annual charges	13 March 1943
5 The inclusion in accounts of proposed profit appropriations	13 March 1943
6 Reserves and provisions	23 October 1943
7 Disclosure of the financial position and results of subsidiary companies in the accounts of holding companies	12 February 1944
8 Form of balance sheet and profit and loss account	15 July 1944
9 Depreciation of fixed assets	12 January 1945
10 The valuation of stock-in-trade	15 July 1945
11 Excess profits tax post-war refunds	19 July 1946
12 Rising price levels in relation to accounts	14 January 1949
13 Accountants' reports for prospectuses: fixed assets and depreciation	11 March 1949
14 The form and contents of accounts of estates of deceased persons and similar trusts	12 August 1949
15 Accounting in relation to changes in the purchasing power of money	30 May 1952
16 Accountants' reports for prospectuses: adjustments and other matters	13 November 1953
17 Events occurring after the balance sheet date	18 October 1957
18 Presentation of balance sheet and profit and loss account	October 1958 (sic)
19 Treatment of income tax in accounts of companies	October 1958 (sic)
20 Treatment of investments in the balance sheets of trading companies	13 November 1958
21 Retirement benefits	29 February 1960
22 Treatment of stock-in-trade and work in progress in financial accounts	16 November 1960
23 Hire purchase, credit sale and rental transactions	9 December 1964
24 The accounting treatment of investment grants	14 April 1967
25 The accounting treatment of major changes in the sterling parity of overseas currencies	17 February 1968
26 Land Commission Act 1967: accounting implications	11 May 1968
27 Treatment of taxation in accounts of companies	July 1968
28 The accounts of investment trust companies	7 August 1968
29 Trust accounts	5 November 1969

Source: "Recommendations on accounting principles", London: Institute of Chartered Accountants in England and Wales, 1975.

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APPENDIX 3.2 THE ACCOUNTING STANDARDS COMMITTEE: PROJECTS IDENTIFIED IN 1970

	<u>Outcome at 1983</u>
Disclosure of accounting bases	SSAP2
Form and content of P & L account	Abandoned
Form and content of balance sheet	Abandoned
Treatment of extraordinary and prior year items	Review of SSAP6 January 1983
Changes in accounting bases	Review of SSAP6 January 1983
Treatment of investments in the accounts of trading companies and industrial holding companies	Abandoned
Treatment of income of associated companies	SSAP1 (Revised 1982)
Fundamental principles of inventory valuation	SSAP9
Fundamental principles, form and content of group accounts	SSAP14
Accounting for mergers and acquisitions	ED31
Accounting for contract work in progress	SSAP9
Fundamental principles of depreciation	Review of SSAP12 December 1982
Earnings per share	SSAP3
Accounting for research and development	SSAP13
Accounting treatment of pension funds in company accounts	ED32
Form and content of pension fund accounts	Discussion paper June 1982
Accounting for changes in purchasing power of money	PSSAP7 (Since withdrawn)
Fundamental objects and principles of periodic financial statements	The Corporate Report
Accounting for goodwill	ED 30
Insurance company accounts	Abandoned

Source: Based on Tweedie [1981, pp.186-187] (Updated to 30 June 1983)

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APPENDIX 3.3 STATEMENTS OF STANDARD ACCOUNTING PRACTICE PUBLISHED

		<u>Date Issued</u>
	Explanatory foreward	January 1971
SSAP1	Accounting for the results of associated companies	January 1971
SSAP1 (Revised)	Accounting for associated companies	April 1982
SSAP2	Disclosure of accounting policies	November 1971
SSAP3	Earnings per share	February 1972
SSAP4	The accounting treatment of government grants	April 1974
SSAP5	Accounting for value added tax	April 1974
SSAP6	Extraordinary items and prior year adjustments	April 1974
PSSAP7	(Provisional)Accounting for changes in the purchasing power of money (withdrawn January 1978)	May 1974
SSAP8	The treatment of taxation under the imputation system	August 1974
SSAP9	Stocks and work in progress	May 1975
SSAP10	Statements of source and application of funds	July 1975
SSAP11	Accounting for deferred taxation (withdrawn October 1978)	August 1975
SSAP12	Accounting for depreciation	December 1977
SSAP13	Accounting for research and development	December 1977
SSAP14	Group accounts	September 1978
SSAP15	Accounting for deferred taxation	October 1978
SSAP16	Current cost accounting	March 1980
SSAP17	Accounting for post balance sheet events	August 1980
SSAP18	Accounting for contingencies	August 1980
SSAP19	Accounting for investment properties	November 1981
SSAP20	Accounting for foreign currency translations	April 1983

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APPENDIX 3.4 EXPOSURE DRAFTS PUBLISHED

		<u>Issued</u>
ED1	Accounting for the results of associated companies	June 1970
ED2	Disclosure of accounting policies	January 1971
ED3	Accounting for acquisitions and mergers	January 1971
ED4	Earnings per share	March 1971
ED5	Extraordinary items and prior year adjustments	August 1971
ED6	Stocks and work in progress	May 1972
ED7	Accounting for extraordinary items (replaced ED5)	July 1972
ED8	Accounting for changes in the purchasing power of money	January 1973
ED9	The accounting treatment of grants under the Industry Act 1972	March 1973
ED10	Accounting for value added tax	May 1973
ED11	Accounting for deferred taxation	May 1973
ED12	The treatment of taxation under the imputation system in the accounts of companies	May 1973
ED13	Statements of source and application of funds	April 1973
ED14	Accounting for research and development	January 1975
ED15	Accounting for depreciation	January 1975
ED16	Supplement to extraordinary items and prior year adjustments	September 1973
ED17	Accounting for research and development - revised (replaced ED14)	April 1976
ED18	Current cost accounting	November 1976
ED19	Accounting for deferred taxation	May 1977
ED20	Group accounts	July 1977
ED21	Accounting for foreign currency transactions	September 1977
ED22	Accounting for post balance sheet events	February 1978
ED23	Accounting for contingencies	November 1978
ED24	Current cost accounting	April 1978
ED25	Accounting for the results of associated companies	October 1979
ED26	Accounting for investment properties	September 1980
ED27	Accounting for foreign currency translations	October 1980
ED28	Accounting for petroleum revenue tax	March 1981
ED29	Accounting for leases and hire purchase contracts	October 1981
ED30	Accounting for goodwill	October 1982
ED31	Accounting for acquisitions and mergers	October 1982
ED32	Disclosure of pension information in company accounts	May 1983
ED33	Accounting for deferred tax	June 1983

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APPENDIX 3.5 OTHER PUBLICATIONS OF THE ACCOUNTING STANDARDS COMMITTEE

	<u>Date Issued</u>
Inflation accounts (discussion paper and fact sheet)	September 1971
Notes on accounting for corporation tax under the imputation system (discussion paper)	September 1972
Evidence to the Inflation Accounting Committee (Sandilands Committee)	April 1974
A review of the relationship between historical cost accounting, current purchasing power statements, and replacement cost accounting (evidence to the Sandilands Committee)	October 1974
A note on last in first out (LIFO), first in first out (FIFO), base stock and CPP supplementary statements (evidence to the Sandilands Committee)	October 1974
The corporate report	August 1975
Initial reactions to the report of the Inflation Accounting Committee	October 1975
Inflation accounting - the interim period	December 1975
The Corporate Report and the future programme of the ASC	July 1976
Inflation accounting - an interim recommendation	November 1977
Price level accounting - statement of intent	July 1978
Setting accounting standards: a consultative document	September 1978
Submissions on the Accounting Standards Committee's consultative document:	1979
Setting accounting standards	April 1979
Guidance notes on ED24	March 1980
Guidance notes on SSAP16	1980
Submissions on the Accounting Standards Committee's ED24 "Current cost accounting"	June 1980
Accounting for goodwill: a discussion paper	July 1980
CCA the easy way	July 1980
Draft guidance notes on the application of SSAP16 to the oil and gas industries	July 1980
Draft guidance notes on the application of SSAP's to local authorities in England and Wales	August 1980
Setting accounting standards: Report and recommendations by the Accounting Standards Committee	May 1981
Draft guidance notes on the application of SSAP's to local authorities in England and Wales	June 1981
Guidance notes on ED29	October 1981
Corresponding amounts and ten year summaries in current cost accounting: A discussion paper	January 1982
Accounting for pension costs: An interim report	February 1982
The usefulness of current cost accounting: by Bryan Carsberg	1982
Draft guidance notes on the application of SSAP's to local authorities in England and Wales	April 1982
Draft guidance notes on current cost accounting in interim reports	June 1982
Pension scheme accounts: A discussion paper	June 1982
A review of SSAP12 - Accounting for depreciation: A discussion paper	December 1982
A review of SSAP6 - Extraordinary items and prior year adjustments: A discussion paper	January 1983
Review of the standard setting process: A report by the Accounting Standards Committee	June 1983

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APPENDIX 3.6 FINDINGS OF THE US FINANCIAL ACCOUNTING FOUNDATION'S SURVEY OF OPINION ON THE US FINANCIAL ACCOUNTING STANDARDS BOARD

- 1 Support for private sector standards
- 2 Standards are no more than conventions
- 3 "Due process" is supported
- 4 Openness is crucial for communication
- 5 Financial Accounting Standards Advisory Council, FASAC, is crucial but is not being used adequately (because FASAC does not want to involve itself with the technical issues)
- 6 Task forces need to be exploited
- 7 FASB misses too many deadlines and is too slow
- 8 FASB hierarchy is poor and not conducive to good organisation
- 9 Economic impact analysis is crucial and results should be included in exposure drafts
- 10 The post of Research Director should be equivalent to that of FASB board member
- 11 American Institute of Certified Public Accountants should lose their right to veto appointments to the Financial Accounting Foundation (FAF)
- 12 The voting rule of five out of seven should be reduced to a simple majority. Reduction of FASB board membership should be considered
- 13 The relationship between the SEC and the FASB is satisfactory
- 14 An educational programme designed to enhance adoption of FASB proposals is essential
- 15 Fund raising by appeals would be unsatisfactory
- 16 The FAF trustees should be more involved in planning
- 17 Funding should be more long term and more independent

Source: FAF 1977 "The Structure of establishing financial accounting standards"

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

PART II REVIEW OF PREVIOUS RESEARCH IN ACCOUNTING AND ECONOMICS

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PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

CHAPTER 4 INTRODUCTION TO PREVIOUS RESEARCH IN ACCOUNTING AND ECONOMICS

4.1 Introduction

4.2 Previous research in accounting and economics

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

CHAPTER 4 INTRODUCTION TO PREVIOUS RESEARCH IN ACCOUNTING AND ECONOMICS

4.1 INTRODUCTION

As yet, there exists no substantial body of research which addresses, directly, the UK professional accounting standards setting processes. It was observed above, in Section 3.8 "International comparisons", that the ASC is not unique as a mechanism by which a national accounting profession seeks to narrow areas of difference and variety in practice by publishing authoritative statements. This study draws on a body of research that has been conducted, in particular, in the USA. For example, Bromwich [1981], discussing the role of research in the process of setting UK professional accounting standards, also acknowledges the debt due to US research.

The review of previous research starts by describing the development of the literature as from a technical orientation, through an economic theory orientation to a relatively recent interest in the political dimension. The chapters in this Part II "Review of previous research in accounting and economics" follow the sequence of the development of the literature.

In view of the importance attached by US studies to the economic dimension, Chapter 6 "Information economics" and Chapter 7 "Other economic processes" explore the mechanisms by which economic consequences are generated. After that review, the research studies which explicitly address the political dimension are reviewed in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes". The order in which these chapters is presented is intended to reflect the development of the literature.

4.2 PREVIOUS RESEARCH IN ACCOUNTING AND ECONOMICS

Chapter 5 "Professional accounting standards, the political dimension and economic consequences" demonstrates the underlying reasons for the importance of both professional accounting standards and the processes by which they are determined.

Firstly, the chapter explores the relatively recent appearance in the accounting literature of discussion the political dimension. Secondly, the underlying economic consequences rationale for the existence of the political dimension is identified. The evidence in support of this rationale is reviewed briefly. Finally, the notion that the professional accounting standards setting processes can be characterised as a policy-making process is discussed.

Chapter 6 "Information economics" develops the interest in the economic consequences of professional accounting standards setting processes by addressing the question "Where do economic consequences come from?".

Firstly, the chapter reviews the underlying information economic framework which is implied by the economic consequences argument. Secondly, it reviews briefly the idea of a free market for accounting information; and finally, some alternative institutional mechanisms for regulating the supply of accounting information are discussed.

The literature on the economics of information is important because it can make a substantial impact on the analysis of the problem of explaining professional accounting standards setting processes. It offers a model of the behaviour of people who have access to, or the expectation of, information. This adds insight into the behaviour of the professional accounting standards setting processes because the latter are processes by which the flow of accounting information is regulated.

Chapter 7 "Other economic processes" explores some other research which flows from the underlying economic properties of accounting information.

Firstly, rational choice theory is explored. This is concerned with the analysis of the use of information by an individual. Secondly, agency theory is explored. This is concerned with the analysis of both the role of management as agent of the owners of the firm; and the information requirements of both agents and owners. Some important empirical studies are reviewed under this heading. Finally, the characterisation of the professional accounting standards setting processes as a policy-making process leads to an exploration of social choice theory. This is concerned with the analysis of conditions under which heterogeneous preferences might be aggregated to generate stable choices.

Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes" reviews the few empirical studies in which the political dimension is the primary focus of interest. The review of these studies follows from the relatively recent appearance in the accounting literature of discussion the political dimension and provides important material on which the remainder of the present study is based.

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CHAPTER 5 PROFESSIONAL ACCOUNTING STANDARDS, THE POLITICAL DIMENSION AND ECONOMIC CONSEQUENCES

- 5.1 Introduction
- 5.2 Professional accounting standards and the political dimension
- 5.3 Professional accounting standards and economic consequences
- 5.4 Empirical studies of the economic consequences of professional accounting standards
- 5.5 Professional accounting standards setting as policy-making
- 5.6 Summary
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CHAPTER 5 PROFESSIONAL ACCOUNTING STANDARDS, THE POLITICAL
DIMENSION AND ECONOMIC CONSEQUENCES

5.1 INTRODUCTION

In this chapter are demonstrated the underlying reasons for the importance of both professional accounting standards and the processes by which they are determined.

It is shown that characterisations of the professional accounting standards setting processes have recently changed from a purely "technical" description to a newly emerging "political" description. Changes in professional accounting standards have economic consequences to which can be attributed wealth and welfare generation and redistribution effects. The problem of where the benefits or redistributions fall is the issue which gives rise to a political dimension in the sense that individuals will seek to influence the incidence of the costs and benefits. Recognition of a political dimension in a theory of professional accounting standards setting processes suggests that these processes can fruitfully be characterised as a social policy-making process.

Section 5.2 "Professional accounting standards and the political dimension" shows that the recognition of a political dimension in the research literature is a relatively recent phenomenon dating back to the early 1970's in the US literature and, arguably, not appearing in the UK literature until the early 1980's.

Section 5.3 "Professional accounting standards and economic consequences" shows that the US research argues that the source of a political dimension lies in the economic consequences of changes in professional accounting standards. The evidence for this is discussed in Section 5.4 "Empirical studies of the economic consequences of professional accounting standards".

Finally, Section 5.5 "Professional accounting standards setting as policy making" follows the political orientation into a body of literature which adopts a policy-making characterisation of professional accounting standards setting processes with an implied objective of social welfare maximisation.

In a sense, this chapter demonstrates that the literature has discovered the existence of the political dimension only recently. It has yet to describe that dimension adequately and to explore its implications. Therein lies the contribution of the present study.

5.2 PROFESSIONAL ACCOUNTING STANDARDS AND THE POLITICAL DIMENSION

The accounting literature has long been characterised by a search for, or discussion of, better accounting practices and the external financial reporting practice of corporate management is the natural empirical domain of this literature; for example, Ijiri [1975], AAA [1966], Chambers [1966], Sprouse & Moonitz [1962], Edwards & Bell [1961], Moonitz [1961], Littleton [1953], Alexander [1950], Paton & Littleton [1940], Gilman [1939], MacNeal [1939], Sweeney [1936], Canning [1929], Hatfield [1927], Paton [1922] and Sprague [1907].

There is a noticeable trend in the more recent accounting literature toward discussion of what is becoming termed the "political dimension of professional accounting standards". Examples include Thomas [1983], Bromwich & Hopwood (Eds) [1983], Burggraaff [1983], Hope & Briggs [1982], Hope & Gray [1982], Solomons [1983, 1980 & 1978], Beaver [1981], Hakansson [1981], Hope [1979], Watts & Zimmerman [1979 & 1978], Henderson & Peirson [1978], Kirk [1978], Standish [1978], Zeff [1978], Watts [1977], Armstrong [1976], Horngren [1976, 1973 & 1972], Moonitz [1974] and Gerboth [1973A; 1973B & 1972]. Although a UK literature is beginning to appear, the history of this trend in the US precedes that in the UK. This is perhaps because the former has

- 1 a longer experience of explicit professional accounting standards, that is, from at least as early as 1936 with the AICPA's Committee on Accounting Procedure; and
- 2 an institutionalised focus for the "political" dimension, that is, the SEC.

To illustrate the nature of this trend in the literature, selected arguments are summarised below.

A significant UK contribution to this literature is represented by Bromwich & Hopwood (Eds) [1983]. This is a collection of papers with a substantial European flavour, which addresses, and in most cases simply describes, the various institutional arrangements which exist in Europe by which professional accounting standards setting processes operate. The political dimension is implicit in many of these papers, but explicit in Burggraaff [1983], Hopwood [1983] and, to a lesser extent, Coleman & Petite [1983].

Burggraaff [1983], uniquely discusses what is meant by a "political" dimension. He suggests two possible sources of meaning.

- 1 "an issue has political implication when the issue is taken up by political bodies, governments, governmental agencies, or political parties in order to pursue their objectives" and
- 2 "an issue may be said to have a political dimension where in the private sector the interests of various groups are affected by the way the issue is solved and those groups vary in their judgement as to the appropriateness of the solution." [1983, p.4]

The second of these definitions is consistent with the analysis of the literature below in Section 5.3 "Professional accounting standards and economic consequences". As such, it provides the best (and only) available definition of the term "political". Nevertheless, it is the intent of the present study not to exclude the possibility of the governmental oriented alternative also being significant in the political dimension of the professional accounting standards setting processes.

Burggraaff goes on to conclude that

"Information, including financial statements, entails power in today's society, and thereby affects the interests of people both at home abroad. It is legitimate for parties whose interests are affected to try to influence the rules applied in preparing and disseminating information. There is room for such influence in those areas where the experts are unable to come up with one single unequivocal and irrefutable answer."
[1983, p.11]

Coleman & Petite [1983] is more concerned with the implementation of the political objectives of the European Commission and so addresses the first of the two Burggraaff meanings of "political". In suggesting ways in which accounting research can be effective as an input to the political process, at the European Commission level, they argue that

"approaches which pay insufficient attention to the objectives of the rule makers, and to the constraints under which they are operating, are unlikely to influence events to any appreciable degree." [1983, p.102]

The Burggraaff [1983] and Coleman & Petite [1983] works are important because they reflect, in the UK literature, an interest in the political dimension of professional accounting standards setting processes. Burggraaff is particularly important as it is, as yet, the only example of a discussion of the meaning of the term "political".

Thomas [1983] is a study which offers an empirical investigation of UK disclosure practice. Thomas finds an unpredicted result that disclosure of expensed research and development costs is related to company size. In the discussion it is suggested that the Watts & Zimmerman [1978] factor of political costs might be important. Watts & Zimmerman argue that larger firms are more likely to bear costs from the increased interest of pressure groups and politicians in their operations. Increased disclosure practice is argued by WZ 1978 to be a strategy aimed at minimising these costs. WZ 1978 is reviewed further below in Section 7.3 "Agency theory".

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Hope & Briggs [1982] has addressed the political dimension of UK professional accounting standards setting processes by investigating the power relationship between the constituency of the ASC and its policy outcomes. The study is somewhat anecdotal in nature. It addresses the deferred taxation issue which resulted in the publication of UK accounting standard SSAP 15 "Accounting for deferred taxation" in October 1978. No quantitative analysis of data is provided, rather an historical discussion of the issue is presented. The discussion is followed by several assertions about the authors' views on improvements which could be made to the UK professional accounting standards setting processes. As such, the study is more in the nature of a position statement than an empirical study. Nevertheless, the study is important because it demonstrates clearly that the arguments in support of a political dimension, which hitherto had been developed in a predominantly US oriented literature, have application to the UK professional accounting standards setting processes.

Carter [1981] throws light on professional accounting standards setting processes by utilising the algebra of rational choice theory. Those arguments are discussed in more detail in Chapter 7 "Other economic processes" following. Carter argues that, for many accounting alternatives, the information set is wholly contained within the information set of others, that is, one set is "finer" than the other, so making the latter absolutely preferable to the former. Carter illustrates this proposition by suggesting that accrual accounting information contains, and so is finer than, cash flow accounting information. He asserts that, in fact, debate within the US professional accounting standards setting processes is centred on the benefits of these alternatives rather than the costs and this is inconsistent with the above hypothesis. He goes on to argue that this fact can only be explained by the existence of incentives for participation which are based on economic consequences. These incentives, if publicly disclosed, would be considered unethical

so he argues that they are not revealed.

Carter's work is important because it focusses attention on the nature of debate in the US professional accounting standard setting processes. In particular, Carter alerts us to the possibility that in the debate the various participants have incentives to favour outcomes consistent with their own economic interests and that they also have incentives to adopt arguments which do not necessarily reveal their true positions. A weakness of Carter's conclusion is that it is speculative. He uses his informal observation of the processes to disprove the initial hypothesis, but then offers one explanation of his observation which has no argument to support it at all. Rather, Carter simply asserts that the above incentives to misrepresent positions are sufficient to explain the nature of the debate. Also, as we shall see later in the detailed review of the rational choice theoretic research, Ng [1978, p.915] has shown that in a multi-person setting, fineness is not even a sufficient condition for preference.

Hope [1979] uses two distinctions found in the literature of (a) organisational decision making and (b) accounting standard setting. The distinctions are (a) "rational comprehensive" vs. "incremental" in which he cites both Simon and Lindblom and (b) "technical" vs. "political" in which he cites both Chambers and Gerboth. Hope argues that implications flow from assumptions about these distinctions and goes on to make positive recommendations to ASC about the ideal professional accounting standard setting processes. The value of this work is that it highlights the importance of the assumptions about these distinctions and the nature of the implications that flow therefrom. Unfortunately, no attempt is made to test the validity of possible assumptions and no framework for conducting such tests is put forward.

Solomons [1978] briefly describes, again from the viewpoint of a participant in the US professional accounting standards setting processes, the nature of intervention in those processes by interested parties. Solomons continues the debate concerning whether or not professional accounting standards setting processes are essentially technical or political. In so doing, he assumes that accounting is strictly technical and concludes that political intervention is undesirable and so to be resisted.

Solomons' work is important because it gives us further evidence, albeit somewhat anecdotal, of the nature of the US professional accounting standards setting processes.

Standish [1978] is notable as being perhaps the earliest contribution to the UK literature which makes any attempt to use the political dimension to describe the professional accounting standard setting processes. Standish identifies "capital markets" and "political markets" in a discussion which is not attributed but is very much like that of Watts [1977] reviewed below in Chapter 7 "Other economic processes". He then goes on to discuss the desiderata of an accounting standard setting process designed to serve the interests of those two markets. To the extent that Standish's capital and political markets are sufficiently rich to capture the needs of society, then his study is of value in presenting many of the issues which arise in discussion of the professional accounting standards setting processes. Unfortunately, his style is often assertive and backed up by very little reference to the existing literature. In his section describing political markets there is not one reference to literature on political markets to support his assertions. For these reasons the study is of limited usefulness as a scholarly work and it is unfortunate in its lack of attribution to Watts [1977].

Moonitz [1974] provides another example of insight gained from personal experience, as a Board member, of the US professional

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accounting standard setting processes. In his monograph, Moonitz describes the history of US professional standards setting in both auditing and accounting. He observes that professional accounting standards only gain general acceptance when they have no effect on the income calculation. From this observation he infers that the role of interested parties, and in particular management, is important because they will attempt to influence the professional accounting standards setting process to their own advantage. Moonitz sees this influence as undesirable. He asserts that professional accounting standards are technical and so should be enforced by agencies such as the SEC or the New York Stock Exchange, which are more powerful than the FASB.

Moonitz's monograph is important because of his insight gained from experience. He has used this to generate inductively an argument supporting his view of an idealised process, namely one in which the US accounting profession is left alone to determine professional accounting standards against some set of objective and strictly technical criteria.

Gerboth [1973] discusses the role of research in the US professional accounting standards setting processes as based on his own views and experience as a researcher in the American Institute of Certified Public Accountants. Gerboth's thesis is that human affairs, of which professional accounting standards setting processes number one, are of such complexity that the methods of scientific analysis are not capable of being usefully applied. He asserts that policy-makers should rely on their own intuition which, based on their own wide experiences, is alone sufficiently expansive to capture the richness of the problems. Within this context, he sees the political approach to the professional accounting standards setting processes as being the only approach sufficiently flexible to capture the relative importance of the needs of all those who are affected by professional accounting standards. Gerboth appeals, without reference, to the writings of economists who, he says, long ago

realised that the concepts of "wealth" and "income" are normative and subjective concepts and so not susceptible to rational analysis.

Gerboth's work is important in that it is an early attempt to introduce both a notion of the complexity of the professional accounting standards setting processes and a potential solution for coping with that complexity. His arguments on the inadequacy of scientific analysis are given support in the present study in the review below in Chapter 11 "Scientific choice processes".

Horgren [1973 & 1972] describes a model of the US professional accounting standards setting processes as a large, decentralised, organisation with a three-tier structure of top management, that is, Congress; middle management, that is, the SEC; and lower management, that is, the FASB's forerunner, the Accounting Principles Board (APB). Within this framework Horngren sees the APB as fulfilling a production role and he argues for a complementary marketing role, which he sees to be missing. Marketing, he argues, is a politically active function.

Horngren's work is important because it captures the insights of one who has been involved in the US professional accounting standard setting processes as a Board member.

5.3 PROFESSIONAL ACCOUNTING STANDARDS AND ECONOMIC CONSEQUENCES

Carter [1981] and Hakansson [1981] argue that one explanation for the existence for the political dimension in professional accounting standards setting processes is recognised by the "economic consequences" accounting literature. For example, Benjamin & McEnroe [1981], Carter [1981], Earl [1981], Foster [1981], Horwitz & Kolodny [1981 & 1980], Laughlin & Puxty [1981], Selto & Newman [1981], Dukes, Dyckman & Elliot [1980], Kelly [1980], Zeff [1980 & 1978], Brown [1979], AAA [1978], Benston & Krasney [1978], FASB [1978], Kirk [1978], Solomons [1978], Norby [1977], Prakash & Rappaport [1977, 1976 & 1975], Rappaport [1977], Swieringa [1977], Wyatt [1977], Buckley [1976] and Demski [1974].

Demski [1974] has modelled the impact of changes in professional accounting standards on the consumption patterns of individuals. Using a rational choice theoretic framework, considered below in Section 7.2 "Rational choice theory", he predicts that

- 1 economic consequence effects exist in the form of altered consumption schedules for individuals [pp.222-226]; and
- 2 "a given firm's reporting policy may effect both owner and non-owner individuals; moreover, there is no compelling reason to suspect that individual firm decisions will be desirable in a social sense" [p.226].

Demski's result is important because it gives an explicit and formal statement of the expectation that individuals will suffer a wealth redistribution when a professional accounting standards change is implemented. This, then, is the economic consequence.

Briefly, the economic consequences argument states that there exist rational and self-interested economic agents who have incentives to change their behaviour as a result of changes in professional accounting standards. These incentives derive from three underlying sources.

Firstly, accounting information is assumed to be used for

decision making purposes ["ASOBAT", AAA 1966]. If different accounting information is provided to accounting information users then different decisions will result. This is known as the "information-use" framework [AAA 1977, p.22].

Secondly, the outcomes of many financial contracts are assumed to be dependent on accounting information. If different accounting information is generated, then the financial contracts will either result in unanticipated outcomes or will need to be renegotiated [Watts & Zimmerman 1978 and Watts 1977]. This will be referred to below as the "financial contracts" framework.

Thirdly, corporate management is assumed to seek to control the behaviour of accounting information users as part of its function of controlling the organisation it manages. Management possesses theories and beliefs about the behaviour of accounting information users given the disclosure of specific accounting information. If management has no control over accounting information disclosure, because this is determined externally by the professional accounting standards setting processes, then the only means by which it can control the behaviour of accounting information users is by modifying its own behaviour. This is known as the "information-inductance" framework [Prakash & Rappaport 1977].

Benston & Krasney [1978] argue that the "information-use" framework effects include the following

- 1 the linking, by the US Internal Revenue Service, of inventory valuation rules and taxation payments, implies that a change in valuation rule would have a direct effect on the tax payable [p.166];
- 2 the regulation of the price structures of several US industries, such as electricity supply, is based on accounting information and so changes in the basis of calculating that information has a direct effect on the revenues of those industries [p.168];
- 3 unionised labour groups have successfully negotiated large pay increases which are strongly correlated with large increases in earnings [Tomczyk 1975; Horowitz & Shabahang 1971];
- 4 unsophisticated customers of technically sophisticated goods or services, particularly financial services such as insurance and

- banking, may make their purchasing decisions in part based on financial accounting information. Changes of disclosure of in the basis of computation could have a direct effect on those decisions. Put more sepcifically, customers will shift from less profitable to more profitable firms [pp.171-172];
- 5 financial contracts, including managements' own compensation schemes, are often written in terms of accounting information which determines either the outcomes in terms of rewards or costs, or alternatively the conditions on which a default is recognised. Changes in the basis of computation of the accounting information can result in either the outcome being different from that originally intended or, alternatively, costs being incurred in re-writing the contracts [pp.172-174];
 - 6 the use of accounting information by the investment community implies that changes of disclosure, or in the basis of computation, of the accounting information will directly effect the allocation of resources in the capital market [pp.180-185].

Watts and Zimmerman [1978] argue that management compensation plans belong to the class of financial contracts which are dependent on accounting information. In particular, the effects of accounting information changes on management compensation plans can be expected to be particularly important for smaller firms [p.120].

Benston & Krasney [1978, p.175] argue that the "information-inductance" framework effects include the following

- 1 the use of an inventory valuation method which results in a higher taxation cost, that is a real cash outflow, in order to avoid disclosing a reduced net income;
- 2 mergers undertaken or foregone in circumstances in which the only advantage is the effect on earnings per share;
- 3 investments undertaken or foregone in circumstances in which the only effect is on the deferred taxation charge to income;
- 4 reduced bank lendings to high risks when there exists the possibility of loss disclosure;
- 5 changes in operations to bring reported accounting information in line with previously published forecasts;
- 6 use of outside insurance contracts rather than self-insurance when contingent liabilities are no longer to be accrued;
- 7 reduction in expenditure on research and development when the expenditure is no longer to be carried forward;
- 8 merging of small oil companies to avoid the variability of earnings proposed by a new FASB ruling.

Hakansson [1981] provides an illustration of the economic consequence effects arising from the interaction of the above three frameworks. Using an hypothetical example of a taxi-cab

firm, Hakansson shows that different information disclosure policies generate different distributions of wealth amongst the following groups of individuals: management; and analysts who actively seek out information; investors who subscribe to information services provided by analysts; and investors who adopt a passive role.

5.4 EMPIRICAL STUDIES OF THE ECONOMIC CONSEQUENCES OF PROFESSIONAL ACCOUNTING STANDARDS

Economic consequence arguments have been used in the context of debate on specific professional accounting standards [Amershi, Demski & Wolfson 1982, Carter 1981, Solomons 1978, Zeff 1978 and Moonitz 1974]. They have also been subjected to empirical testing. The field in which most empirical work has been undertaken is that of information use by the investment community. Reviews of that empirical work (for example, Selto & Neumann [1981], Foster [1980], Watts & Zimmerman [1980], Kaplan [1978] and Gonedes & Dopuch [1974]) have generally concluded that published accounting information changes have little or no measurable impact on the securities markets. There is no general agreement about the explanation for this result. Possible explanations include the following, of which items 2 to 5 are discussed by Watts & Zimmerman [1980] in the context of the US replacement cost disclosure requirements.

- 1 confirmation of the hypothesis that the securities markets are efficient in the sense that, on average, they can process all publicly available information and so "see through" superficial accounting information changes (for example, Gonedes & Dopuch [1974] and Ball [1972]); or
- 2 confirmation of the hypothesis that the securities markets do not make substantial use of published accounting information but rather obtain additional or alternative information from other sources (for example, Watts & Zimmerman [1980]); or
- 3 confirmation of the hypothesis that published accounting information possesses externalities and so the security price effect is diffused across many securities (for example, Leftwich [1980]); or
- 4 confirmation of the hypothesis that there is a learning effect which results in a delay before the information has any impact (for example, Beaver [1979]); or
- 5 confirmation of the hypothesis that the research methodology or theoretical frameworks utilised in these tests are inadequate to support the conclusions drawn (for example, Amershi, Demski & Wolfson [1982], Foster [1980] and Kaplan [1974]).

To illustrate the empirical studies, without seeking to establish a comprehensive review, selected studies are summarised below.

Horwitz & Kolodny [1981 & 1980] have tested the hypothesis that

research and development expenditure has been reduced by some managements as a result of the US requirement ["SFAS2", FASB 1974], that such expenditure is no longer to be carried forward. Their results show that, for small, high-technology firms who had previously carried the expenditure forward, research and development expenditures had been reduced. On the other hand, sample of all firms which included "a concentration of large firms in the sample" [p.21] and did not find any significant reduction.

Eccles & Lifford [1979], although not actively researching and testing hypotheses, state authoritatively [p.9] that returns under UK Government contracts for research and development are based on published accounting information; this is elaborated in Hope & Gray [1982] which is reviewed below in Chapter 7 "Empirical studies of the political dimension in professional accounting standards setting processes". The existence of an associated economic impact is significant.

Lev [1979] tested the hypothesis that the returns on the securities of US oil and gas companies changed as a result of the announced intention to implement a change in the basis of accounting for oil and gas exploration costs (subsequently published as "SFAS19", FASB [1977]). His results show [p.500] there was a significant change in security returns associated with that announcement. These results are consistent with those of Benjamin & McEnroe [1981].

Evans, Folks & Jilling [1978] have tested the hypothesis that the foreign exchange risk management practices of US multinationals have been changed by some managements as a result of the US requirement ["SFAS8", FASB 1975] that foreign currency translations be accounted for on a uniform basis, known as the temporal method. Their results show [pp.19-20] that for many firms the change in accounting practice has been a major factor in explaining changes in foreign exchange risk management

practice. On the other hand, Dukes [1978] tested the hypothesis that the returns on the securities of US multinationals changed as a result of the implementation of SFAS8. His results show [pp.3 & 43] that no change in returns could be detected, a result which is consistent with the "efficient markets hypothesis" noted above, but not consistent with the Evans, Folks & Jilling [1978] result.

Goshay [1978] tested the hypothesis that the risk and insurance management practices of US firms have been changed by some managements as a result of the US requirement ["SFAS5", FASB 1975] to disclose contingent losses. His results show [pp.3-4] that there was no significant change in the risk and insurance management practices associated with the new requirement.

Morris [1975] tested the hypothesis that returns on the securities of UK companies changed as a result of the publication of inflation adjusted accounting information. His results show [p.86] that there was no significant change associated with the publication of inflation adjusted information.

From the above survey of the empirical tests of economic consequences arguments, it can be seen that some are supported and some are rejected. Importantly, it can be seen that some economic consequence effects do exist. The mechanisms by which they arise are often complex, particularly where the primary underlying reason is explained by the information-inductance framework of Prakash & Rappaport [1977]. Within such a framework, it is managements' theories and beliefs about the behaviour of accounting information users that is significant rather than whether or not those theories and beliefs are well founded.

Laughlin & Puxty [1981] have argued that the economic consequences arguments are invariably adopted by firms who dissent from proposed changes to professional accounting

standards. Rather than being concerned with technical accounting characteristics or allocative efficiency of the proposals, such firms are said to be "concerned about the survival and growth of their respective enterprises. Where anything is perceived to threaten such survival or growth, it needs to be aggressively dealt with." [p.11, emphasis in original]. Clearly, this argument implies that, not only are firms concerned about the distribution of costs and benefits arising from proposed changes, but where a firm perceives a substantial cost consequence then its very survival or growth may be called into question.

From the above discussion it can be seen that professional accounting standards possess wealth and welfare generation and redistribution properties in the sense that resource reallocations are dependent, inter alia, on accounting information changes. Individuals possessing claims to a resource whose value is increased by an accounting information change enjoy an increase in their wealth and welfare; individuals not possessing those claims and individuals possessing claims to a resource whose value is decreased by an accounting information change suffer a decrease in their wealth and welfare.

Given that these wealth and welfare redistribution properties exist, then an interest in the political dimension is a natural focus for the consideration of the issue of the redistribution of wealth and welfare. The study of politics is arguably concerned with the study of decisions about the incidence of transfers for the purposes of wealth generation and redistribution.

5.5 PROFESSIONAL ACCOUNTING STANDARDS SETTING AS POLICY-MAKING

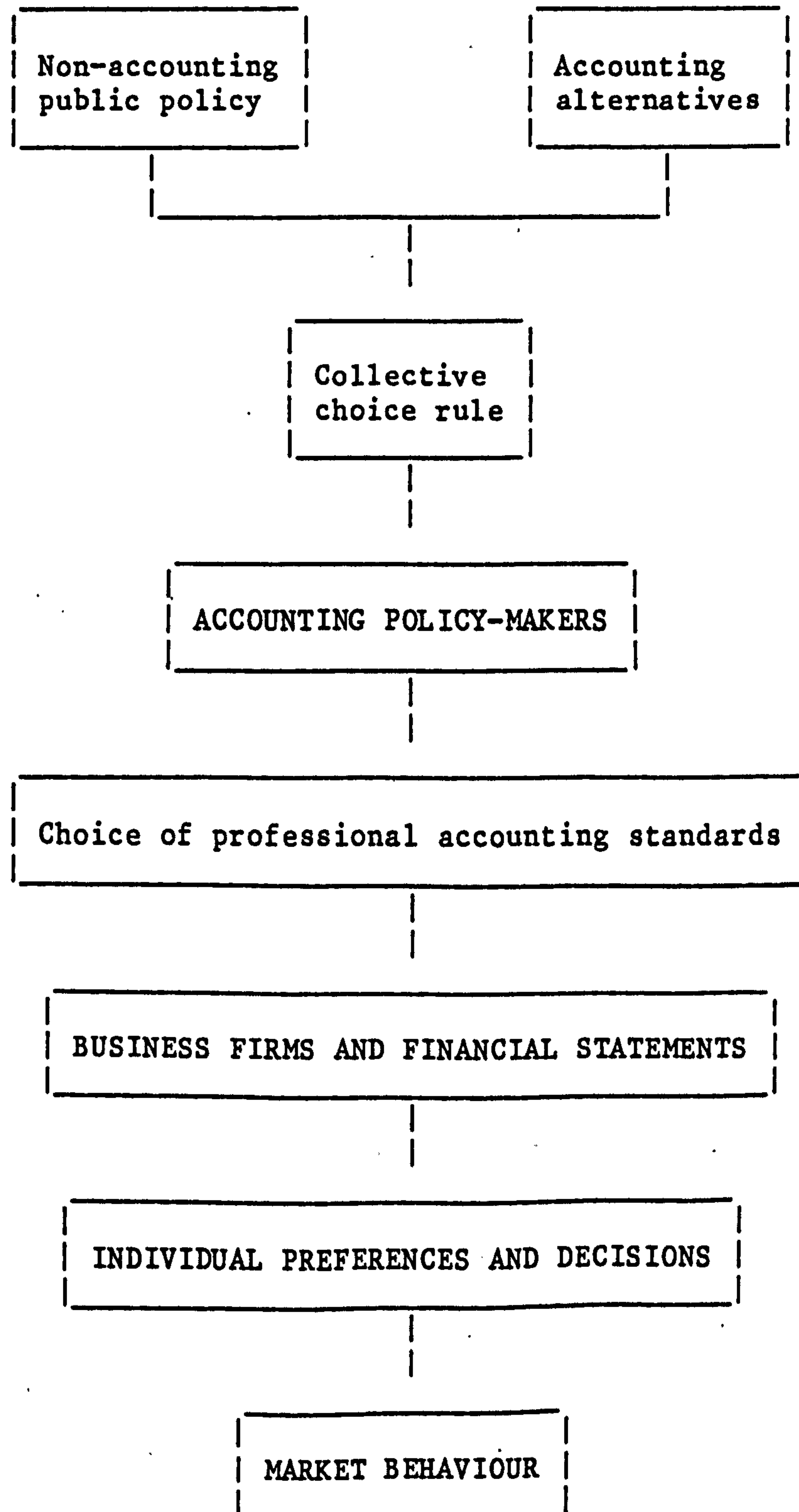
Given that professional accounting standards possess wealth and welfare distribution properties, May & Sundem [1976] characterise the professional accounting standards setting processes as a "process of accounting policy-making" [p.747]. That is, accounting policy-making is a social choice process which "requires a commitment to goals and, therefore, requires a policy-maker to make value judgements" [p.748]. From this social choice framework, maximisation of social welfare is argued to be the goal against which proposals should be tested; the cost of not adopting such a goal being the alternative of having the "power (of accounting policy-makers) consistently pre-empted by the legislature" [p.749].

Following Demski [1973], May & Sundem argue that accounting policy-makers must take account of individual preferences and that the results of the accounting policy-making process can therefore be characterised as being the outcome of a collective choice rule, that is, an implied decision model [p.750]. However, using the "impossibility" result of Arrow [1963 & 1951], May & Sundem conclude that no such collective choice rule exists which "satisfies even a relatively few desirable properties" [p.751]. Further, they argue that exploration of the problem posed by this result might fruitfully follow the social choice literature as applied to accounting by, for example, Demski [1974]. The social choice framework is discussed further in Chapter 7 "Other economic processes" of the present study. In that discussion it is suggested that Arrow's "impossibility" result is important because it provides a clear basis for expecting there to be constraints on the preferences of individuals. It is the existence of these constraints which makes social choices possible; and it is the structure of these constraints which is in need of description and elaboration. In an important sense, professional accounting standards are themselves constraints on the preferences of individuals and, in

particular, management.

From the basic social choice theoretic framework, with the goal of social welfare maximisation, May & Sundem develop a model of the professional accounting standards setting processes characterised as "the accounting policy-making process". Their model is summarised below in Figure 5.1 "The accounting policy-making process".

FIGURE 5.1 THE ACCOUNTING POLICY-MAKING PROCESS



Source: Adapted from May & Sundem [1976, p.752]

May & Sundem [1976] is, for two reasons, an important contribution to the problem of investigating UK professional accounting standards setting processes.

Firstly, it is the seminal characterisation of the professional accounting standards setting processes as a single policy-making process.

Secondly, it is the first use of a criterion other than Pareto-optimality for choosing between alternative professional accounting standards; social welfare maximisation is advocated. The review below in Chapter 6 "Information economics" and Chapter 7 "Other economic processes" demonstrates the importance of Pareto-optimality to economic models of behaviour. Pareto-optimality requires that a state is optimal if no one individual can be made better off without making at least one other individual worse off [Cirillo 1979, p.44]. Social welfare is an aggregate function in which redistributions, that is making some individuals worse off, can actually increase social welfare in the cause of "equity" [McClelland & Rohrbaugh 1978]. The distinction between the two criteria is illustrated further below in Appendix 6.2 "Social welfare maximisation and the irrelevance of Pareto-optimality".

At the time of writing, no other writers have sought to characterise the professional accounting standards setting processes as a policy-making process with an explicit social welfare maximisation goal. However, Kelly-Newton [1980] organises much of the previously published work into a review of the US professional accounting standards setting processes. Kelly-Newton adopts a characterisation of the processes as an agency of engineered social change. Within such a framework, new professional accounting standards are seen as innovations and the policy-making and implementation process is characterised as a process of diffusion of an innovation.

Hussein [1981 & 1977] adopted just such a diffusion of innovation perspective. Hussein sets out to generate a comprehensive descriptive theory of the US professional accounting standard setting processes. His model represents an interaction of frameworks developed from two non-accounting disciplines, namely
1 diffusion of innovation (for example, Rogers & Shoemaker [1971]); and
2 bargaining (for example, Young [1975]).

Hussein characterises the professional accounting standards setting processes as one in which the accounting profession adopts an accounting standard as an innovation. There are, he argues, conflicting interests to be met in the decision-making stages and, because participants do not all have the same decision-making power, they bargain with each other to determine the outcome.

To test his hypothesis Hussein considered the same issue as did Watts and Zimmerman [1978], that is, US inflation accounting. A mail questionnaire was conducted in which respondents were participants in the US professional accounting standard setting processes, either as decision-makers, that is, members of the FASB, or as others, that is, change agents, opinion leaders or bargainers. Discriminant analysis was conducted on several variables and the results did not reject the hypotheses.

Hussein's adoption of the diffusion of innovation process model represents a further substantial move toward characterising the professional accounting standards setting processes as essentially a social choice process. Although May & Sundem argue that a social welfare maximisation goal is implicit, Hussein makes no assumptions about the nature of the implied goal.

Hussein's use of the inflation accounting issue may introduce a systematic bias to the extent that it is an issue of extreme positions and as such may, or may not, be unrepresentative of the US professional accounting standards setting processes. The

study has also ignored questionnaire bias except in one minor case of a particular group of non-responses. Questionnaire bias includes well-recognised problems such as different interpretations of the meanings and intents of questions, "socially acceptable" answers and unknown motives for the response decision [Oppenheim 1966]. In addition, Hussein has hypothesised that, in a bargaining situation, communications channels are manipulated in order to change the behaviour of the receivers. Nevertheless, he ignores the fact that his questionnaire may also constitute a communications channel to be manipulated by the participants.

5.6 SUMMARY

It has been shown how, over the period from the early 1970's to the early 1980's, the US research studies which are concerned with professional accounting standards setting processes have moved away from a conventional, technical, characterisation of those processes. That characterisation concerned the resolution of technical issues using well established criteria which apply to accounting information per se. The processes are coming to be seen as possessing a political dimension and that dimension is explained, at least, as being generated by the economic consequences of a change in professional accounting practice. A change in the measurement or disclosure of accounting information results in economic agents changing their decisions. This has consequent wealth and welfare generation and redistribution effects.

Thus a new perspective is evident in these studies. The professional accounting standards setting processes have been characterised as

- 1 an accounting policy-making process [Kelly-Newton 1980; May & Sundem 1976]; and
- 2 a political process [Solomons 1980 & 1978; Gerboth 1973A, 1973B & 1972]; and
- 3 a diffusion of innovation process [Hussein 1981 & 1977]; and
- 4 a social choice process [May & Sundem 1976].

It is noteworthy that, at the time of writing, one UK empirical research study, [Hope & Gray 1982], has been conducted which has made a contribution to this literature. It is reviewed below in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes".

Professional accounting standards setting processes are acknowledged as possessing not only a technical dimension but also a political dimension [Burggraaff 1983, Hopwood 1983 and Solomons 1978]. The technical dimension can be said to focus on the rational selection of accounting practices based on the established body of knowledge available to accountants. As such the technical dimension is analogous to scientific enquiry whereby new practices or knowledge are sought within the framework of existing theoretical understanding, implied or otherwise.

The political dimension can be said to focus on the selection of accounting practices based on the preferences of individuals. The general processes, by which individual preferences are translated into selections, are the subject of interest to researchers in a number of disciplines within the social sciences [Mueller 1976].

The underlying importance of professional accounting standards setting processes is attributable to the economic consequences of changes in professional accounting standards [Demski 1974]. These changes generate economic consequences which have subsequent wealth and welfare generation and redistribution effects and which in some cases can be significant [Horowitz & Kolodny 1981, Eccles & Lifford 1979, Lev 1979 and Evans, Folks & Jilling 1978]. Individuals have preferences concerning where the benefits or redistributions are to fall. The expression of these preferences in a forum which had hitherto been regarded as an exclusively technical forum caused some debate in the US accounting profession [Carter 1981, Solomons 1978, Zeff 1978, Moonitz 1974 and Gerboth 1973]. In the UK accounting profession, there is evidence that these preferences may well underly the technical debate [Hope & Gray 1982].

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Given that wealth and welfare generation and redistribution properties exist, then professional accounting standards setting processes can be characterised as a policy-making process [May & Sundem 1976], in which it is impossible to meet individual preferences by using solely technical criteria [Demski 1973]. Intentional wealth and welfare redistributions might be made using professional accounting standards setting processes as processes of social engineering [Kelly-Newton 1980] in which the adoption of a new professional standard accounting practice is characterised as a diffusion of innovation process [Hussein 1981].

5.7 CONCLUSIONS

The problem of investigating UK professional accounting standards setting processes has been substantially illuminated by the changing perspective of previous research studies. The description of the UK ASC provided above in Chapter 3 "The Accounting Standards Committee" encompassed not only an accounting activity of specific technical matters being resolved by a profession's own committee of experts, but also an accounting activity with economic, political and professional dimensions. Clearly, some of those dimensions are reflected in the US literature.

The economic dimension is the most strongly represented in that US literature; the political dimension less so. However, the professional dimension seems not to be represented. No US study has sought to investigate the way in which the accounting profession, as a profession, influences the accounting standards setting processes. The reason for this apparent lack of interest in the implications of the professional dimension is perhaps not difficult to identify. The US institutional arrangement changed in 1973 when the FASB, as an independent body, took over the processes of setting accounting standards from the US accounting profession. Prior to that date, there was no serious US research interest in accounting standards setting processes per se.

The previous research studies have moved the orientation from a strictly technical professional accounting standards setting process to a political process. The political dimension is seen to stem from the economic consequences of accounting information. Yet a major question has been left unanswered, that is "where do the economic consequences come from?" The studies have either asserted their existence and so argued they cause a political dimension to come into being; or alternatively, the studies have sought to generate evidence that they exist. To explain the mechanisms by which economic consequences are generated is to

contribute an important part of the explanation of the mechanisms underlying professional accounting standards setting processes. This contribution is made in the following Chapter 6 "Information economics" and Chapter 7 "Other economic processes".

Additionally, the previous research studies reviewed above have not sought to describe the political dimension. The literature is almost polemic. The research studies which explicitly address the political dimension are reviewed in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes".

CHAPTER 6 INFORMATION ECONOMICS

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- 6.2 The supply-side view
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CHAPTER 6 INFORMATION ECONOMICS

6.1 INTRODUCTION

This chapter reviews the extent to which previous research suggests how economic processes operate to translate the generation of accounting information into incentives which might influence the professional accounting standards setting processes. In other words, it sets out some of the mechanisms by which economic consequences are generated.

Information economics is concerned with, on the one hand, the analysis of the impact of information on markets, and on the other hand, the analysis of the conditions for a market in which information itself is traded. In the present study these two frameworks are labelled "supply-side" and "demand-side" respectively to distinguish between the underlying assumptions being made about the information generation process. These two frameworks are then compared. Some additional economic frameworks by which institutional solutions to the problem of introducing information into the market place are also addressed in this chapter.

A review of information economics is important in the context of the present study because it offers a model of the behaviour of rational, utility-maximising, individuals who have access to, or the expectation of, information. Such a model can add insight into the behaviour of individuals in the professional accounting standards setting processes because the latter are processes by which the flow of accounting information is regulated.

6.2 THE SUPPLY-SIDE VIEW

6.2.1 The underlying framework

In economics, information is defined in a similar sense to that elaborated by Shannon [1948], that is, as a message which changes the subjective probability of the occurrence of some future event or state. The literature on the economics of information can make a substantial impact on the analysis of the problem of explaining professional accounting standards setting processes. Examples of this literature include Hakansson, Kunkel & Ohlson [1982], Hakansson [1981], Beaver [1981], Bejan [1981], Bird & Locke [1981], Hirshleifer & Riley [1979], Gonedes [1976 & 1975], Gonedes & Dopuch [1974], Marschak & Radner [1972], Fama & Laffer [1971], Hirshleifer [1971] and Akerlof [1970]. Hirshleifer & Riley [1979] (H&R) has surveyed much of the information economics literature.

Information has a value to an individual who receives it because, by trading, he can then adjust his claims to resources in future states. The prices at which he trades will depend, inter alia, on

- 1 the characteristics of that information; and
- 2 the characteristics of the markets both before and after receipt of the message.

The economic analysis considers the effects of these differing characteristics. In the case of public information received in markets which are complete, in the sense that all possible contingent state claims are tradable, then H&R point out that, subject to a "rational expectations" assumption, the markets will be Pareto-optimal [H&R, p.1400]. With different combinations of market or information incompleteness, there are incentives to either acquire information or to trade, for example by mutual insurance, in the absence of information [p.1402]. In the case of research or invention an individual with new information can trade speculatively in future claims favoured by his information.

After his trading he then releases the information. Further, if his property rights to the information, or the productive opportunities derived from that information, are protected by patent laws then he has the opportunity to increase his trading gains. Clearly, patent laws act as an incentive to invention by offering opportunity for increased gain. If the property rights conferred by patent laws are unnecessarily protective, then there comes a point at which there may be a general overinvestment in invention [p.1404]. There is, then, a conflict between the need to create incentive to invention; the need to ensure equitable use of the invented information afterwards; and the need to limit the possibility of overinvestment of inventive resources. The patent laws, in their use of a fixed term for property rights to information, seek to achieve this balance of equity.

The above argument has a clear analogue in the field of financial reporting where accounting information can be viewed as "invention" information. Management have incentives to make that information public but can often increase the gains to themselves or to the firm by withholding the information and realising the gains from the productive opportunity [Hakansson 1981]. In this sense, at least, arguments against regulation requiring additional disclosure of accounting information can be rational.

H&R go on to consider the effects of the use of information in realising the possible gains to an individual.

Firstly, they consider the "signalling" effect [p.1406] which occurs after the individual has traded by taking up his speculative positions. The individual will then wish to signal to the markets by release of the information so that he can then reverse that speculative position. Here the problem is one of authentication of the message. This can be particularly problematic for high-quality goods or services. For example, a perverse form of adverse selection often operates as can be

illustrated in the case of insurance markets. It is particularly difficult for good risks to be distinguished from bad risks and so there is a tendency for insurers to bias the prices of their insurance towards the bad risks. This has the effect of pricing good risks out and so, without any other signal to discriminate, the bad risks are insured whereas the good risks are not. H&R note that good risks can signal their superiority by accepting a higher deduction [p.1406]. Akerlof [1970] argues that in the absence of distinguishing signals which can be adequately authenticated, the used car market tends to result in only the "lemons" being traded in the market. H&R argue that some sort of, non-Pareto, stability in markets can be expected if the market agents come to expect reactions by other agents. This equilibrium they term a "reactive equilibrium" [p.1408] and on this basis conclude

"the endogenous revelation of information via markets is, after all, explainable as a noncooperative equilibrium phenomenon" [p.1409].

Secondly, H&R consider the "information leakage" effect [p.1409]. This effect arises from a relaxation of the assumption that traders have homogeneous beliefs. In this case the individual who has acquired new information and trades speculatively in the market will find that other individuals will observe the price changes which result from his initial trades and they will infer some, or all, of the information upon which he is acting. As a result they, too, will trade speculatively in these same goods thereby depriving the original trader of further opportunity for gain. In a sense this situation is problematic for, there is little or no incentive to buy new information except where such information leakage is sufficiently adversely affected by either time lags between initial trade and the trades of other individuals; or noise from other signals arriving approximately simultaneously.

H&R point out [p.1411] that both "signalling" and "information leakage" are disequilibrating effects. If an individual has acquired costly new information then each of these effects tends to make it less likely for gains to be made from that information. It is only by introducing non-market factors, that is, expectations of reactions by other agents in the case of "signalling", and time and noise in the case of "information leakage", that information generation remains an explainable phenomenon.

To summarise, the possibility of equilibrium in the markets in which information plays a role has been discussed by H&R and, while Pareto-optima are not obtainable because of the externalities involved, some sort of stability is suggested in the partial analysis of each of the two problems of "signalling" and of "information leakage". H&R conclude [p.1414] that information generation is a disequilibrating process while information dissemination is an equilibrating process and that current theory is not adequate to determine "the dynamically optimal level of such activities" [ibid.].

6.2.2 The framework applied to accounting information

The above, then, constitutes a general framework for a consideration of accounting information. Clearly, accounting information is a particular type of information and the relevant markets into which accounting information flows are, primarily, the securities markets. It is also possible that accounting information has a role to play in product markets. For the time being the present study concentrates attention on the securities markets. Within this framework, accounting information is interesting for the following reasons.

It is possible to hypothesise about demand for accounting information in completely unregulated securities markets. Clearly management is in a position to generate new accounting

information costlessly as a by-product of their normal trading and production processes. Additionally, there is production by individuals outside of management, namely analysts, whose primary function is to generate accounting information for private consumption. In both these cases of private production, individuals have strong incentives to trade on that information, that is, take speculative positions in the sense of H&R, considered above. Having taken up speculative positions it can be expected that the information leakage effect would start to operate and this effect would be strongly enhanced by the existence of the body of active analysts. The speed and degree to which that information is impounded in the prices of the securities traded is the subject of the efficient market hypothesis (EMH) (for example, Fama [1970]). It has been argued that this initial, speculative, trading is a disequilibrating process. The individual with the information now has a strong incentive to release the information in order to realise the trading gains. To overcome the signalling problem the individual has an incentive to have the information attested, a procedure which is clearly easier for management than for an outsider. To summarise, in completely unregulated securities markets there are strong incentives on management to publish audited accounting information. Similarly, analysts have as strong incentives to seek the publication of their own private accounting information. Note that nothing has been said about the nature, or the timing of the publication, of the accounting information.

The above can be illustrated by assuming unregulated securities markets and considering the information economics of raising new capital. In this context, management can be viewed as the sellers of a good, that is the security, in a situation of quality uncertainty. The sellers have considerable knowledge about the quality of the good but the buyer has less knowledge and perhaps no knowledge at all. This situation has been modelled by Akerlof [1970] as a market for "lemons", in which the price is determined in the market on the basis of the poorer quality goods. Here

corporate management has a strong incentive to signal to the buyers. This incentive can be conceptualised in exactly the same sense as H&R discussed earlier. Corporate management have some information and they have taken a speculative position in additional productive capacity. They are now reversing that speculative position by selling rights in the expected cash flows. As already observed, corporate management is in a strong position to signal by publishing accounting information which has been audited. There is evidence of just such accounting information disclosure in unregulated markets [Watts 1977 and Choi 1973].

Now consider the equilibrium properties of published accounting information in unregulated securities markets. H&R concluded that current theory is inadequate to determine an equilibrium concept. This arises from the underlying supply-side property of published accounting information. Essentially, accounting information, as analysed above, is not published in response to any demand but as a result of incentives operating on individuals who already possess the information. Further, nobody in these markets has any incentive to demand published accounting information because prior to publishing the information individuals will already have taken their speculative positions and the redistributive effects will have been exhausted. Accordingly, within the framework of this analysis the supply of published accounting information is essentially a stochastic process and there is no actual demand. There is then, no relevant concept of equilibrium in this process. This can be summarised in the following statement.

In unregulated securities markets, management have strong incentives to publish accounting information which has been audited even in the absence of a demand for published accounting information; in such cases there will be no associated market equilibrium concept.

6.3 THE DEMAND-SIDE VIEW

A number of studies have approached the problem of the economics of accounting information from a completely different perspective. These attempt to avoid the apparently counter-intuitive statement, derived from the H&R analysis, that there need not be a revealed demand for public accounting information. These studies avoid the "no demand" problem by assuming that such a demand exists. In substance, they are consequently addressing a quite different problem, namely the identification of the characteristics of the market for accounting information. In contrast, the H&R analysis addresses the problem of the characteristics of other markets, capital and product, under conditions of incomplete information when the information set changes.

Gonedes [1975] utilises the game theoretic model of a "market game" suggested by Shubik [1959]. The market game has proved to be a useful concept in economics because Scarf [1967] and Debreu & Scarf [1963] have demonstrated that the "core", which "consists of those utility vectors which are feasible for the entire group of players and which can be blocked by no coalition" [Scarf 1967, p.50], comprises just those very utility vectors, or preference functions, associated with a Pareto-optimum. Gonedes contribution was to demonstrate sufficient conditions under which an unregulated market for accounting information would itself be Pareto-optimal. These conditions require a demand for information to be characterised as a demand for a "gamble" on a signal about a specified attribute [Gonedes 1975, p.863]. It is argued that such a demand for gambles exists and that the resultant market for accounting information is Pareto-optimal. The underlying securities market is assumed to be Pareto-optimal. One of his other conditions is that "participants may enter into a contract for information at mutually acceptable terms. Produced information resulting from such a contract is only made available to those who entered into the contract" [p.843].

Additionally, the information which Gonedes participants may buy is "a completely reliable message 'from nature' about the actual distribution functions" [Appendix p.862 and p.846]. All outcomes are realised in this two period model and so the private information is automatically made public in period two as a "realisation". Gonedes also implicitly assumed away the "signalling" and "information leakage" problems of the H&R analysis above.

Bird & Locke [1981] (B&L) seeks to establish sufficient conditions under which an unregulated market for corporate information would be Pareto-optimal. B&L essentially postulate that the usual assumptions of perfect markets can be applied to accounting information without any market failure being implied. They envisage value maximising firms and utility maximising investors as the market agents and, like Gonedes, assume an underlying securities share market which is Pareto-optimal. The supply and demand characteristics of information are then discussed by B&L in order to demonstrate that they are not inconsistent with the usual assumption of, inter alia, increasing marginal costs of production and zero externalities.

Bromwich [1981] also adopts this demand-side view in his consideration of the UK professional accounting standards setting process. After a review of the UK historical background, supporting the discussion above in Chapter 3 "The Accounting Standards Committee", Bromwich considers some of the problems facing those who attempt to determine UK professional accounting standards. Bromwich argues [p.49] that the market for accounting information is incomplete and so some form of intervention is required. Market incompleteness is argued to arise from both reducing marginal costs of supply [p.48]; and positive externalities, or "free riders" [p.47].

Given that market incompleteness is a sufficient condition for intervention to elicit the preferences of individuals, Bromwich then identifies some institutional solutions to the incompleteness problem recognised by the economics literature. These solutions are bargaining games; taxation systems, such as the Clarke process reviewed below in Section 6.5 "Some alternative institutional arrangements"; and "norms of social behaviour" [p.50], reviewed below in Section 7.4.2 "Social choice and the social welfare function". Additionally, Bromwich identifies Arrow's Possibility theorem [Arrow 1963 & 1951] as sufficient to argue that there exists no unique conceptual framework from which can be systematically deduced general purpose professional accounting standards setting solutions. This is also reviewed below in Section 7.4.2 "Social choice and the social welfare function".

6.4 COMPARISON OF THE TWO VIEWS

It is now possible to review the above literature in the context of the study of professional accounting standards setting processes. The contribution that such a review can make is to generate an understanding of the nature of the underlying economic forces which work in the markets. By considering an idealised, unregulated, market the implications of economic behaviour become clear and the behaviour of those markets under those conditions can be determined. Against that understanding of free-market behaviour can be assessed the utilities and disutilities of existing and potential real-world institutional structures. In contrast, the setting up of free-market behaviour as a goal, against which real-world institutional structures are each regarded as deficient in varying degrees, has been criticised by Demsetz [1969] as the "nirvana" approach.

The literature has been characterised above by two fundamentally different approaches. On the one hand, there is the approach that considers the behaviour of markets when the information set changes. This has been called, above, the supply-side view and is represented by the Hirshliefer & Riley [1979] survey. The implications of differing market assumptions and different information properties have been explored as they affect the efficiency of the underlying resource allocating markets. On the other hand, there is the approach that posits the existence of a market for information itself. This has been called, above, the demand-side view and is represented by Gonedes [1975]. It assumes that the underlying resource allocating markets are perfect. In a sense, these two approaches almost correspond to differing "Kuhnian" world views [Kuhn 1970]. Kuhn's analysis of the structure of scientific "revolutions" suggests that individual researchers are often theory-bound in the sense that their views of the world are determined by their theories or "paradigms". Only when those individuals are succeeded do new theories gain general acceptance.

The source of the above difference lies in the concluding remarks of Riley [1979] on the nature of information equilibrium "that the imperfectly competitive market structures described above are a major departure from the standard neo-Walrasian model" [p.353, emphasis in original]. Essentially Riley is saying that where there is an information asymmetry between buyer and seller then the usual market analysis breaks down and no Pareto-optimal equilibria are available. Green [1977, p.451] has argued independently that Pareto-optimal equilibria are not available. He attributes this to the findings of his analysis that individuals without information are not able to fully infer the information from prices - "the space of prices is not 'large enough', in a certain sense, to transmit all of the relevant data" [ibid.]. As H&R observed, Riley's major contribution is to suggest the existence of equilibria which, however, are not Pareto-optimal.

So then, the results of analysis in which a market for information is not assumed is not yet adequate to explain the manner in which stability, if any, is determined. However, when Gonedes and B&L make the more traditional assumptions and posit the existence of a market for information, their analysis is in contradiction to that of H&R; Pareto-optimal equilibria are argued to be determinable. Examination of the assumptions of the two schools helps to clarify this paradox. Gonedes explicitly assumes that information is only available to those who contract to purchase it. Implicitly then, the "information leakage" effect, namely that at least some of the information is unavoidably transmitted through prices, is assumed away. Further, B&L recognise a problem in their discussion of the characteristics of the demand for information [B&L, p.38]. In their analysis, the problem is "interpreted as being synonymous with showing that accounting information is a public good" [ibid.]. The nature of public goods and the implications for Pareto-optima are discussed in Appendix 6.1 "Pareto-optimality

and public goods". Here, then, is the kernel of the debate. Gonedes has assumed away externalities for his market game and when the externalities do exist then a Pareto-optimum is impossible (at least in the case of negative externalities). B&L have argued away the externalities [p.39] by both positing contractually defined property rights which can be enforced; and, as an alternative, arguing that corporate information as a public good is a necessary but not sufficient condition "for suggesting that a form of intervention is required" [p.38]. This second argument is simply avoiding the issue. Their analysis is primarily concerned with Pareto-optimality rather than the need for intervention (although they fail to distinguish the two; on which see Appendix 6.2 "Social welfare maximisation and the irrelevance of Pareto-optimality") and so the second argument can be dismissed as irrelevant. Essentially then, B&L argue that enforceable property rights are sufficient to escape the externalities. H&R demonstrate this not to be the case because "information leakage" will be re-allocative and so there will be both positive and negative externalities simultaneously. Walker [1983] has criticised the B&L argument on much the same grounds.

In summary, the H&R supply-side analysis assumes that externalities are associated with information generation and usage; whereas the Gonedes and B&L demand-side analysis assumes that these externalities can be suppressed, either costlessly or otherwise. The empirical existence of externalities, both positive and negative, is supported by the available evidence [Foster 1981; Gonedes & Dopuch 1974] and we must conclude that the analyses of Gonedes and B&L are of limited descriptive value. Further, it is possible to conjecture that the assumption of being able to alter the system of property rights to treat information as a private, rather than public, good would involve infeasible institutional arrangements. This conjecture is supported to an extent by the Demsetz [1970] analysis of public goods noted in Appendix 6.1 "Pareto-optimality and public goods".

The following section considers research which assumes the existence of accounting information externalities and which explores alternative institutional arrangements for selection amongst accounting information systems.

6.5 SOME ALTERNATIVE INSTITUTIONAL ARRANGEMENTS

Johnson [1979] has analysed an institutional solution to the problem of determining professional accounting standards given the existence of information externalities. Following Demsetz [1970] he characterises accounting information as a "collective good" (elaborated below in Appendix 6.1 "Pareto-optimality and public goods"). Johnson argues that there is an adequate investment of research into the description of both the economic consequences of professional accounting standards changes and the implications of the existence of information externalities. Where he does perceive a need is in modelling institutional processes for formulating policy [p.26]. Five extant proposals for such institutional processes are reviewed.

Firstly, Cushing [1977] is reviewed and criticised on the grounds that a "finer" information set is not always preferred, a criticism based on Ng [1978, p.915]. Additionally, Johnson points out that Cushing's pairwise selection procedure permits a considerable degree of agenda control. The problem of agenda control is noted again below in Chapter 12 "Political choice processes".

Secondly, Scheiner [1975], which developed a multi-dimensional optimisation technique based on "spatial-analysis", a technique popularised in political science by Riker & Ordeshook [1973], is reviewed and criticised. Johnson's main criticism is that Scheiner made unrealistic assumptions about (a) the measurability of preferences; (b) the impartiality of assigning weightings to revealed preferences; (c) the use of "acceptability thresholds"; and (d) the ability to overcome individuals' incentives to misrepresent their preferences.

Thirdly, Scott [1977], which suggested that Black's "single-peakedness" condition [Black 1948] can be used, is reviewed and criticised on the grounds that (a) the assumption of single peakedness of preferences is not realistic; and (b) again the pairwise selection procedure admits agenda control problems.

Fourthly, Gonedes [1975] is reviewed and criticised on much the same grounds as in the preceding section of the present study, namely that the elimination of information externalities requires infeasible institutional arrangements.

Fifthly, Demski [1977], which suggested a pairwise selection voting scheme based on the notion of a "constitutional game" [Bloomfield & Wilson 1972], is reviewed and criticised. The main criticism is again that pairwise selection schemes permit a considerable degree of agenda control. Additionally, Johnson notes that (a) only ordinal preferences are utilised, so no account is taken of the strength of preference; and (b) although "power" is modelled as an independent variable, there is no provision for it to be explicitly incorporated into the process.

From this review of extant proposals for alternative institutional arrangements, Johnson argues that the Clarke process [Clarke 1972 & 1971] remains to be considered for its ability to select among professional accounting standards proposals. The Clarke process (also noted below in Appendix 6.1 "Pareto-optimality and public goods") is essentially a taxation regime in which participants are asked to reveal their preferences, for goods which possess consumption externalities, knowing that there is a real probability (but not a certainty) that at the end of the process they will be called upon to pay the sum they declared themselves willing to pay. Here is not the place to review the Clarke process. It is important for the present study to note that the process exists. Johnson argues [p.64] that if a market based scheme could be applied to the selection of professional accounting standards then it would have

the following three advantages

- 1 it would always be Pareto-efficient;
- 2 actual payments would ensure honest preferences are elicited; and
- 3 it would allocate entire information systems and so avoid problems of interaction and agenda control with an issue-by-issue process.

Johnson goes to some length to argue [pp.64-78] that his first criterion of Pareto-efficiency is a desideratum of social welfare. Citing Bator [1957] as demonstrating that Pareto-optimality is not sufficient for maximisation of social welfare, he argues that a problem exists in defending the case for the criterion and cites only Tindbergen [1952]. A careful reading of Tindbergen shows that his analysis of "productive efficiency" demonstrates only several conditions under which Pareto-optimality is not sufficient for social welfare maximisation, a result Johnson has already recognised in Bator [1957]. The question of whether or not Pareto-optimality is a necessary or sufficient condition for social welfare maximisation is addressed below in Appendix 6.2 "Social welfare maximisation and the irrelevance of Pareto-optimality".

Johnson proceeds [pp.79-124] to consider the production and consumption properties of accounting information. In contrast to Bird & Locke's [1981] analysis, reviewed above in the preceding section, Johnson concludes that, in each case, a priori analysis is insufficient to determine the nature of those properties and calls for further empirical work. The four properties he considers are as follows

- 1 the rival/non-rival consumption property, that is, whether or not consumption by one individual deprives others from benefitting by subsequent consumption. It appears that a test of this property in the securities markets amounts to a test of the strong form of the efficient markets hypothesis;
- 2 the excludability of non-purchasers, that is, whether or not it is technically or economically feasible to restrict access to purchasers only;
- 3 the returns to scale for information production, that is, whether or not these are increasing or decreasing; and
- 4 the existence of negative consumption externalities, that is, whether or not consumption by one individual results in a cost to another individual. Johnson argues that the very purpose of

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information as a decision input implies the existence of negative externalities.

Based on his review of these production and consumption properties of accounting information, a review which he admits is necessarily inconclusive, Johnson makes the assumption that

"accounting information is a non-rival consumptive good from which it is technologically impossible to exclude non-purchasers" [p.126].

Using this assumption Johnson proceeds to illustrate the potential operation of the Clarke process as a professional accounting standards setting process. He selects the US debate on accounting for oil and gas producing companies to illustrate the application and then identifies the following problems which would be encountered in making such a process operational

- 1 even if the process generated a Pareto-optimal solution, this would not guarantee social welfare maximisation [Bator 1957], and so a central intervention agency would still be required to protect the "public interest" through constitutional safeguards [p.168];
- 2 control of the agenda is a problem because the ability of the Clarke process to generate a Pareto-optimal solution depends on the presentation of all possible alternatives; and
- 3 the collections of tax under the process need to be "wasted" and this might be difficult to arrange in a socially meaningful way.

In summary, Johnson classifies, and comments on, possible professional accounting standards setting processes as

- 1 expert opinion, such as the US FASB and the UK ASC, in which selected individuals arrive at a decision on the basis of their collective experience. Expert opinion is subject to bias and is not Pareto-optimal;
- 2 market forces, such as the market game scheme proposed by Gonedes [1975], in which a Pareto-optimal solution is available, but only if there is no market failure. Market forces are not Pareto-optimal to the extent that market failure exists;
- 3 voting schemes, such as that proposed by Demski [1977], in which a pairwise selection procedure generates an outcome based on power dominant coalitions. Voting schemes are not comparable because they incorporate a different objective, namely power dominance rather than Pareto-optimality; and

4 the "willingness-to-pay" scheme, based on the Clarke process proposed by Johnson, in which a tax is levied on successful bidders. Willingness to pay schemes are Pareto-optimal but can impose a heavy tax burden and might be dynamically unstable (in the sense that preferences might change).

In conclusion, Johnson argues that there is no rational basis for selecting between these processes and in each there is still a need for a separate body to provide constitutional safeguards in the public interest. To Johnson's argument can be added the argument of May & Sundem [1976], reviewed above in Chapter 5 "Professional accounting standards, the political dimension and economic consequences", that professional accounting standard setting processes are social choice processes in which the objective of maximisation of social welfare is implied. Clearly, professional accounting standards setting processes in the UK may, or may not, be adequately characterised as such; and so, then, Johnson's constitutional safeguard in the name of the public interest may or may not be redundant.

Johnson's analysis is important because it appears to draw together the different possible institutional arrangements for determining professional accounting standards. Using his review, the present study is better able to identify the specific institutional structure which best describes the professional accounting standards setting processes in the UK. The description of the ASC, above in Chapter 3 "The Accounting Standards Committee", suggests that Johnson's "expert opinion" is that institutional structure.

Importantly, Johnson has further implications for the present study and for future research studies in as much as his review highlights the claimed advantages and disadvantages of these alternative institutions. The present study needs to be alert to the existence of these advantages and disadvantages. This alertness will enable generation of statements of whether or not, and if so, how, the processes attempt to cope with the factors of the environment not captured by the basic model. These statements

can then be incorporated into the description. For example, Pareto-optimality is an important goal of some of these alternatives. It is important to know to what extent "expert opinion" incorporates the Pareto-optimality criterion. Also, overcoming the incentive to misrepresent preferences is important to the rationale for adopting the Clarke process; it is important to know to what extent "expert opinion" accomodates such incentives. Finally, the objective of the voting scheme was argued to be to generate a power dominated outcome; it is important to know to what extent "expert opinion" generates such outcomes. All of these offer suitable topics for further research.

6.6 SUMMARY

The information economics literature is essentially analytic in nature. Information economics suggests that the very subject matter of professional accounting standards setting processes, namely corporate information, is a resource the possession of which enables economic agents to realise gains at the expense of others [Hirshliefer & Riley 1979]. That is, it has inherent economic consequences. Information economics is concerned both with the effects of changes in the information set on the underlying capital and product markets; and with the possible properties of a market for information itself.

In the first case, individuals are seen to stand to gain significantly from the possession of private information. In the absence of regulation, some sort of audited, financial statements would be expected because accounting information is generated privately. Speculative gains can be realised by subsequent publication of the information in a form in which it is credible. There is evidence of such published accounting information in unregulated markets in the form of audited financial statements [Watts 1977; Choi 1973]. The trading activities of individuals with private information are essentially de-stabilising, and any resultant equilibria are not likely to be Pareto-optimal. Such an analysis is generating a reconsideration of the nature of general equilibrium economics.

In the second case, the properties of a market for information are explored in order to determine its possible equilibrium properties and, in particular, the conditions under which such a market would be Pareto-optimal.

These two analyses are seen to be mutually inconsistent, the primary distinction being the extent to which information is assumed not to possess consumption externalities and so support a clear demand for information as a tradeable good. Under the existing institutional structure, accounting information clearly possesses externalities [Foster 1981; Gonedes & Dopuch 1974] and so the characterisation of a market for information is of little relevance to the present study.

Comparison of market and non-market based information allocation processes suggests that there is no rational economic basis for selecting between processes [Johnson 1979]. Some are Pareto-optimal, others only approximate Pareto-optimality and, in each, some sort of constitutional safeguard is required to protect the "public interest" [op.cit]. The economic analysis leaves unanswered the problem of identifying the public interest [Appendix 6.2 "Social welfare maximisation and the irrelevance of Pareto-optimality"].

Review of the proposals for differing institutional arrangements for selecting professional accounting standards highlights the fundamental distinction between the two information economic perspectives. Some institutional arrangements assume the existence of consumption externalities and attempt to overcome the related problem of "market failure" by adopting non-market solutions. These arrangements include expert opinion, voting schemes and taxation regimes. On the other hand, other institutional arrangements assume that consumption externalities can be eliminated by appropriate changes to the system of property rights [Bird & Locke 1981; Gonedes 1975]. These latter arrangements are essentially free market solutions. From the variety of different possible institutional arrangements can be drawn two observations

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- 1 the "expert opinion" arrangement most closely matches the UK professional accounting standards setting processes; and
- 2 the different arrangements possess different properties and objectives. Future studies might be able to address themselves to the problem of discovering to what extent the UK professional accounting standards setting processes reflect any or all of those properties and objectives.

6.7 CONCLUSIONS

Of importance to the problem of investigating UK professional accounting standards setting processes is the understanding that there are private gains available to those who hold both private information and can control the subsequent publication of that information. Clearly, it is possible to characterise management as holding private information and so they have incentives to seek to control its subsequent publication. A professional accounting standards setting programme will necessarily restrict managements' freedom to exercise that control and so incentives exist for management to resist such a programme. The fundamental mechanism generating financial statements implies that some level of professional accounting standards is inevitable. The interesting question is how they are actually determined.

The next chapter reviews the literature which investigates more closely managements' incentives by explaining their behaviour in terms of the agency relationship.

Given that there is no unique economic solution to the problem of choice amongst alternatives for accounting information, there is a natural and clear interest in the structure of the present, existing, institutional, solution. One important contribution has been made by the dissertation of Johnson [1979].

Johnson identifies different institutional arrangements under which professional accounting standards might be selected. Among the objectives of those arrangements, the usual economic criterion of Pareto-optimality is central although non-economic alternatives are clearly seen to be possible. Johnson's review suggests the following areas for further research specifically based on existing professional accounting standards setting processes:

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- 1 to what extent do existing professional accounting standards setting processes incorporate the Pareto-optimality criterion?
- 2 to what extent do existing professional accounting standards setting processes overcome incentives to misrepresent preferences?
- 3 to what extent do existing professional accounting standards setting processes incorporate a power dominated objective?

APPENDIX 6.1 PARETO-OPTIMALITY AND PUBLIC GOODS

In the above review of the information economics literature, the property of information to possess positive or negative externalities was seen to be of fundamental importance. One implication of this lies in the well known result that markets for goods which possess externalities cannot be guaranteed to be Pareto-optimal. Pareto-optimality is the criterion for which "a state is reached (where) it is not possible to increase the utility of some consumers without diminishing that of others". [Cirillo 1979, p.44].

It is clear that, under the existing institutional arrangements, accounting information constitutes a public good. This appendix briefly identifies some of the theoretical issues without attempting to conclude on the implications for professional accounting standards setting processes. Those implications are addressed in the main body of the text.

One of the usual assumptions of economics is "that there are no (nonpecuniary) external economies or diseconomies of production and consumption" [Bator 1957, p.42]. Commodities which possess the property of having external economies or diseconomies are known as "public goods", which Samuelson [1969, p.102] defines as a good which enters into two or more persons preference functions simultaneously. Under such conditions, market agents have incentives to misrepresent their preferences. For example, for a good (such as a television broadcast, a transport system or a defence system) with positive externalities, consumers and producers have incentives to understate their preferences in the hope of transferring the costs of production and consumption elsewhere; for a good with negative externalities (such as pollution) consumers have an incentive to overstate their preferences in order to reduce or even prevent production and consumption. Much attention in the literature has been given to the problem of overcoming these incentives to misrepresent preferences. In the case of non-purchasers who can be economically and technologically excluded from consumption then the usual solution proposed is exclusion [Demsetz 1970]. In the case of non-excludable consumers, understating preferences has become known as the "free-rider" effect. For example, Clarke [1972;1971] has suggested a process for marketing on a multi-part pricing system in which part of the pricing structure is determined by a central agency. Demsetz calls goods for which it is impossible to exclude non-purchasers, "collective goods" [1970, p.295].

One of the major problems of public goods which has tested theorists is the identification of necessary and sufficient conditions (if any) for the existence of a Pareto-optimum. Samuelson started to analyse the problem in his three seminal papers [1958;1955 & 1954]. In his model he conceptualised a "pure public good" (that is one in which consumption by any one individual could be at any level and without limitation on the consumption by other individuals). In the following paragraphs

it will be shown that the literature has progressed somewhat since Samuelson, but still the position is that no Pareto-optima can be guaranteed.

Two lines of analysis of the problem of the existence of Pareto-optima with public goods can be discerned. These are the game theoretic approach which utilises the concept of the market game of Shubik [1959], and the marginalist approach represented by Samuelson [1958;1955 & 1954].

Firstly, in the market game analysis, interest is focussed on the "core" of the market, in which lies the set of feasible solutions (which cannot be blocked by any other coalition). Shapley & Shubik [1969] demonstrated that the existence of a non-empty core is guaranteed when the externalities are positive but is not guaranteed when the externalities are negative. Their analysis was restricted to the case of externalities of production only. Roberts [1974] continued the analysis and demonstrated that, in cases with either (a) decreasing returns to scale; or (b) non-excludable purchasers, then there is no core. Scarf [1967] identified some sufficient conditions for the core to exist and be Pareto-optimal but he did not consider the case of public goods. So the question remains open as to what are the necessary and sufficient conditions for a Pareto-optimal core to exist in the case of public goods.

Secondly, in the marginalist analysis, Musgrave [1959], Samuelson [1954] and Wicksell [1896] each demonstrated that Pareto-optima are not guaranteed in the case of public goods. The phenomenon has become known as "market failure" and, as such, analysis suggests supplementing the market with some institutional mechanism. Recent analyses by Hurwicz [1975] and Ledyard & Roberts [1974] have provided more rigorous demonstrations of market failure and have considered further the problem of incentives to conceal true preferences. The result of both of these lines of analysis is, again, that when there are externalities then a Pareto-optimal solution may exist but it is not guaranteed.

As already noted much of the recent literature has turned itself to the problem of discovering necessary and sufficient conditions (if any) for the existence of a Pareto-optimum. This problem seems to be intractable. However, there has been some limited success in discovering specific institutional mechanisms under which a Pareto-optimal solution is guaranteed, that is, some sufficient conditions are being identified albeit in a piecemeal fashion. Examples of some of the processes so discovered are reviewed by Hurwicz [1973]. Clarke's [1972 & 1971] process is to date the most celebrated of these novel mechanisms [Tideman 1977] and is reviewed above in Section 6.5 "Some alternative institutional arrangements" as part of the review of the Johnson [1979] suggestion for an alternative to the existing professional accounting standards setting processes.

An interesting outcome of the growth of a literature of alternative mechanisms has been an increased awareness of their different properties, such as feasibility, convergence to stability and, in particular, their information requirements. For Hurwicz [1973], the most interesting property of the classical free-market mechanism is that of information decentralisation; a property that makes it a most attractive mechanism in Western democracies as opposed to Eastern socialist states. This observation could be interpreted as an ideological justification of the dominant US interest in the free market mechanism.

APPENDIX 6.2 SOCIAL WELFARE MAXIMISATION AND THE IRRELEVANCE OF PARETO-OPTIMALITY

One result of economic analysis and, in particular welfare economics, is that Pareto-optimality is not a sufficient condition for social welfare maximisation [Hennipman 1976, Arrow 1974, Sen 1970, Bator 1958 & 1957, Tindbergen 1952 and Little 1950].

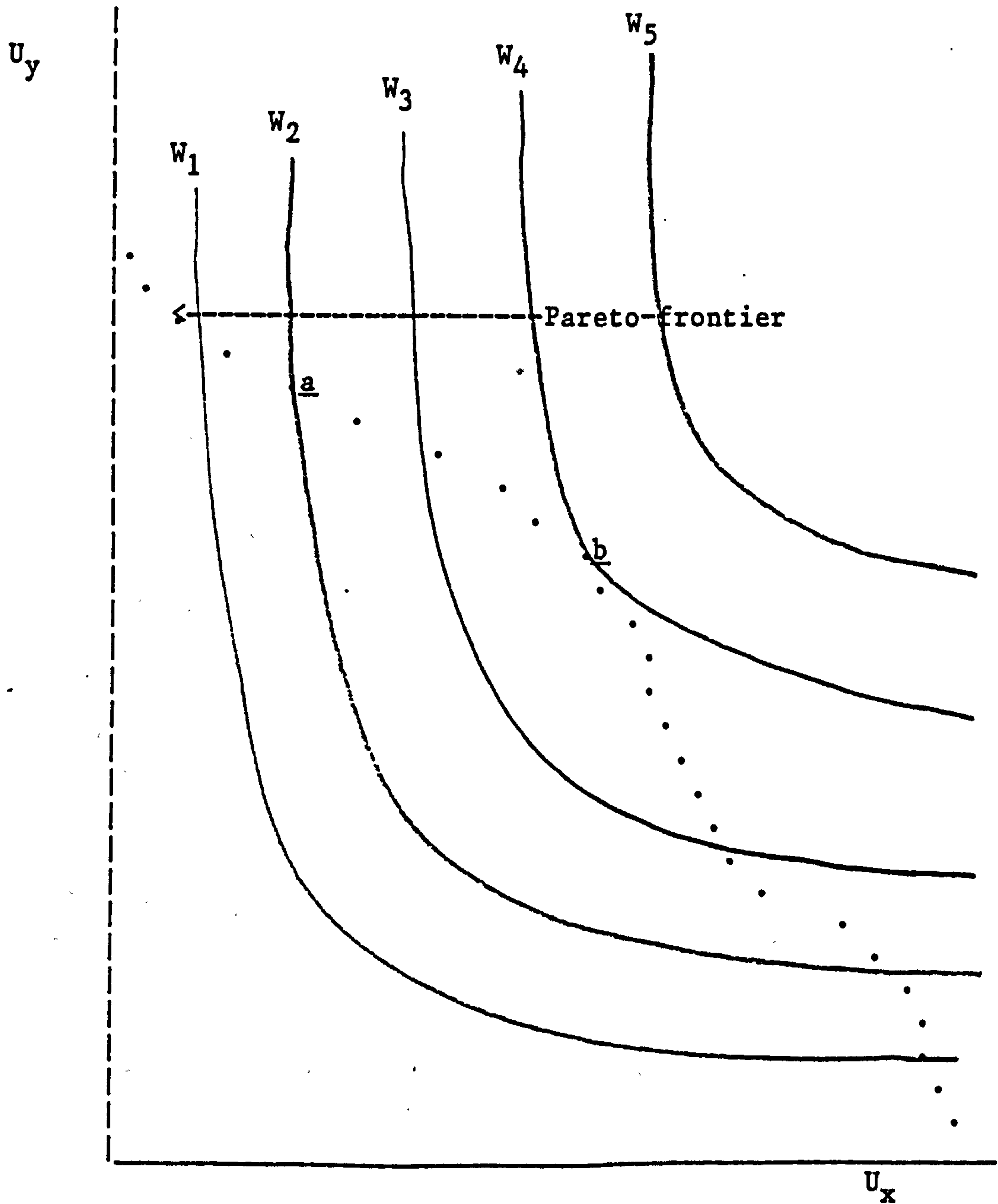
A second result of economic analysis is that there exist conditions under which Pareto-optimality is not even a necessary condition for social welfare maximisation [Mishan 1965 and Lipsey & Lancaster 1956].

Bergstrom [1971] gives an interesting example of the case of a Pareto-optimal slave economy; and Kaldor [1972] a criticism on different grounds, namely that Pareto-optimality oriented equilibrium analysis has no empirical meaning because the empirical world is rich with examples of increasing returns to scale in direct contravention of the classical assumption of decreasing returns to scale.

The irrelevance of Pareto-optimality for social welfare maximisation can be elaborated by adopting Bator's analysis and exposition in the two-person two-commodity case. Using conventional consumer utility analysis, Bator constructed the following Figure 6.2.1A "Conditions under which Pareto-optimality is not sufficient for social welfare maximisation".

In Figure 6.2.1A, convex social welfare indifference curves are shown as W_1 to W_5 in increasing order of welfare. The irregular line is the Pareto-frontier, that is the locus of all points on which the market is Pareto-optimal. For an analytical discussion of Pareto-frontiers see Biller & Bixby [1974] and Zeckhauser & Weinstein [1973]. Clearly, Pareto-optimality is not sufficient for welfare maximisation because both points a and b are Pareto-optimal whereas point b corresponds to a higher level of social welfare than point a.

FIGURE 6.2.1A: CONDITIONS UNDER WHICH PARETO-OPTIMALITY IS NOT SUFFICIENT FOR SOCIAL WELFARE MAXIMISATION



Source: Bator [1957, p.28].

Further to the above result, there may actually be a welfare frontier, that is a level of social welfare which it is not possible to exceed but toward which social welfare indifference curves tend [Mishan 1981, pp.269-270 and Bator 1958, p.378]. Kaldor argues that "except in a purely short term sense, total output can never be confined by resources" [1972, p.1251]. The implication of Kaldor is that production of individual commodities is limited by the existence of a social welfare frontier. The case of a welfare frontier is set out next in Figure 6.2.1B "One condition under which Pareto-optimality is not necessary for social welfare maximisation: The case of a welfare frontier".

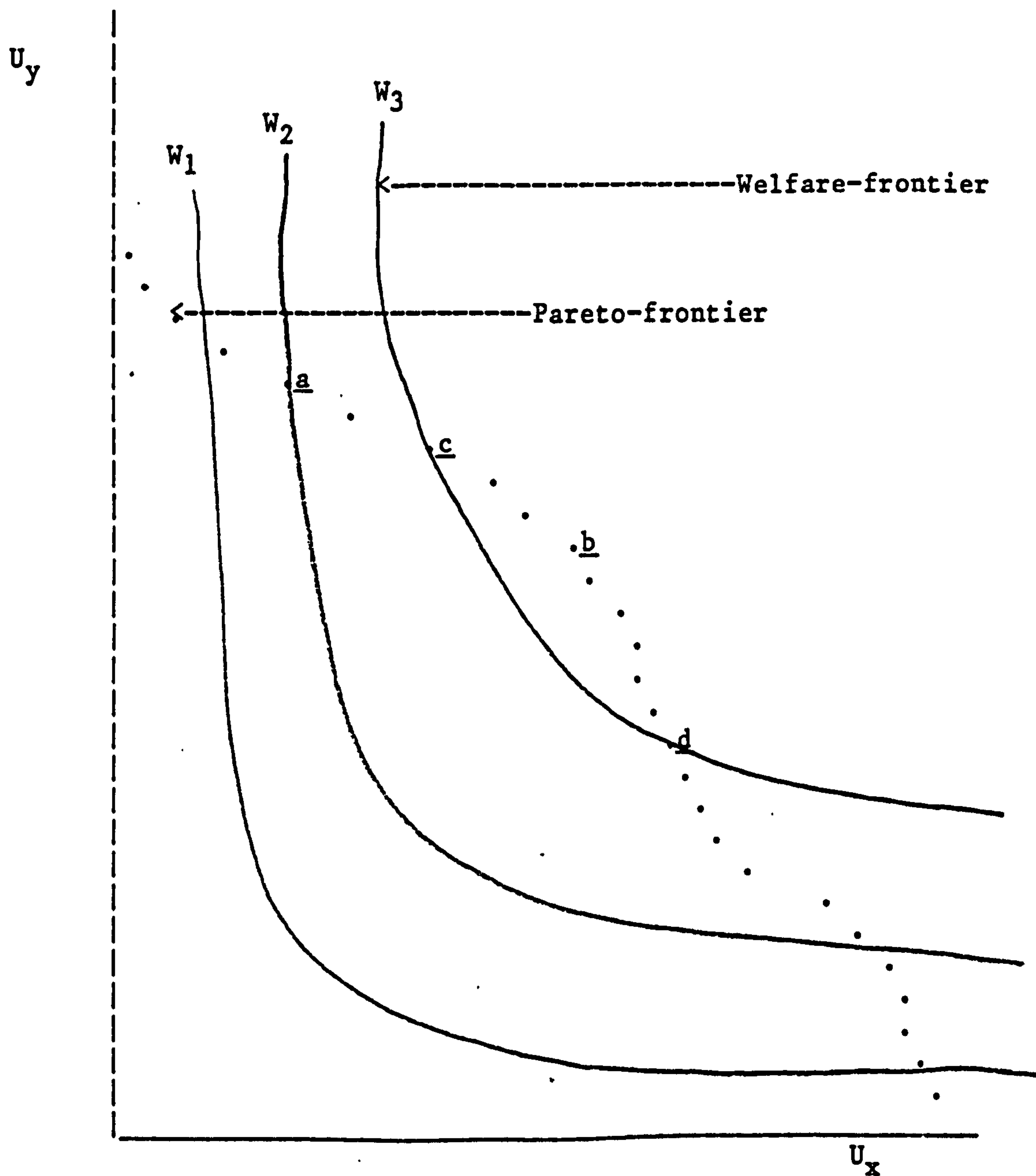
In Figure 6.2.1B, it can be seen that Pareto-optimality is not necessary for welfare maximisation because all points on the welfare frontier segment, c to d, correspond to maximum social welfare whereas only the end-points, c and d, are Pareto-optimal.

Having argued the irrelevance of Pareto-optimality for social welfare maximisation in the two-person, two-commodity case it is no difficult task to extend the analysis to the n-person, n-commodity case.

The irrelevance of Pareto-optimality can be elaborated in alternative terms based on considerations of "equity". One of the initial conditions of economic models is the distribution of initial endowments. Immediately then, Pareto-optimality becomes efficient only with respect to that initial endowment distribution. There is no guarantee that the distribution of equilibrium endowments will be "equitable" [Arrow 1974, p.269]. All that Pareto-optimality guarantees is that the system in equilibrium is operating "efficiently", that is, nobody can be made better off without making at least one other person worse off.

This "equity" interpretation can be illustrated. In terms of Figure 6.2.1B, it can be seen that as a point moves along the Pareto-frontier, away from "centrist" position, towards one or other of the two axes of the figure, then the distribution of utilities becomes increasingly less balanced. In this sense, these "away-from-centre" distributions can be said to be less "equitable" and so correspond to lower social welfare indifference curves.

**FIGURE 6.2.1B: ONE CONDITION UNDER WHICH PARETO-OPTIMALITY IS NOT NECESSARY FOR SOCIAL WELFARE MAXIMISATION:
THE CASE OF A WELFARE FRONTIER**



Source: Original adaptation of Bator [1957, p.28].

CHAPTER 7 OTHER ECONOMIC PROCESSES

7.1 Introduction

7.2 Rational choice theory

7.3 Agency theory

7.4 Social choice theory

7.5 Summary

7.6 Conclusions

Appendix 7.1 A conflict minimisation hypothesis

CHAPTER 7 OTHER ECONOMIC PROCESSES

7.1 INTRODUCTION

This chapter reviews the extent to which previous research shows how economic processes, other than information economics, operate to translate the consequences of, or the incentives for, the generation of accounting information into factors which might influence the professional accounting standards setting processes. In other words, it sets out additional mechanisms by which economic consequences are generated.

The literature on these other economic processes can make a substantial impact on the analysis of the problem of explaining professional accounting standards setting processes. Three separate subsets of this literature are reviewed.

- 1 **Rational choice theory**, which is concerned with the analysis of information and its use by an individual, in which the focus of interest is the maximisation of expected utility for an individual. Examples of this literature include Beaver [1981], Cushing [1981 & 1977], Bromwich [1980], Demski [1976, 1973 & 1972], Beaver & Demski [1974], Marshall [1972] and Feltham [1968].
- 2 **Agency theory**, which is concerned with the analysis of both the role of management as agent of the owners of the firm; and the information requirements of both agents and owners. Examples of this literature include Fama [1980], Sutton [1980], Watts & Zimmerman [1978], Watts [1977], Jensen & Meckling [1976], Alchian & Demsetz [1972].
- 3 **Social choice theory**, which is concerned with the analysis of conditions under which heterogeneous preferences might be aggregated to generate stable, or unique, choices. Examples of this literature include Mueller [1976], Fishburn [1973], Sen [1970], Arrow [1963 & 1951] and Black [1948].

7.2 RATIONAL CHOICE THEORY

Demski [1973] demonstrates that, if maximisation of expected individual utility is an objective, then, there exists no set of criteria ("standards" in his terminology) which both

- 1 can be used to determine an accounting information system optimal for an individual; and
- 2 does not take into account the preferences of that individual.

Demski's argument, although presented in algebraic notation, can be paraphrased by saying any set of technical criteria can only serve to partition the available set of accounting alternatives into subsets based on those technical criteria. Unless an explicit utility criterion is also applied, there is no guarantee that accounting alternatives selected on the basis of the technical criteria would also meet the utility criterion.

Sets of technical criteria had been advocated, for example, by ASOBAT [AAA 1966], and by Chambers [1976 & 1966]. They continue to be advocated by, for example, Stamp [1980, pp.55 & 90] who lists some twenty criteria. By way of example, the four ASOBAT criteria were relevance, verifiability, freedom from bias and quantifiability [p.8].

Demski's [1973] conclusion is important because it is now known that it is impossible to guarantee that a set of strictly technical criteria will always be sufficient even for an individual, or a class or individuals with homogeneous preferences, in a world in which preferences are meant to count. That is, if we assume a society in which the wants and needs of individuals are to be translated into behaviour, then those preferences must be taken into account at some stage. This result has clear implications for an understanding of professional accounting standards setting processes. It predicts that professional accounting standards setting processes will be structured in such a way that both technical and preference criteria are taken into account. The evidence above in Chapter 3

"The Accounting Standards Committee" confirms just such an arrangement.

Chambers [1976] criticised Demski's analysis on the grounds that there does exist a set of technical criteria which must be satisfied before any information can be useful for the purposes of making a decision. That is, Chambers sets up a set of necessary conditions [pp.649-650] for information to be decision useful. However, Demski counters [1976] with the observation that usefulness stems from preferences, that is, that Chambers' conditions are not sufficient. Demski further counters [1976, p.654] that Chambers' conditions are not even necessary; that is, in comparing two information systems then fineness is the only necessary and sufficient condition for one system to be preferred to the other [Blackwell 1953]. By fineness Demski means [1976, p.654 and 1973, p.722] that the information contained in one system is, at least, also contained in the other system.

Ng [1978, p.915] has shown fineness not to be a sufficient, or even necessary, condition for absolute preference. This result is generated by moving away from the individual utility maximisation framework of rational choice theory and introducing a multi-person setting. Management's and investors' preferences are shown to conflict and so the fineness result is shown to be limited to the single person setting.

Bromwich [1980] seeks to develop the impossibility result of Demski [1973] by investigating sufficient conditions under which partial standards might be optimal for an individual. Bromwich contrasts partial standards with the general standards of Demski's [1973] analysis by describing partial standards as those which are "narrowly defined" and which

"prescribe a desired treatment for one or more accounting items in isolation from the procedures adopted for solving other accounting problems" [p.288].

Bromwich shows [p.293] that, using a result of Marschak [1971], one sufficient condition for partial standards to be optimal for an individual is that the individual's utility function be a simple linear function of independent variables. That is, it should be an "additively separable" utility function [p.294]. The implication is that, provided the accounting alternatives available under one issue have no interaction effects with alternatives available under a separate issue, separate consideration of those issues can determine outcomes optimal for an individual, that is, maximise his expected utility.

Cushing [1977] takes issue with the impossibility result of Demski [1973], arguing that it is an "artifact of the way in which the issue is initially formulated" [p.308] and as such unnecessarily pessimistic. Cushing argues that each accounting choice problem can be treated as a pairwise choice between two alternatives, a proposal and the status quo, and so the fineness condition is sufficient to ensure optimality for the individual. Cushing was presumably unaware of the Ng [1978] result that fineness is not sufficient in a setting with more than one individual.

Cushing's analysis is criticised in Bejan [1981], Bromwich [1980] and Johnson [1979]. Bejan [pp.707-709] argues that Cushing's rational choice framework, focussing as it does on the preference function of the individual is insufficient to capture the effects of public information in a multi-person setting. Bromwich [1980, p.295] argues that it is insufficient even to capture the interaction effects in a single-person setting. Bejan argues further that these phenomena need to be studied within a general equilibrium setting in which "the welfare analysis of public information has great potential" [p.709]. Cushing replied [1981] to Bejan's criticism by a restatement of his earlier position. It is clear that the two writers are analysing the problem of information system selection from different positions; Cushing from an individual utility position and Bejan from a multi-

person, or markets, position. There is no reason to expect that these two perspectives should generate identical results. Johnson's [1979] criticism of Cushing picks up the Ng [1978] fineness insufficiency result and further argues that the pairwise choice process is unstable and subject to agenda manipulation. Agenda manipulation is the term often applied to the process of selection of issues by individuals who control the stage at which issues are identified for further consideration. Agenda manipulation is discussed further below in Chapter 12 "Political choice processes".

It has been noted that the individual utility, or rational choice, framework implies that even an individual cannot select amongst accounting alternatives without taking account of his preferences [Demski 1973] and that an "additively separable" preference function is sufficient for such selection to proceed on a partial basis [Bromwich 1980]. It is, then, natural to enquire, as Bejan has prompted, into the results of the analysis of a multi-person, or market, setting. This is undertaken in the following review and in the remaining sections of this present chapter.

Beaver & Demski [1974] has extended the individual orientation of rational choice theory by explicitly considering the implications of a multi-person framework in which there are heterogeneous preferences. Heterogeneity implies that there should not be expected any agreement on which accounting information should be provided to users [p.171]. This result is supported by the argument in Hakansson [1981]. Further, in order to reduce the areas of disagreement between individuals, or classes of individuals, accounting policy-makers have conventionally sought to achieve agreement on the underlying objectives of accounting information [p.175]. Examples of such attempts include Stamp [1980], ASC [1975], AICPA [1973], AAA [1966], Sprouse & Moonitz [1962] and Moonitz [1961]; as such their role "is to specify the nature of the tradeoffs" [p.185].

The Beaver & Demski analysis draws attention to the implications of heterogeneity in a multi-person environment. The previous Chapter 6 "Information economics" reviews, in much greater detail, several analyses of how the inherent heterogeneity, or conflict, might interact with the market place.

The following section considers the implications of the individual expected utility maximising assumption in the specific context of individuals who act as managers, that is, as agents of the owners of the firm.

7.3 AGENCY THEORY

7.3.1 The agency theoretic framework

Agency theory is a body of literature which seeks to explain the behaviour of non-owner managers in establishing the ownership structure of a firm. In a seminal article, and following Alchian & Demsetz [1972], Jensen & Meckling [1976] (J&M) models the firm as a set of contractual relationships [pp.310-311]. Managers are shown to have incentives, deriving from a utility maximising assumption, to consume not only their contracted pecuniary remuneration but also non-pecuniary benefits. Such non-pecuniary benefits are assumed to be appropriated by managers from the firms resources and result in a discounting of the value of the firm [pp.316-319]. This discounting arises because outside owners of an equity claim to the resources of the firm are assumed to expect that the managers will consume those non-pecuniary benefits. The amount by which the value of the firm is discounted is known as the agency cost; that is, given that there is a separation between ownership and management, then the agency cost is the difference between

- 1 the market value of equity claims on the resources of the firm, given that the manager is (notionally) also the owner of the firm; and
- 2 the market value of equity claims on the resources of the firm.

Given the existence of agency costs, then at the same time that he offers to the market equity claims on the resources of the firm, the owner-manager has an incentive to offer bonding commitments not to consume these non-pecuniary resources [J&M, p.325]. This incentive derives from the result that when he offers equity claims then he bears the full agency costs himself as the discount in the market value of those claims. So, by incurring "bonding costs" the manager increases the market value of equity claims to the resources of the firm. Similarly, by monitoring the manager's performance of the bonding commitment, then the non-managing owner also increases the value of equity claims to the firm [p.323]. Assuming that the full agency cost

cannot be bonded or monitored away then there will be a residual cost. In this sense the agency cost can be said to be made up of three elements, namely bonding costs, monitoring costs and residual loss [p.308]. Further, J&M argue that owner-managers have an incentive to engage in risky projects when the firm's activities are financed by debt because the lender bears the risk of loss whereas the owner captures the chance of gain [p.334-337]. Again, this incentive generates an agency cost by the same market discounting mechanism described above and so there is an incentive to engage in bonding and monitoring costs in those circumstances also.

Using these results, J&M develop their model further to demonstrate the existence of optimal levels of debt and equity in a "theory of the corporate ownership structure" [J&M, pp.343-351]. The present study is not concerned with these extensions but with implications of the results that bonding and monitoring contracts are likely to be entered into when securities are offered to the markets. Clearly, if subsequent to the creation of those contracts some important measures of the monitoring variables are changed exogenously then there will be a wealth transfer from (a) one or more of the manager, equity claim owner or debt claim owner; to (b) one or more of the others; except where such changes can be costlessly adjusted in the bonding and monitoring process. Changes in professional accounting standards operate precisely as changes in monitoring variables to the extent that they change the methods by which these variables are measured.

Fama [1980] has criticised the J&M model of the agency relationship between owners and managers of the firm. Supporting the characterisation of firms as a set of contractual relationships, Fama argues that the concept of the entrepreneurial owner embodied in the J&M model is unnecessary as a device for the explanation of the structure of the firm [p.290]. Further, Fama argues [*ibid.*] that, in attempting to understand how control

is exercised over the firm and its decisions, the notion that a firm is any sense owned is misleading. In particular, the firms equity owners can be said to own nothing more than claims to residual rights in the net flows of resources through the firm. From this position then, managers are best controlled not by the owners of the firm's securities but rather by the mechanism of the market for managers. This argument is clearly not consistent with the J&M agency theory argument, in which managers are controlled not by the market for managers but by the monitoring activities of the owners of debt and equity securities. In the J&M model monitoring signals are, in part, provided on a contractual basis to securities holders; in the Fama model monitoring signals are provided on an uncontracted (and so ad hoc) basis to the management labour market.

It is an open question whether the J&M "agency theory" model or the Fama "market for managers" model proves to more fully explain the observable world of firms and their contractual relationships (or firms as their contractual relationships).

7.3.2 The framework applied to professional accounting standards setting processes

Watts [1977], in a seminal development of an earlier study [Watts 1974], sought to extend the application of agency theory to an explanation of financial information production. As such, his study represents a substantial change in the approach of the literature to the professional accounting standards setting processes. Watts develops a deductive theory of the processes by integrating the results of both agency theory [Jensen & Meckling 1976] and economic theory of politics [Downs 1957]. He argues that agency theory predicts that the content of financial statements will be determined by market forces and that those contents will be dependent on the circumstances of individual companies; he argues that economic theory of politics predicts that bureaucratic standards setters will be risk-averse in the sense that they will generate standards which will minimise the risk of their being blamed for failures. Politicians are described as using crises, created by the media, as opportunities to apply simplistic solutions. Watts tests some of his hypotheses by using evidence of accounting history.

Watts work is important because it represents a first attempt to develop a model of the professional accounting standards setting processes as processes. Within the framework of this model, Watts has provided a richness of ideas and hypotheses for testing.

Watts & Zimmerman [1978] (WZ 1978) extends the work of Watts [1977] by testing some of the implications of the agency theory assumptions. In this work, it is deduced that management will behave in a manner consistent with the minimisation of costs. WZ 1978 categorises the costs of professional accounting standards as they affect companies and tests predictions of management behaviour based on that categorisation. By the authors' own

admission, the extent of testing was not great. One US professional accounting standards issue, that of inflation accounting, was selected for testing and another study's previously published transformations of historic cost data into general purchasing power data was used. WZ 1978 discriminated between different effects based on informal estimates of costs, including political interference costs, and on the basis of the impact of these costs on management as predicted by the hypotheses. The results did not reject the hypotheses and, in particular, suggested that size is by far the most important factor in determining choice in inflation accounting.

The WZ 1978 study is important because it develops further the Watts [1977] model and shows how some of those hypotheses might be tested.

Nevertheless, the WZ 1978 study suffers from limitations of method. As with the Hussein [1981 & 1977] study reviewed above in Chapter 5 "Professional accounting standards, the political dimension and economic consequences", the use of the inflation accounting issue does not represent a randomised approach to sample selection and, arguably, introduces a strong systematic bias to any generalisations based on it. It is arguable that the inflation accounting issue is one of extreme positions and as such it may be unrepresentative of professional accounting standards issues generally. More work needs to be conducted to investigate this question alone.

A number of studies have followed the lead of Watts [1977] and WZ 1978.

Hagerman & Zmijewski [1979] (HZ) seeks to extend the analysis of WZ 1978 by deducing possible economic variables which, it is hypothesised, might operate as determinants of accounting policy choice on the part of management. These economic variables are size, risk, capital intensity, competition and existence of management incentive plans. Four accounting policy issues were selected for testing. These were accounting for inventory, depreciation, investment tax credits and pension costs. Interestingly, HZ adopted probit analysis as the statistical tool by which to analyse their data; their arguments are considered more fully below in Chapter 18 "Research approach and method". The HZ results suggest that different sets of economic variables are associated with managements' choice of accounting policy on different issues. In particular, size was the most important variable in only two of the four issues. This is a result that limits the generalisability of the WZ 1978 finding that size was most important for the inflation accounting issue.

Zmijewski & Hagerman [1981] provides evidence additional to that of HZ. It is demonstrated that, when the individual issues of the HZ study are combined to form an overall "income strategy", then the association between the accounting policy choice and the economic variables is stronger than in HZ (above). This result only holds for larger firms in concentrated industries.

Sutton [1980] is a study which is particularly important for the present study because it seeks to test the WZ 1978 result against data from the UK professional accounting standards setting processes. As has been done above in Chapter 5 "Professional accounting standards setting processes, the political dimension and economic consequences", Sutton notes that many writers recognise the political nature of these processes. As part of a brief review of the history of these processes, both in the US and in the UK, Sutton suggests that

"the economic consequences argument has a strong appeal to non-accountant critics of a standard. 'Technical' arguments the (ASC) can rebuff, all the more easily if the standard accords with an 'agreed conceptual framework'. But non-technical arguments lie outside its competence and, more crucially, its authority" [p.22, footnote 19].

Sutton argues that the ASC has shown itself to be sensitive to corporate self-interest and so management has not found it necessary to openly pursue wider, economic consequences, arguments. In a sense, the evidence presented below in Part IV "Evidence from the empirical study of UK data" offers qualified support for Sutton's assertion.

Following Watts [1977], Sutton develops implications of Downs' [1957] analysis of the economics of political action. From a rational choice theoretic framework, Downs predicted that rational, self-interested individuals would not perceive sufficient benefit to induce them to vote in general elections. That is, voting costs would exceed expected benefits. Sutton argues that corporate managements' behaviour as lobbyists in the professional accounting standards setting processes can be assumed to be explained by this simple cost/benefit analysis. From such an assumption it follows that

- 1 lobbying costs must be less than expected benefits. For some managements close to the decision makers, the costs of information acquisition and lobbying will be relatively low;
- 2 high levels of uncertainty will induce lobbying in an attempt to reduce the uncertainty;
- 3 supportive lobbying will be less frequent than opposing lobbying; and
- 4 group lobbying will be more influential, but only in the area of the group interest.

In developing the framework for his study, Sutton is sensitive to criticisms of the Downs [1957] analysis. In particular, Barry [1978] argues that Downs' analysis is internally inconsistent and his conclusion, that individuals in general will not vote in general elections, is counter intuitive. However, Sutton relies on Riker & Ordeshook [1968] which provided some evidence in support of Downs. So, by assuming Downs, Sutton aims "to

determine if there exists a measurable relationship between perceived "benefits" and stated preferences" [p.59]. He uses the UK professional accounting standards proposal ED18 "Current cost accounting" as the issue to investigate and identifies the written submissions of management to the ASC as evidence of stated preferences. Sutton provides a brief description of the ED18 proposals, discussing the main points of contention such as high costs of implementation and expected taxation effects.

Sutton's research design utilises four critical stages, namely

- 1 discover stated preferences from the written submissions;
- 2 discover incentives for stated preferences by assuming Downsian rational self-interest;
- 3 classify preferences into supporting/opposing; and
- 4 use discriminant analytic techniques to determine whether or not the incentives are sufficient to discriminate between the stated preferences.

In order to identify the incentives, Sutton classified the expected economic consequences of the ED18 "Current cost accounting" proposals into

- 1 the additional cost of generating the information;
- 2 the increased probability of a change in the taxation base or rate structure;
- 3 the increased probability of "political" consequences, such as additional price controls, monopolies investigations, dividend controls and corporate legislation; and
- 4 the additional costs of rewriting existing financial contracts based on the changed accounting ratios.

The following accounting characteristics were used by Sutton to distinguish the expected economic consequences.

FIGURE 7.1 SUTTON'S ACCOUNTING CHARACTERISTICS OF ECONOMIC CONSEQUENCES

<u>Economic consequence</u>	<u>Accounting characteristics</u>
1 Information costs	Size of company Proportion of overseas assets Current cost information already being generated
2 Tax effect	Size of current cost adjustments relative to taxable income
3 Political effect: Size Profitability Monopoly	Sales and absolute profit Actual margin relative to a reference margin Legal definition of monopolist
4 Contract rewriting	Interest cover

Source: Sutton [1980]

Sutton's data analysis took the form of a test of the hypothesis that

corporate management will expect a professional accounting standards change to alter cash flows and so they will support or oppose a proposal if the net benefit is positive or negative respectively.

Managements' preferences were inferred from the accounting characteristics identified above in Figure 7.1 "Sutton's accounting characteristics of economic consequences". In summarising the results of his analysis, Sutton observed that

- 1 the characteristics chosen discriminated poorly between the supporters and opponents of the proposal;
- 2 there was only weak evidence of a relation between size and support for the proposal;
- 3 the taxation variable seemed to be unimportant;
- 4 companies currently under investigation by the Monopolies and Mergers Commission were more likely to support the proposal; and
- 5 price controls appeared to have little impact. [p.139].

The unanticipated failure of Sutton's results to confirm his hypothesis led him to conclude his study, firstly, by analysing possible points at which his study may have failed to adequately operationalise the variable he was investigating; and, secondly, by analysing the possible points at which his hypothesis might not have captured all the variables relevant to the study.

An operational criticism identified by Sutton was that his initial classification of stated preferences into supporting or opposing may have been incorrect. He did earlier (in his Chapter 3) admit to having difficulty with this classification because some statements of preference were conditional and others expressed varying degrees of strength of preference. This particular point is important to the present study and is considered below in Chapter 18 "Research approach and method". Additionally, Sutton identified the possibility of introducing bias into the choice of proxy accounting characteristics and the possibility of the exclusion of some important ones. This self-criticism of Sutton's is valid, for at no stage did he develop a model to show how his selected characteristics could be seen to

be predictive of the expected economic consequences with which they were associated.

Sutton's self-criticism also explores the possibility that the hypothesis might not have captured all the variables relevant to the study. For example, he suggests that there may have been disagreement amongst the different managements about the effects of the proposal; or "public spirited" managements might have lobbied regardless of the expected cost or benefit. Sutton suggests that the literature of political science might be a fruitful source of explanations of the professional accounting standards setting processes. Sutton further suggests investigation of the nature of the power of the professional standards setting authority and of the constitutional aspects.

A final criticism of Sutton's contribution focusses on the role of theory construction in his dissertation. As he adequately noted, insufficient attention was given to an exploration of other possible explanatory factors within which the study was being conducted. In particular, the introduction to his study clearly identified a political dimension to his problem. He failed, however, to explore the implications of the existence of that political dimension. Rather, those implications were dispensed with in an early decision to consider only the Downs [1957] rationalisation of political behaviour. As is demonstrated below in Chapter 12 "Political choice processes", the literature of political science is rich with alternative rationalisations and a careful review is necessary before any one is selected in preference to others.

Christenson [1983] criticises applications of the agency theoretic framework to studies of the professional accounting standards setting processes which are based on the Watts & Zimmerman model. Christenson argues that the "positivist" methodology underlying the work of Watts 1977 and WZ 1978, amongst others, is philosophically unsound. This unsoundness lies in the aim of the researchers to describe the world "as it is". The philosophy of science is argued [p.10] to have moved away from such a characterisation of theory construction to one in which theories are seen as statements of what the world is not, rather than what it is [Popper 1959, p41]. This is known as the "strictly universal negative-existential proposition" and is often illustrated by the ubiquitous "black swan" argument, in which an observation of two swans, one black and one white, no longer leads to the proposition that "one half of all swans are black"; rather it leads to the proposition that "it cannot be said that either all swans are white or all swans are black". In this brief review of the empirical studies addressing the economic processes which underly professional accounting standards setting processes, there is insufficient opportunity to consider these arguments in depth. However, it is noted that they do exist and have implications for the way in which theories are interpreted. Beyond that naive observation, the present study avoids the underlying subtleties by not pursuing the point further. Rather, the Popperian position is adopted below Part IV "Evidence from the empirical study of UK data" and the issue of its philosophical rectitude is left to others to debate and criticise.

7.4 SOCIAL CHOICE THEORY

7.4.1 Introduction

Two analyses have led to the literature of social choice theory.

Firstly, in Chapter 5 "Professional accounting standards, the political dimension and economic consequences", it was shown that May & Sundem [1976] argues that professional accounting standards setting processes are themselves social choice processes with an implied objective of social welfare maximisation.

Secondly, in Chapter 6 "Information economics", it was shown that Johnson [1979] argues that there are a number of possible institutional structures for determining professional accounting standards and that there is no rational economic basis for selecting among them; each requires some separate constitutional safeguard acting to defend the "public interest".

Additionally, it is shown, below in both Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes" and in Chapter 12 "Political choice processes" that the characterisation as a social choice process is meaningful. The importance of such a characterisation is elaborated in the following sections.

7.4.2 Social choice and the social welfare function

The literature of social choice theory, or public choice, and the social welfare function has grown considerably over the period since the analyses of Arrow [1963 & 1951] and Black [1948]. Surveys of the field are provided by Mueller [1976], Fishburn [1973] and Sen [1970]. What follows is an elementary introduction to the topic supplemented by elaboration only in so far as is useful to the present study.

Much literature in the social sciences assumes, either implicitly or explicitly, that a goal of collective human behaviour is the maximisation of social welfare. Equally, the literature is agreed that the specification of a social welfare function is problematic. Indeed, Arrow's "Possibility theorem" [1963 & 1951] demonstrated that it is only possible to determine a unique social welfare function by violating one or more of the following four conditions

- 1 all logically possible orderings of the alternative social states are admissible [1963, p.96];
- 2 the choice between two alternatives depends only on the preferences of individuals concerning those two alternatives, (the independence of irrelevant alternatives) [1963, p.98];
- 3 if every individual prefers x to y , then so does society (the Pareto principle) [1963, p.96];
- 4 the social welfare function is not dictatorial [1951, p.30].

Arrow's result then states, in other words, that, under the specified conditions, social choices are indeterminate. The result of such indeterminacy would be instability of choice, with a constant recycling of alternatives. Nevertheless, society is not unstable. Much behaviour is orderly and, to some extent, predictable. So then, the interesting question is "What mechanisms are there that operate on individual preferences such that they do not generate unstable choices?". Black [1948] elaborated one of these mechanisms in his work on the preference structure of committees. Black's contribution was to demonstrate that if individual preferences were "single-peaked", in the sense

that there is a single maximum, then a unique preference function is determinable. Generalising, it can be said that

if individual preferences can be constrained then, there exist circumstances under which a social welfare function can be determined.

This is an important result. For in a sense, it can be seen as a clue to a possible re-interpretation of the purposes of the present study. That re-interpretation would suggest that the present study investigates the structure of constraints on individual preferences such that professional accounting standards are determined in the UK. This notion of the investigation of the structure of constraints on preferences is seen again below in Chapter 12 "Political choice processes" to be advocated by Riker [1980].

Black's result violates one of Arrow's essential conditions. Reflecting on those conditions, it can be seen that preferences are constrained as everyday occurrences. There are some activities in which individuals are not permitted to engage without fear of penalty. There exists a coercive force, namely the penal system of the law, by which individuals can be restrained from engaging in some of these activities. That is not to say that preferences have been constrained into "single-peakedness", but Black's constraint may be but a single example of a class of constraints under which a unique social welfare function is determinable. Arrow's conditions are not, then, as reasonable as seems at first sight. One of them, at least, does not accord with the social world. That is, not all logically possible orderings of the alternative social states are admissible. The contribution of Arrow's work is the formal statement that unconstrained freedom in social choice and a stable social structure are inconsistent with each other.

Constraints that operate on individual preferences to generate stability of social choice can be identified. Trivially, there is the coercive force of the State. In a sense this represents the dictatorial imposition of a class of preference rankings and so identifies a breach in Arrow's fourth condition. The social structure is subtle, though, and many other constraints to preferences exist. For example

- 1 economists have identified a set of constraints they call "market forces". In the firm, market forces operate to determine output prices;
- 2 political theorists have identified a set of constraints they call "institutions". The family is an institution; and, in the firm, the audit is an institution [Thornton 1979];
- 3 sociologists have identified a set of constraints they call "norms". In the firm, norms might operate to restrict the freedom of the employee to act against the employer's wishes;

The source of each of these constraints may be explained in terms of economic factors; political factors; or sociological factors; or one or more of many other factors depending on the perspective of the analyst. For the purposes of the present study, the sources of these constraints are less important than the fact of their existence. For it is their very existence that enables the social welfare function to be operationalised.

7.4.3 Social welfare maximisation and a conflict minimisation hypothesis

It has been argued above that, if a unique social welfare function has been determined then, Arrow's "Possibility theorem" [Arrow 1963 & 1951] implies that at least one person's preferences must have been constrained. That is, not all logically possible orderings of the alternative social states are admissible, a violation of the first of Arrow's conditions as listed above.

Assuming heterogeneous preferences, there will exist some individuals whose preferences are in conflict with others including, if any, those whose preferences are identically equal to the outcome of social choice. In this sense, conflict is being equated with heterogeneity of preferences. Such conflict could be based on market forces, social norms, psychological needs or what have you. The formulation is general, and everyday experiences confirm that conflicts with roots in religious or political ideology also abound. A natural question is that of how the maximisation of the social welfare function might be operationalised.

As a basis for starting to consider the role of conflict, we can observe that, in some sense, social welfare and social conflict are opposing concepts. In particular, when we have one in abundance we would expect to find less of the other, in short they are at least negatively correlated. Further, it can be observed that many social problems or issues seem to be generated by conflict. Conflict seems to be the natural answer to the question "where do issues come from?". Also, it is possible to characterise decision opportunities as conflict occasions, where if there were no conflict then there would be no underlying ambiguity of choice. The very ambiguity arises from the existence of differing, and so conflicting, preferences for alternative outcomes. Only in the very restricted case of the

decision theoretic approach to problem solving is there no conflict of preference. That case is discussed in more detail below in Chapter 11 "Scientific choice processes".

It can be observed that, although social welfare is not a readily observable phenomenon, it is clear that social conflict is observable. It is conceivable that a scale of conflict measurement might be constructed with, say, conflict in the form of "physical violence" at one extreme and at the other extreme perhaps "mild irritation". It is not suggested that such a scale actually be constructed, rather that a discussion of the possibility of its construction helps to clarify the concept. From the negatively correlated relationship it should be deducible that a non-trivial, that is non-zero, point of maximum social welfare is, in some unspecified way, related to a non-trivial point of minimum social conflict. The elaboration of this relationship is beyond the scope of the present study but is presented as a topic for further research. So, although society cannot easily maximise its welfare function directly, it might operationalise that goal by minimising conflict. A simple corollary then is that evidence of conflict is prima facie evidence of non-optimality.

Empirical meaning is difficult to attach to the concept of social welfare maximisation because of its inherent unobservability. Minimisation of social conflict is considerably more tractable in empirical terms because it is observable. Arrow predicts [1963 & 1951] that no state would occur in which no conflict occurred at all. But it is likely that there is the opportunity to achieve a minimum level of conflict, deviations from which would necessarily be in the direction of increasing conflict and would be evidence of deviation of the social welfare function from its maximal level. This can be summarised as

Social welfare maximisation is related to social conflict minimisation. Evidence of increasing social conflict is prima facie evidence of non-optimality of social welfare.

The precise nature of this relationship is as yet unspecified and its specification provides an opportunity for further research. In particular, such a specification would include a statement of the conditions under which it would be true. A first development of such a specification is presented below in Appendix 7.1 "A conflict minimisation hypothesis".

7.4.4 Conflict minimisation and equity

Myerson [1981], Yaari [1981], Rohrbaugh, McClelland & Quinn [1980], McClelland & Rohrbaugh [1978], Rawls [1974;1971 & 1958] and Sen [1973] are a number of writers who introduce the notion of "equity" (or "fairness" or "justice") into the analysis of social choice. In the following, equity and conflict minimisation are equated. Equity is important to the literature on criteria because of the irrelevance result set out above in Appendix 6.2 "Social welfare maximisation and the irrelevance of Pareto-optimality".

Samuelson discusses two distinct concepts of equity which he says "have lived on in unpeaceful coexistence within Western man these last two centuries" [1969, pp.100-101].

On the one hand Samuelson sees incomes (or wealth) being allocated in order to maximise welfare. Such an allocation process involves redistribution, so making one or more individuals less well-off in order to increase other individuals (and the aggregate) well-offness.

On the other hand, Samuelson sees individuals as comprising an inviolable core of rights the property to which is absolutely unassailable. Arguably these are not inconsistent. For clearly when individuals are considering actions based on preferences then issues become matters of degree. Some (but not all!) individuals appear to be prepared to sacrifice a little of their wealth in order to improve the wealth of others. They make these

sacrifices with no evidence of conflict between the parties and so we infer that their own preferences are (at least in the sense of this partial analysis) being optimised. However, if these same altruistic individuals were coerced into sacrificing all of their wealth, they (but perhaps not all!) would appeal to the existence of their own core of inviolable rights. Each individual's core preferences would of course not necessarily be equal to the core preferences of others. Nevertheless, we can see that Samuelson's dilemma stems (in terms of our analysis) from a false dichotomy. There are not two different types of equity, but simply two different levels of conflict. The individual who feels that his inviolable core of rights is being threatened (or has been violated) will embark on a pattern of conflict behaviour different from the individual whose preferences have been offended only at the margin. The former might well take to the streets and be violent, the latter might well simply curse. The notion of conflict is addressed again in the present study below in Section 12.4 "Power".

By what mechanisms can society, either spontaneously or by means of some social agency, minimise conflict? The above discussion gives an insight into the nature of some of the constraints on preferences by which the social welfare function can be determined. There exists a class of constraints, then, that operate to determine the given level of conflict associated with any social welfare function. Following Riker [1980], discussed below in Section 12.3 "Political institutions", these constraints can be characterised as institutions and, as has been seen, some of these institutions are fundamental to human existence. Other institutions are, although arguably equally fundamental, more in the nature of artifacts which can be engineered at will. Consequently, it is this latter class of institutions which society can use, in a process of social engineering, to minimise conflict. Thornton [1979] has characterised the audit as an institution and other characterisations are to be found in the literature of political theorists. For example, Croham says, of

the UK Civil Service

"fear of producing social inequity is deeply ingrained in Whitehall" [Croham 1981, p.214].

It is arguable that the professional accounting standards setting processes could equally well be characterised as a conflict minimising social institution.

7.4.5 Implications of social choice theory for the study of professional accounting standards setting processes

A first implication for the study of professional accounting standards setting processes is that, given Arrow's four conditions, conflict will always exist between individuals in respect of (a) the existing set of professional accounting standards; and (b) any proposals to change that set of professional accounting standards. Hakansson [1981] illustrates this with an example of a taxi firm. This result applies regardless of whether accounting standards are implicit, as in much of conventional accounting practice, or explicit, as in the requirements of legislation or the requirements of professional institutions. Examples of explicit requirements can be found in the UK 1948 Companies Act and in the Statements of Standard Accounting Practice published by the UK accounting bodies.

A second implication is that the resolution of that conflict will involve the constraining of individual preferences in some undefined way. It has already been noted above that, in an important sense, the exploration of the constraint structure can be seen as part of the objective of the present study.

A third implication is that, if social welfare maximisation is a criterion in any sense embedded in the professional accounting standards setting processes, then there might be conditions under which conflict minimising behaviour would be expected. The discussion above in Section 3.10 "Criticisms of the Accounting Standards Committee" suggests that the ASC might be behaving in this way and so development of the conflict minimisation hypothesis is an important area for further research.

7.5 SUMMARY

The preceding sections have reviewed previous research relevant to the problem of identifying economic processes, other than information economics, which might contribute to an explanation of UK professional accounting standards setting processes. These economic processes have been considered under the headings of rational choice theory, agency theory and social choice theory.

An understanding of these other economic processes underlying the incidence of the economic consequences of changes in professional accounting standards is important. It facilitates an understanding of the factors which determine the preferences of individuals and so their participation in the professional accounting standards setting processes [Watts & Zimmerman 1978].

The rational choice theoretic research is essentially analytic in nature. It has demonstrated, on the basis of a reasonable individual expected utility maximisation criterion, that it is not possible to construct any set of professional accounting standards selection criteria which would guarantee maximisation of an individual's expected utility without that set of criteria, in some way, taking account of that individual's preferences [Demski 1973]. This result has been debated by Chambers [1976] and Cushing [1977]. If the more restrictive assumption is made that the individual's preference function is additively separable, then it is sufficient to select professional accounting standards sequentially without considering the effects of interaction with existing professional standards [Bromwich 1980]. Recognition of heterogeneity of preferences in a multi-person context immediately establishes a conflict between individuals, or classes of individuals, with no subsequent agreement on the desirability of any given accounting information set [Beaver & Demski 1974].

The agency theoretic research is also analytic in nature, but empirical work has been conducted based on the analytic framework. Management's own wealth is seen to be dependent upon professional accounting standards through such factors as non-pecuniary benefits and remuneration contracts which are based on the firm's income. In particular, managements are characterised as having incentives to enter into contracts to publish audited accounting information [Watts 1977]. Having entered into these contracts, management then has incentives to either support or oppose proposals to change professional accounting standards. These incentives are dependent on characteristics of the firms. It is an open question whether or not the agency framework can adequately predict managements' position in relation to specific proposals [Fama 1980]. In the case of inflation accounting, the behaviour of management in the US professional accounting standards setting processes has been shown to be consistent with agency theoretic predictions [Watts & Zimmerman 1978] but a replication in the UK failed to generate unambiguous evidence [Sutton 1980].

In brief then, under the existing institutional arrangements, public accounting information is essentially a supply-side phenomenon, with strong economic incentives for individuals to supply, but limited economic incentives for individuals to demand. Having contracted to supply accounting information, managements have additional incentives to prefer some accounting information over other accounting information. In a multi-person, utility-maximising setting, there is no set of criteria by which a unique solution can be determined to the problem of choice among alternatives for accounting information.

The social choice theoretic research seeks to analyse the structure of choices which are made under these conditions of indeterminacy. Arrow first identified a minimum set of conditions under which this indeterminacy would hold [Arrow 1951] and so implicitly identified the need for additional constraints. One such constraint, the "single-peakedness" of preferences, had already been identified by Black [1948]. In general terms, Arrow's first condition, that all logically possible orderings of the alternative social states are admissible, is the one condition subject to violation by additional constraint. The inadmissibility of some alternative social states can be illustrated simply by drawing attention to the existence of laws prohibiting some alternative behaviours.

Embedded in the social choice theoretic research is the social welfare maximisation criterion [May & Sundem 1976]. It can be argued that social welfare maximisation is related to social conflict minimisation and that evidence of increasing social conflict is prima facie evidence of non-optimality of social welfare. The equity (or fairness or justice) criterion [Samuelson 1969; Rawls 1958] can be equated with a conflict minimisation criterion and there is evidence that such a criterion is institutionalised in the UK Civil Service [Croham 1981].

7.6 CONCLUSIONS

Chapter 6 "Information economics" and Chapter 7 "Other economic processes" have together demonstrated that there are gains available to individuals who hold private accounting information and can control the subsequent publication of that information. The existence of these gains arguably provides sufficient incentive for individuals to hold preferences in favour of some classes of accounting information as against other classes. Such is the economic rationale for participation in professional accounting standards setting processes.

The economic rationale for participation is not sufficient to explain the resultant choices of professional accounting standards. Firstly, the aggregation of individual preferences is indeterminate and, secondly, there exists no unique social preference function by which that indeterminacy can be resolved. It follows that the general problem of the present study (namely, the exploration of factors which might be used to explain the processes by which UK professional accounting standards are determined) can be characterised as an investigation of a social choice process in which non-economic criteria play an important part. Such is the rationale for the existence of a political dimension to professional accounting standards setting processes.

Given that there is no unique solution to the problem of choice amongst alternatives for accounting information, there is a natural and clear interest in the structure of the present, existing, solution. Two important contributions have been made by the dissertations of Sutton [1980], reviewed in the present chapter, and Johnson [1979], reviewed above in Chapter 6 "Information economics".

Firstly, Johnson identifies different institutional arrangements under which professional accounting standards might be selected. Among the objectives of those arrangements, the usual economic criterion of Pareto-optimality is central although non-economic alternatives are clearly seen to be possible.

Additionally, Johnson's review suggests the following areas for further research specifically based on existing professional accounting standards setting processes:

- 1 to what extent do existing professional accounting standards setting processes incorporate the Pareto-optimality criterion?
- 2 to what extent do existing professional accounting standards setting processes overcome incentives to misrepresent preferences?
- 3 to what extent do existing professional accounting standards setting processes incorporate a power dominated objective?

Secondly, Sutton has demonstrated that the theoretical frameworks being developed in a predominantly US orientated literature have potential application to the UK professional accounting standards setting processes. Sutton also argues that an adequate explanation of the professional accounting standards setting processes must take into account the political nature of those processes. Such an argument is supportive of the discussion in Chapter 5 "Professional accounting standards, the political dimension and economic consequences".

Clearly, before substantial progress can be made in investigating UK professional accounting standards setting processes it is important to review the empirical studies which seek to investigate and explain that political dimension. Such a review is undertaken in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes".

APPENDIX 7.1: A CONFLICT MINIMISATION HYPOTHESIS

Development of a conflict minimisation hypothesis

DEFINITION 7.1.1: Assume a society, S , of individuals, k , with individual preference functions, P_k , mapping the set, C , of commodities onto individuals, j . Then we can write

$$P_k = \{(j, c_{ij}^k)\}$$

where j is the j th individual, and

c_{ij}^k is the amount of the i th commodity allocated to the j th individual under k 's preference function, P_k .

Clearly, P_k can be presented by a simple matrix whose elements are c_{ij}^k .

DEFINITION 7.1.2: Assume there exists a social welfare function, W , mapping the commodity allocations, c_{ij}^k , onto the real line.

Then we can write

$$W = \{(c_{ij}^k, w_{ij}^k)\}$$

where w_{ij}^k is the welfare measure of the amount of the i th commodity allocated to the j th individual under k 's preference function, P_k .

DEFINITION 7.1.3: A non-trivial "state of equity" can be said to exist when

$$w_{ij}^k - w_{ij}^l = d_{ij}^{kl} = 0, \text{ and} \\ w_{ij}^k \neq 0 \text{ and } w_{ij}^l \neq 0$$

for all individuals, j , k and l , belonging to S , and for all commodities, c_i , belonging to C .

In words, a non-trivial "state of equity" exists when the welfare measure of the amount of the i th commodity allocated to the j th individual is the same under the preference functions of all individuals.

DEFINITION 7.1.4: Conversely, we can define a "state of conflict" to exist when

$$w_{ij}^k - w_{ij}^l = d_{ij}^{kl} \neq 0$$

for at least one pair of individuals, j, k or l , belonging to S , and for at least one commodity, c_i , belonging to C .

Clearly, d_{ij}^{kl} is a measure of conflict.

On the observability of conflict

It is possible to distinguish between observable conflict and unobservable conflict by assuming the existence of a threshold below which conflict is unobservable.

DEFINITION 7.1.5: Conflict can be said to be unobservable if there exists some value, e_{ij}^{kl} , such that

$$0 < d_{ij}^{kl} < e_{ij}^{kl}$$

Conversely, conflict can be said to be observable if

$$0 < e_{ij}^{kl} < d_{ij}^{kl}$$

ASSUMPTION 7.1.1: All conflict is observable. That is

$$e_{ij}^{kl} \text{ tends to zero.}$$

That is, we assume $d_{ij}^{kl} \neq 0$.

Assumption 7.1.1 has empirical meaning in that it is only possible to minimise a variable to the extent that it is observable or otherwise measurable. Once a variable becomes unobservable, either directly or indirectly, then it is for all practical purposes equal to zero.

Application to the linear weighted social welfare function

In the most general of terms, and following McClelland & Rohrbaugh (1978), the social welfare function can be characterised as the linear weighted sum of two independent variables, efficiency and equity, as follows

$$W = aU + bE, \quad a + b = 1 \quad \text{and} \quad 0 < a, b < 1$$

where U is usual utilitarian concept of efficiency, that is

Pareto-optimality; and

E is any selected concept of equity.

Clearly, this characterisation admits the possibility of equity being weighted to zero, in which case the social welfare function becomes the usual efficiency criterion of economic theory, that is, Pareto-optimality. Additionally, it admits the possibility of efficiency being weighted to zero, in which case the social welfare function becomes strictly egalitarian. Within this framework, an interesting research question becomes one of determining the deviation from the "centrist" weightings of

$$a = b = 0.5$$

Somewhat less agreement exists amongst theorists on the specification of a criterion for equity than on the specification of a criterion for efficiency. Pareto-optimality is universally adopted as a workable efficiency criterion.

THEOREM 7.1.1: It follows that there exist conditions under which the problem of maximising the social welfare function, W , corresponds to a problem of minimising d_{ij}^{kl} , that is minimisation of conflict.

Further, research needs to be conducted to identify and explore these conditions.

Exploration of conditions for conflict minimisation to equal social welfare maximisation

Efficiency and equity are dependent to the extent that they are both functions of individual preferences. That is both

$$U = f(P) \quad \text{and} \quad E = g(P)$$

where f and g are the functional operators translating individual preferences, P , into efficiency and equity respectively.

By inverting the functions and putting $f^* = fg^{-1}$ then $U = f^*(E)$.

Substituting into the linear weighted social welfare function gives

$$W = a.f^*(E) + b.E \quad , \quad a+b = 1 \quad \text{and} \quad 0 < a, b < 1$$

Now if we define the social welfare function as a mapping onto the interval $\{0,1\}$ of the real line, then we can define a conflict function, $D = 1 - E$, which satisfies the properties of Definition 7.1.4 above. Substituting again, we get

$$W = a.f^*(1-D) + b.(1-D)$$

which is a maximum when

$$\frac{df^*}{dD} = -b/a \quad \text{and} \quad \frac{d^2f^*}{dD^2} = +ve$$

These conditions clearly define a curve convex to the origin and a point on that curve for which the slope is $-b/a$.

Further elaboration of the relationship between social welfare maximisation and conflict minimisation is not central to the present study and will not be undertaken here. It is, however, put forward as a promising area for further research.

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**CHAPTER 8 EMPIRICAL STUDIES OF THE POLITICAL DIMENSION IN
PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES**

8.1 Introduction

**8.2 Empirical studies of the political dimension in
professional accounting standards setting processes**

8.3 Summary

8.4 Conclusions

CHAPTER 8 EMPIRICAL STUDIES OF THE POLITICAL DIMENSION IN
PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES

8.1 INTRODUCTION

This chapter reviews empirical studies of the professional accounting standards setting processes in which the political dimension is the primary focus of interest.

The context within which professional accounting standards are to be found is characterised as one of heterogeneous interest groups, collectively known as the constituency. An important feature of the studies reviewed is their interest in the nature and preferences of the constituency.

The study of the political dimension in professional accounting standards setting processes is at an early stage of development. Because of this, no attempt is made in this study to offer a comprehensive criticism of each individual study. In particular, it would be unrewarding because every piece of empirical work in such an ill-developed area must necessarily be subject to inadequacies of data generation and data analysis. Such generalisations as are made are restricted to the underlying approach to the theoretical analysis and its relationship to the data analysis.

8.2 EMPIRICAL STUDIES OF THE POLITICAL DIMENSION IN PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES

Watts & Zimmerman [WZ 1979] characterises professional accounting standards setting processes as being embedded within a wider, political, environment in which intentional wealth and welfare redistributions are made [p.280]. This political environment includes the activities of the legislature; regulatory agencies, such as the US SEC, the UK Department of Trade and the UK Monopolies and Mergers Commission; and professional accounting standards setting bodies such as the US FASB and the UK ASC. Within such a framework WZ 1979 characterises two separate groups of individuals, namely the regulators and the regulated. The WZ 1979 thesis is, essentially, that rational self-interested individuals belonging to either group have incentives to adopt accounting theories which support their positions. On the one hand regulators have incentives to demand theories that enable them to make predictions about the consequences of their regulations; and on the other hand, the regulated have incentives to demand theories which favour the positions they adopt in supporting or opposing proposals [pp.281-285].

Given that there exists a demand for differing accounting theories and given that

"there exists a large number of individuals who are able to supply a wide diversity of theories at relatively low cost, then supply will be very responsive to demand" [p.286].

With this assertion, WZ 1979 proceeds to argue that there exists a market for accounting theories. Existence is demonstrated empirically by investigating three issues, namely depreciation accounting by early railway companies; the effects of taxation legislation on depreciation accounting; and the effects of government intervention both in the US and in the UK.

In addition to the more fundamental criticism of the theoretical underpinnings of this study and others made by Christenson [1983] and reviewed above in Chapter 7, "Other economic processes", a number of other criticisms can be made of the WZ 1979 study.

Firstly, the arguments used to deduce the hypothesis that there exists a market for accounting theories are often assertive. For example, a crucial assumption that "the predominant contemporary demand for accounting theories (the demand for accounting in a regulated economy) is the demand for justifications" [p.286, emphasis added], is not argued fully. Only the existence of such a demand is argued; its predominance is asserted.

Secondly, the empirical evidence presented is insufficient to adequately distinguish the events by which the hypotheses can be tested. For example, WZ 1979 predicts that new accounting theories will emerge, or existing accounting theories will change, "when a new law is passed which impinges on accounting practice" [p.289]. The implication here is clearly that the legislative intervention causes the theory shift. However, in the cited case of the UK railway company legislation and the depreciation accounting literature, the first recorded literature preceded the 1844 legislation by three years, whereas in the US the first recorded literature succeeded 1837 legislation by 13 years. Such evidence appears to be internally inconsistent and worthy of alternative explanation not offered by the study.

WZ 1979 is sensitive [p.289] to criticism of the empirical evidence and presents such evidence as a preliminary stage of theory development. At the time of writing no further studies have been conducted to present additional evidence of tests of the hypothesis that there exists a market for theories.

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The WZ 1979 study is important, however, because of its characterisation of the accounting environment as a political one in which rational, self-interested, individuals use arguments, or accounting theories, to support their positions on specific proposals. This framework clearly extends to proposals to change professional accounting standards and, as such, offers a contribution to an understanding of the factors which explain how professional accounting standards setting processes.

Some studies of the political nature of the US professional accounting standards setting processes are now reviewed in detail.

An investigation by the Financial Accounting Foundation [FAF 1977], which is the governing body of the US FASB and is established as a trust, sought to survey opinion concerning the FASB. The present study is not concerned with the substance or the results of that survey, although its findings of the survey are reproduced in Appendix 3.6 "Findings of the US Financial Accounting Foundation's survey of opinion on the US Financial Accounting Standards Board" as comparative material. Of interest is the fact that, in conducting their survey, the FAF adopted a framework which emphasised "constituency relationships". Within this framework, the report discusses analogies with "democratic", "legislative" and "political" procedures. Each such procedure is rejected in turn by the authors as not describing the US accounting standards setting processes adequately. The argument is quoted in full below

"(the US accounting standards setting processes are not democratic) because standard setting requires some perspective (and so) it would not be appropriate to establish a standard based solely on a canvass of the constituents. Similarly, the process(es) can be described as legislative because (they) must be deliberative and because all views must be heard. But the standard setters are expected to represent the entire constituency as a whole and not be representatives of a specific constituent group. The process(es) can be described as political because there is an educational effort involved in getting a new standard accepted. But it is not political in the sense that an accommodation is required to get a statement issued." [p.19]

From this quotation it is clear that the US professional accounting standard setters see the outcomes of the US professional accounting standards setting processes as being dependent, at least to some extent, on the preferences of individuals. Recall that this is supported by the review, in Chapter 6 "Economic processes", of the rational choice theoretic research, and in particular Demski [1973], which argues that the goal of maximisation of individuals' expected utilities implies that individuals' preferences be taken into account.

Following on almost directly from the publication of the FAF survey's emphasis on individual preferences through its "constituency relationships" framework, the following four US research studies, Porter [1979], Sharp [1979], Burke [1978] and Klein [1978], each sought to investigate the nature of those relationships.

Burke [1978] surveyed attitudes in the US towards participation in the accounting standards setting processes of the FASB. Burke argued that both FAF [1977] and Metcalf [1977] had called for a greater understanding of participation in the US accounting standards setting processes and that no existing research had been conducted into attitudes towards participation. Using a mail questionnaire designed to elicit attitudes, Burke presented some 100 statements to the respondents and asked them to state whether or not they agreed. The sample was designed to cover all occupational groups as a basis for distinguishing between those which had participated in the FASB processes and those which chose not to do so. No particular hypotheses were being tested and

"overall, the search was directed at obtaining information potentially useful in developing an information base" [p.32].

From the results, Burke concludes that the respondents generally showed strong positive attitudes which "augurs well for the profession", [p.73]. Limitations of the study identified by Burke included potential misrepresentation by respondents; inability to predict behaviour from attitudes, except to the extent that attitudes are the subject of interest, such as would be the case with written or spoken behaviour. On the problem of predicting behaviour from attitudes see, for example, Bentler & Speckart [1979].

Burke's study is subject to the criticism that, by design, it contributes virtually nothing to theory construction. Such limitations as no testing of hypotheses and no predictive value of results are recognised by Burke. Suggestions for further research in effect, ask others to infer meaning into the data reproduced in the form of appendices to the dissertation

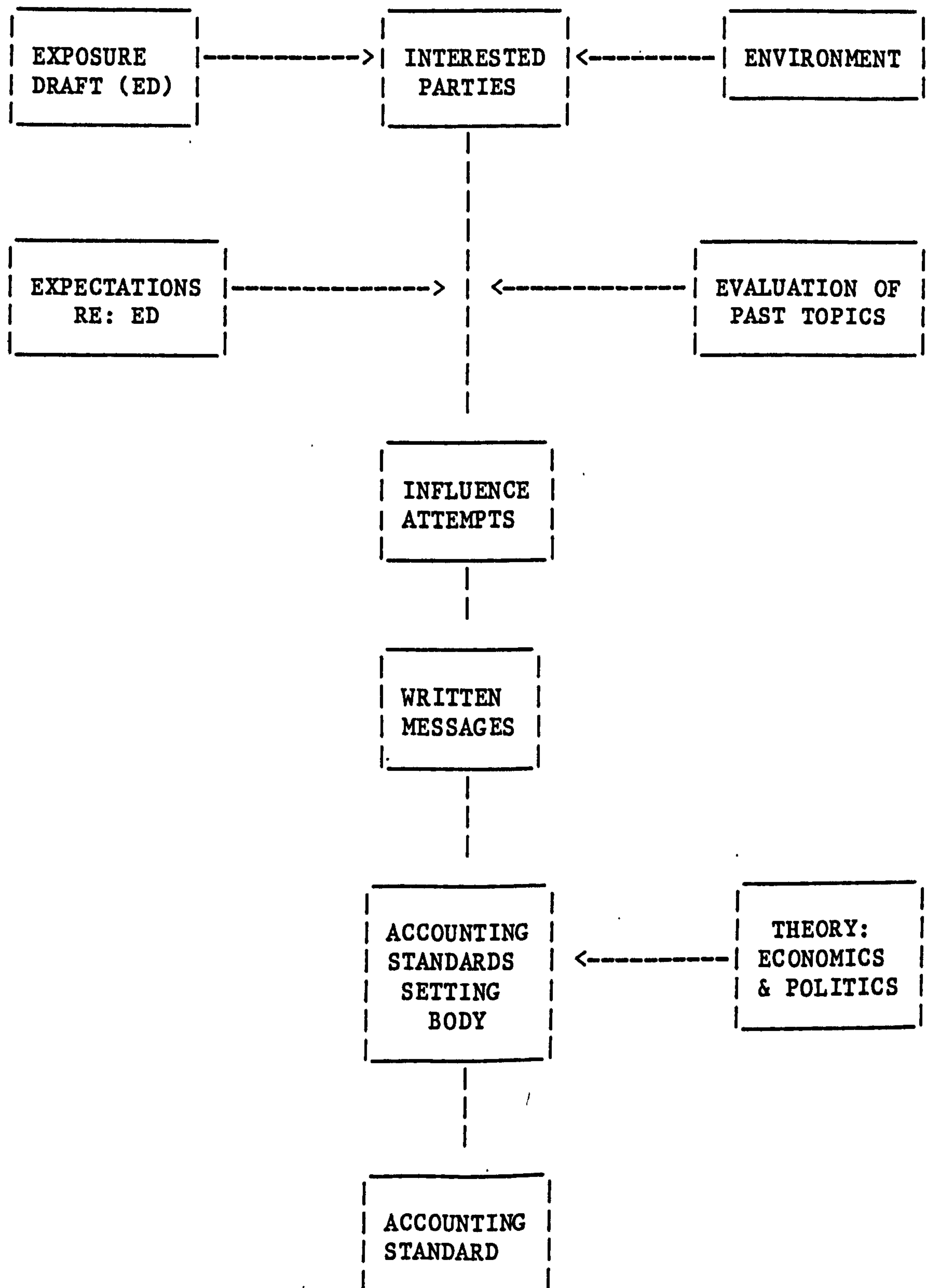
Nevertheless, the Burke study is of value for two reasons.

Firstly, it demonstrates that there is some variability in the structure of preferences on the US professional accounting standards setting processes themselves, that is, the narrative question of which processes should be adopted is not a trivial problem.

Secondly, and more importantly, it demonstrates somewhat vividly the inadequacies of attitude or preferences research, when conducted in isolation from a theoretical framework. Such a framework might possibly be constructed either by surveying attitudes repeatedly over time to determine what factors might influence preferences; or by including a survey of attitudes within a more comprehensive study of inter-related factors. This latter research method was adopted by Klein [1978] who sought to investigate the influence of outside parties on the FASB.

Klein [1978] analysed stated preferences in the responses to the US exposure draft "Financial reporting for segments of a business enterprise", published by the FASB in September 1975. As with Burke's study, no testable hypotheses were developed. Motivation for the study was based on a desire to answer the question "Is the nature of the US financial accounting policy-making process such as to explain the consistent appearance of severe criticism?". No evidence of the existence of severe criticism was provided. In discussing the US professional accounting standards setting processes, Klein models those processes as set out below in Figure 8.1 "Klein's 'Message flows' model of accounting standards setting processes".

FIGURE 8.1 KLEIN'S "MESSAGE FLOWS" MODEL OF ACCOUNTING STANDARDS SETTING PROCESSES



Source: Klein [1978, p.9] "The influence of outside parties on the Financial Accounting Standards Board"

Klein [1978] characterises accounting standards setting processes modelled in Figure 8.1 "The influence of outside parties on the Financial Accounting Standards Board" above, as primarily uncertain and multidimensional. He argues as follows

- 1 uncertainty derives from a lack of information about the alternatives available and the possible future states. However, Klein cites Thompson [1967, p.134] as arguing that, even in cases of complete information, the decision is only analytical if decision makers have homogeneous preferences. If preferences are heterogeneous then the decision is political rather than analytical. This is consistent with the analysis of Beaver & Demski [1974] reviewed in chapter 6 "Economic processes" above;
- 2 multidimensionality derives from "well known", but unspecified, dimensions. Impliedly, Klein has in mind such factors as time, available alternatives, economic consequences, individuals preferences and future states.

Given the primary factors of uncertainty and multidimensionality, Klein adopts the Thompson & Tuden [1959] typology of organisational decision-making styles, discussed in greater detail in the present study in Chapter 13 "Organisational choice processes", as a convenient method of classifying issues faced by the US FASB. Klein's representation is reproduced below in Figure 8.2 "Klein's 'FASB issues typology and manners of resolution'".

FIGURE 8.2 KLEIN'S "FASB ISSUES TYPOLOGY AND MANNERS OF RESOLUTION"

Beliefs about causal relation between solution and expected result	Preferences for believed result	
	Agreement	Disagreement
Agreement	I Analytical resolution	II Political resolution (Compromise)
Disagreement	III Consensual resolution (Judgement)	IV Innovative search (Policy Delphi)

Source: Klein [1978, p.33] "FASB issues typology and manners of resolution". Based on Thompson & Tuden [1959, p.78], reproduced below as Figure 13.1 "Thompson & Tuden's typology of decisions".

Klein [1978] discusses this typology of issues by suggesting that

- 1 an issue located in Cell III "Consensual resolution" can be relocated into Cell I "Analytical resolution" by increasing the information set or by simplification of the issue;
- 2 an issue in Cell II "Political resolution" can be identified when arguments are seen to be consistent but preferences are polarised; and
- 3 the US accounting standard setting processes are located in Cell IV "Innovative search", that is
"for these issues the FASB is forced to take the role of a policy Delphi, employing innovative search techniques in order to alternatively acquire and disseminate information regarding (1) a definition of the issue, (2) the variously perceived relationships between suggested solutions and expected impacts, and (3) the different impact preferences" [p.35].

Clearly, Klein sees the role of information as being important in US accounting standards setting processes in as much as (a) these processes may in fact be located in any of the four "cells"; and (b) the role of information is highlighted as being important to cells III and IV. Within this framework, Klein characterises the written responses to exposure drafts as containing information, or messages, which the FASB can use to resolve issues. Klein's study aims to discover the information contained in those messages and then to determine whether or not that information influenced, that is, is reflected in, the final outcome.

In order to operationalise that objective, Klein selected the technique of content analysis. A programme of seven crucial stages was utilised and these are set out below in Figure 8.3 "Klein's stages in content analysis".

FIGURE 8.3 KLEIN'S STAGES IN CONTENT ANALYSIS

<u>Stage</u>	<u>Operational procedure</u>
1 Choose messages	Use responses to exposure draft on segmental reporting
2 Choose characteristics to be detected in message	Use "general", "topical" and "fundamental". Variables, 151 in total, derived from 1 in 10 pilot survey of responses and from literature review
3 Define context units and recording units	Use sentence or paragraph for context unit and word or sentence for recording unit
4 Construct a dictionary	Each variable represented by expression such as "statement present indicating..."
5 Develop a coding scheme	116 out of the 151 variables represented by binary relations, 0 or 1, for which the mean of all responses is meaningful
6 Select judges	Klein used only himself
7 Code the responses	Read the responses and code them

Source: Klein [1978, pp.50ff]

From the subsequent data analysis, using the frequencies of occurrence, Klein selected as "interesting" those variables for which

- 1 the proportionate occurrence was greater than, or equal to, one half; and
- 2 the proportionate occurrence for at least one sub-group was greater than, or equal to, two thirds, while the proportionate occurrence for at least one other sub-group was less than, or equal to, one third.

Clearly, in making such selection criteria, Klein is using an implied heuristic procedure to identify variables for which either there exists general agreement on the relative importance; or a degree of conflict exists. Using the above criteria, the following seven "interesting" characteristics of the responses were identified [pp.157ff]

- 1 users of accounts predominate, being 85% of all responses;
- 2 there was a pervasive concern about regulations and federal agencies;
- 3 prominent technical criteria were "comparability" and "relevance". Users of accounts expected an increase in comparability but, overall, respondents expected a fall in comparability;
- 4 respondents were generally reluctant to report segmental information in quarterly statements;
- 5 users of accounts raised different functional issues from those raised by preparers of accounts;
- 6 respondents belonging to the accounting profession were from either the major (Big 8) accounting firms or from representative associations. There was no real response from small accounting firms; and
- 7 the major (Big 8) accounting firms were concerned with information production problems, whereas the other (as distinct from small) accounting firms were more concerned with information disclosure problems.

Similarly, the following three "interesting" relationships were identified

- 1 although FASB board members all have backgrounds from the major (Big 8) accounting firms, the positions of those accounting firms were not reflected in the final accounting standard;
- 2 of the ten key issues raised by respondents, four were reflected in the final accounting standard. These served to enhance the clarity and implementation of the proposal; and
- 3 respondents requests for a statement distinguishing between which disclosures are "desirable" and which are "required for a fair presentation" were not met.

From the above Klein draws the following conclusions [pp.162-170]

- 1 the exposure draft is more than a proposal. It is a means by which the FASB can (a) "test market" a proposal; (b) extend its boundaries; and (c) update its own information on interested parties;
- 2 the FASB is more than simply a rule-maker. It serves to buffer those who prepare accounting information from (a) Government agencies; and (b) users of accounting information. It also serves to pre-condition users and preparers to new requirements; and
- 3 "the process ... invites criticism. The fact that this criticism exists is not so important as the manner in which it is handled" [p.170, emphasis in original].

It is difficult to see how Klein's results support his conclusions for they are not based on his data. They are better interpreted as well-informed comment.

Klein identifies limitations to his study as including the subjectivity of his own coding of the content analysis. This he tried to control by (a) using a panel to verify his coding; and (b) testing his own coding over time for consistency. Neither were completely satisfactory. The panel could not cope with the task, and his own identification of variables produced a greater number on a second trial. Klein also identified further areas for research as follows

- 1 repeat his study over more issues;
- 2 study the attitudes of respondents, FASB board members and FASB staff members;
- 3 examine the process of conflict resolution;
- 4 analyse the sensitivity of the content analysis to changes in the parameters; and
- 5 use his description of the US professional accounting standards setting processes as a source of testable hypotheses.

Klein's study is subject to similar criticism as that addressed to the Burke [1978] study. Both are primarily concerned with attitude testing and both fail to develop any testable hypotheses.

Klein [1978] can be distinguished from Burke [1978] in that the former attempts to develop a theoretical framework within which the results of the study can be considered. The framework is that of the Thompson & Tuden [1959] typology of organisational decision-making styles. Klein has made a valuable contribution in identifying this framework, which this present study discusses in greater detail in Chapter 13 "Organisational choice processes" below. Unfortunately, having identified the framework, Klein fails to explore its relationship with the results of his study. The results are simply presented with no further discussion of their implications for the framework.

Klein's results are analysed here in terms of that framework. This analysis is not to be found in Klein's study and can be regarded as an extension of that work.

Firstly, Klein's second and third "interesting" relationships identified quite clear evidence that there is a relationship between the "written messages" and the "Accounting standards setting body" components of his model presented above in Figure 8.1 "Klein's 'Message flows' model of accounting standards setting processes". From this can be deduced that the model is potentially valuable in explaining those processes, and that some, but not all, preferences expressed at the "written messages" stage are translated through to the "Accounting standard" stage. Implicit, then, is an element of conflict between those whose preferences are met and those whose preferences are not met. Klein does suggest that the process of conflict resolution be examined further.

Secondly, Klein characterises the activity within the "Accounting standards setting body" stage of his model as organisational decision-making. This is implicit in his use of the Thompson & Tuden typology of organisational decision-making styles. Klein did not explicitly test this implied characterisation. The results nevertheless provide evidence that, if such a characterisation is valid then, the heterogeneity of preferences locates the accounting standards setting processes in either Cell II "Political resolution" or Cell IV "Innovation search" of Figure 8.2 "Klein's 'FASB issues typology and manners resolution'". Clearly, it is important to further investigate the nature of professional accounting standards setting processes characterised as organisational decision-making processes and this is discussed more fully in the present study in Chapter 12 "Organisational choice processes".

Porter [1979] is the third of the four studies which seek to develop the "constituency relationships" framework of FAF [1977]. Following May & Sundem [1976], Porter characterises the US professional accounting standards setting processes as a policy-making process. Porter asserts that the primary function of the policy-makers, that is the FASB, is that of conflict resolution. An historical perspective is developed in which the lack of an explicit and constitutional authority to set accounting standards is argued to be problematic. In attempting to resolve that problem, the US accounting profession [the AICPA] has handed authority to the FASB but Congress has asserted itself as a higher authority on such issues as accounting for investment credits and accounting by oil and gas producing companies. Those issues were discussed earlier in the present study in Chapter 3 "The Accounting Standards Committee", Section 3.8 "International comparisons".

Porter argues, citing Greenwood [1957, p.46], that the literature of the sociology of the professions suggests that, in general, technical decisions are kept within professions such as the accounting profession but that there is always a threat of veto or withdrawal of concurrence by some higher authority, namely the State

"because of this possibility of revocation, the views of interested parties ... continue to have importance in the standard setting function". [Porter 1979, p.44].

Porter sees the quest by the FASB for a conceptual framework for accounting standards as a reaction to the criticisms of those parties who could potentially withdraw their support. Such a reaction is clearly seen by Porter as consistent with the sociology of the professions literature. This, according to Porter, is increasingly being seen as a naive reaction by writers such as AAA [1977], Armstrong [1976], Horngren [1976, 1973 & 1972], Moonitz [1974], Seidler [1974] and Gerboth [1973, 1973 & 1972]. Somewhat similar conclusions were drawn in a UK study of the topic in Macve [1981].

From the US debate focussing on the quest for a conceptual framework for accounting standards, Porter sees three distinct schools of accounting thought

- 1 the analytical school, represented by Chambers [1973];
- 2 the political school, represented by Gerboth [1973]; and
- 3 the quasi-political school, represented by Horngren [1976].

Porter sees the "quasi-political" school as arguing for political selection amongst analytical alternatives. The selection subsequently being enforced by sanction. Porter's argument continues [p.47] that the institutional problem, of a professional choice always being subject to veto by others, implies that professional accounting standards setting processes can never be strictly judicial, that is analytic, and must be quasi-political. From such a perspective, Porter adopts March & Simon [1958] as a framework for analysing the process of conflict resolution. This use of March & Simon [1958] can be compared

with Klein's use of the Thompson & Tuden [1959] framework to the extent that both are concerned with organisational decision-making processes. As already noted, the present study undertakes a further analysis of organisational decision-making processes in Chapter 13 "Organisational choice processes".

Porter uses the March & Simon [1958] analysis to classify [p.60] sources of conflict under the three headings of

- 1 intra-individual conflict. Being
 - (a) unacceptability of alternatives;
 - (b) incomparability of alternatives; and
 - (c) uncertainty of consequences of alternatives;
- 2 intra-group (or profession) conflict. Being
 - (a) dependence on limited resources;
 - (b) pressure to achieve uniformity;
 - (c) variations in goals;
 - (d) subjective operationalisation of various goals; and
 - (e) interaction of different goals and perceptions; and
- 3 inter-group (or constituency) conflict. Being
 - (a) dependence on limited resources;
 - (b) pressure to achieve uniformity;
 - (c) variations in goals;
 - (d) subjective operationalisation of various goals; and
 - (e) interaction of different goals and perceptions.

The effects of the inter-group, or constituency, sources of conflict will be, in Porter's view, more extreme than in the case of intra-group, or profession, sources because of the increased population heterogeneity.

Additionally, Porter uses the March & Simon [1958] analysis to classify [p.60] processes of conflict resolution under two further headings

- 1 analytic conflict resolution. Being
 - (a) problem solving when objectives are shared; and
 - (b) persuasion when higher-order objectives are shared; and
- 2 political conflict resolution. Being
 - (a) bargaining when no objectives are shared but a fixed arena is agreed; and
 - (b) political when no objectives are shared nor is a fixed arena agreed.

Citing Wyatt [1977 p.94] in support, Porter asserts that the professional dimension of accounting standards setting processes ensures that the bargaining aspect of the conflict resolution process will be ignored by the accounting profession and, in the US, by the FASB. The result is a policy-making process which is a mixed bargaining and analytic process and which has earlier been labelled a "quasi-political" process. This can be contrasted with the Hussein [1981 & 1977] characterisations of the process, as a mixed diffusion of innovation and bargaining process, reviewed above in Chapter 5 "Professional accounting standards, the political dimension and economic consequences."

Porter's analysis immediately generates [p.65] two hypotheses for subsequent testing, namely

- H₁ Analysis of constituency responses will reveal the source of political pressure and the preferred solution; and
- H₂ The FASB will not proceed against its constituency advice when the issue is one about which the constituency has strong feelings and is united.

Developing the policy-making perspective, Porter deduces two further hypotheses.

Firstly, the professional accounting standards setting processes are said to be like an open system (for example, Lowe, Puxty & Tinker [1979] and Bertalanffy [1968]), in which different constituency groupings are affected by different issues. The policy-makers exercise their own value-judgements about "whose input is relevant" [p.66, emphasis in original], and may well balance issues with others either current or future, a practice known as log-rolling and discussed further in Chapter 12 "Political choice processes". Future issues may include reconsiderations of existing issues and an incrementalist policy (for example, Gerboth [1972] and Lindblom [1959]) may incorporate such reconsiderations. In professional accounting standards setting, consideration of constituency responses might correspond to testing policy increments for acceptability. From

this analysis, Porter generates [p.69] the third hypothesis for subsequent testing, namely

H₃ Constituency coalitions shift as issues change, therefore policy decisions between specific issues will not necessarily be consistent and cohesive.

Secondly, Porter repeats Gergen's [1968, pp.184ff] argument that identification of influential individuals in a policy-making process is important to explaining that process but in itself problematic. Such an identification can be approached by modelling three relevant characteristics of individuals involved as follows

- 1 issue relevance, which depends to a greater or lesser extent on the way in which an issue can modify the individual's status quo. This is clearly the "economic consequences" argument discussed above in Chapter 5 "Professional accounting standards, the political dimension and economic consequences";
- 2 sub-phase resource, which depends on which sub-phase(s) of the policy-making process the individual has resources concentrated. Gergen indentified the following sub-phases
 - (a) initiation - participants are very influential
 - (b) staffing and planning - planning reduces alternatives;
 - (c) communication and publicity - role of media in accounting is small;
 - (d) institutional sanction - in the US: AICPA & SEC;
 - (e) intra-elite organising - coalition formation;
 - (f) financing - not important in accounting;
 - (g) sanction and control - enforcement and audit.
- 3 personal efficacy, which depends on the individual's own personality factors such as leadership characteristics.

From this last analysis, Porter generates the fourth hypothesis for subsequent testing, namely

H₄ Groups will act in their own self-interest and resist any accounting standard which has a perceived negative impact.

This last hypothesis is clearly consistent with the Laughlin & Puxty [1981] arguments, reviewed above in Chapter 5 "Professional accounting standards, the political dimension and economic consequences", that firms will aggressively deal with anything that threatens survival.

In order to operationalise the objective of testing the hypotheses, H_1 to H_4 , Porter followed Klein [1978] and selected the technique of content analysis, citing both Klein [1978] and Holsti [1969] as principal references, applied to the stated preferences to be found in the written responses to a proposed professional accounting standard. The issue selected by Porter was that of accounting for troubled debt restructurings; this issue resulted in the publication of US accounting standard SFAS 15 "Accounting by debtors and creditors for troubled debt restructurings" [FASB 1977]. This was chosen by Porter because its controversial nature suggested a significant level of conflict.

Porter's results are presented in the form of extensive reproduction of tables of summarised data. Each table is supported by brief commentary. At no stage are the hypotheses H_1 to H_4 tested, a remarkable omission in view of the care with which they were argued. Such non-quantitative results as are presented take the form of the following answers to the indicated questions [pp. 213 -220]

- 1 Who? Bankers' response rates were high and non-bankers' response rates were low relative to the proportions found in the FASB mailing list;
- 2 Why? Bankers' perceived a negative impact on their financial statements implying a high level of conflict, whereas non-bankers perceived minimal impact on their financial statements implying a low level of conflict;
- 3 How? Bankers used no analytical argument, presenting only declarative statements, whereas non-bankers used a higher degree of analysis. In particular, accountants did not use economic consequence arguments whereas non-accountants did;
- 4 What? Non-accountants objected to the piecemeal introduction of "value accounting" whereas accountants, who possibly perceive "value accounting" as a pervasive issue, tended not to comment on pervasive issues;
- 5 With what effect? A major change, between the initial proposal for a "value accounting" solution, and the final published standard of an "historic accounting" solution, was observed although the data was not sufficient to determine whether this was due to "political action". Minor changes were also observed which were probably aimed at improving implementation.

From the above results, Porter argues [pp.222-228] that the following implications hold

- 1 certain elements of bargaining or political actions are present. The study was not able to determine whether changes were analytic or bargained;
- 2 the policy-making body, that is the FASB, should expect public criticism because of the existence of conflict;
- 3 because coalitions shift with shifting issue-relevance "then policy decisions, to the extent that they are affected by bargaining, will not necessarily be either consistent and/or cohesive" [p.225];
- 4 if bargaining is a necessary part of the process, but is concealed in an analytic argument, then expectations of consistency and cohesiveness will be raised unrealistically;
- 5 analysis and research is only of limited use in the process;
- 6 there is no solution to which the process tends because the majority of responses were from vested interests and few responses were analytic or evidential in nature;
- 7 group conflict (intra-profession or constituency) might be reduced by agreement on objectives, such as might be the aim of the US quest for a conceptual framework. Group conflict can ultimately only be resolved by force or by bargaining [p.228] and so the policy-making function must be one of mediation amongst bargainers in which all participants fully understand the nature of the process.

Porter identifies the study's limitations as arising from

- 1 the use of only written responses, other communication channels might be important;
- 2 the use of only one issue as a case study;
- 3 the use of only one input to the process, other participants might be more influential at other input stages;
- 4 the inherent subjectivity of the content analytic research method.

From these limitations, Porter suggests that

- 1 other issues be investigated; and
- 2 the whole process be studied, so including sub-phases identified from Gergen [1968].

The framework developed in Porter's [1979] study is important because it builds on the contributions of the studies of Burke [1978] and Klein [1978]. The organisational decision-making framework for analysing the policy-making process, introduced by Klein's use of the Thompson & Tuden [1959] typology of organisational decision making styles, is complemented by Porter's use of the March & Simon [1958] analysis of conflict

resolution in organisations.

Clearly, characterising the policy-making process as an organisational process is meaningful in the sense that these two studies have shown how it illuminates our understanding of the processes. Further, Porter has introduced the importance of the literature of the sociology of the professions in the sense that it indicates that there are limitations on the extent to which technical decisions can be kept within professions. The present study investigates this literature more fully in Chapter 14 "Professionalisation processes".

The results of Porter's study are important because, notwithstanding the failure of the analysis to offer direct testing of the hypotheses generated, they do offer evidence, from the stated preferences of bankers, in support of the fourth hypothesis, namely

H₄ Groups will act on their own self-interest and resist any accounting standard which has a perceived negative impact.

Criticism of the Porter study, beyond the limitations already identified, can be made on the grounds that, as with the Burke and Klein studies, no comprehensive survey of the organisational, political or sociological literature had been undertaken in order to discover generalisations to which the professional accounting standards setting processes might correspond. Rather, isolated concepts, of organisational conflict resolution [March & Simon 1958], technical decision-making by professions [Greenwood 1957] and influential individuals, or "leverage points", in policy-making processes [Gergen 1968], are introduced without discussion of the primary theoretical frameworks within which they are embedded. Such an approach does not provide evidence of either substantive support for these concepts within their own frameworks; or of an integrated framework within which to adequately research professional accounting standards setting processes.

Sharp [1979] is the last of the four studies to be reviewed here which seek to develop the "constituency relationships" framework of FAF [1977]. Like Porter, Sharp argues that the professional accounting standards setting processes can be characterised as a policy-making process. Following the March & Simon [1958] distinction between analytic and bargaining decision processes, Sharp distinguishes two types of policy-making process, namely scientific and political. Scientific policy-making is argued to rely on objective measurement and has the advantage that "incorrect theorising can be identified and rejected". Political policy-making is argued to rely on judgement and so has the disadvantage that issues cannot be resolved scientifically.

Sharp asserts that accounting policy-making focusses essentially on four primary questions

- 1 what should be communicated?
- 2 what should be measured?
- 3 how should it be measured? and
- 4 how should it be communicated?

Sharp goes on to classify these questions and their solutions as political, political-cum-scientific, scientific and scientific respectively. Sharp then asserts that political solutions should not be sought when scientific enquiry is capable of yielding solutions. In so doing the following advantages are attributed to scientific solutions. They

- "1 lead to more optimal stable resolution than political solutions;
- 2 give rise to a rational and defensible system of thought;
- 3 in general are more resource efficient than political solutions; and
- 4 reinforce the position of the professional accountant as opposed to viewpoints or attitudes which ignore scientific evidence" [p.11-12].

Sharp argues that the above implies that the political questions should be answered first and then followed by the scientific questions. Such a procedure justifies, in Sharp's view, an investigation of the accounting policy-making constituencies as the determinant of the political solutions. Sharp asserts that the accounting constituency is "pluralistic" and

"it becomes critical to identify the constituencies which do or should interact with the accounting policy process and to assess the attitudes and preferences of those constituencies. This is the intent of the study" [p.15]

Sharp's study seeks to identify groupings within the constituency. Firstly, a wide variety of occupational groupings was selected for survey. Secondly, a wide variety of potential or actual issues was selected upon which individuals surveyed were asked to express preferences, perceptions and expectations. Both the occupational groupings and the issues surveyed were identified by a process described by Sharp as "brainstorming" in which the researcher, assisted by others, simply listed all possible items which came to mind. A questionnaire survey generated a 22% response rate and late responses were used as surrogates for non-respondents in a test for any potential bias in those non-respondents. Such a test is elaborated in Oppenheim [1966].

Sharp analysed the data under three separate heads.

Firstly, "reality testing" was used to describe analysis of the degree to which respondents agreed on the issues represented by the questions asked. The results were presented in the form of some 50 tables and Sharp concluded [p.185] that low levels of agreement were found. This gave Sharp cause for concern, although for reasons unspecified, and it was argued that perhaps different groups interpreted the questions differently. This could be interpreted simply as heterogeneity of not only preferences but also perceptions.

Secondly, "strength of preference" was used to describe analysis of the part of the questionnaire seeking statements of preference. Respondents were asked to reply on a scale from "strongly advocate" to "strongly oppose". Sharp used the factor analysis facility of the SPSS programme [Nie et al 1970], and identified four factors which he interpreted as follows

- 1 the Government should not have a significant and direct role in accounting (and auditing) standards setting and monitoring;
- 2 accounting (and auditing) standards should be left primarily to the company and its auditor;
- 3 the quality of audit work, accounting, auditing and reporting standards, should be set and monitored by a private sector consortium or association or by peer review;
- 4 accounting, auditing and reporting standards should be based on a conceptual framework and an economic reality, not on the basis of political bargaining amongst interest groups.

Additionally under this head, Sharp used cluster analysis, citing McRae [1970] as principal reference, and concluded that "for these issues and these respondents, cohesive, identifiable viewpoints did not exist apart from the collective preference profile" [p.202]. In other words, Sharp found a substantial degree of agreement on preferences amongst the respondents.

Finally, "policy recommendations" was the head under which Sharp used a policy Delphi process [for example, Wedley, Jung & Merchant 1979] in which a panel of "experts" was used to generate a series of policy recommendations on the issues investigated above. The results of this policy Delphi were presented in Sharp's Exhibit 6.2 "Delphi recommendation consensus" which is not reproduced here.

Sharp identifies the study's limitations as

- 1 attitudes were being surveyed, and they are not fixed over time;
- 2 differences may have arisen in question interpretation. This may have been reduced by using several questions for each issue;
- 3 statements of preferences were elicited without regard to costs of realisation;
- 4 responses may have been biased by uncontrolled factors such as length of the questionnaire and contemporary publication of the Metcalf report [Metcalf 1977].

Sharp's study is important because it attempts to distinguish between a scientific and a political approach to the determination of professional accounting standards. Although Sharp's treatment is not of any great depth, and as such is subject to the criticism addressed to the Klein [1978] and the Porter [1979] studies regarding the use of isolated concepts from other disciplines, it does suggest that the two approaches require further analysis to determine the limits of each.

Criticisms of Sharp's study, beyond the limitations already identified, centre primarily on the characterisation of the study as an attitude survey. As such, criticism addressed to Burke's study applies also to the Sharp study. The evidence contributes little to theory construction. Additionally, Sharp's dichotomous characterisation of the US professional accounting standards setting processes, into either scientific or political, represents only a subset of the possible characterisations identified by Klein [1978] on the basis of Thompson & Tuden [1959]. This suggests that the Sharp framework omits some potentially valuable subtlety of explanation. It is useful to contrast this framework with that of Buckley [1980].

Buckley [1980] presents a different analysis of the US accounting standard setting process. He classifies all possible processes into three mutually exclusive and exhaustive classes, namely "constitutional", "legal" and "scientific". He also deduces from economics and sociology that groups act in their own self interest and he uses this hypothesis to argue that the US accounting profession has adopted the "constitutional" pattern of process. He seems to argue that this is empirically self-evident. The value of Buckley's work is that he presents a novel approach to the analysis of the US accounting standard setting process. However, the importance of his conclusions, namely that a changing environment requires a switch into a different class of process (into "scientific" process) rest on the degree to

which his initial classification can be said to adequately describe the alternatives available. Even his own description of the US process contains elements of all these. Buckley's analysis can perhaps be developed if we regard his three classes as separate components which can be combined, each to lesser or greater degrees, at the option of those capable of influencing the design of the process.

At the time of writing, a number of US studies are being published which, in addition to those studies which have followed the lead of FAF [1977] in investigating the nature of the US professional accounting standards setting constituency, are beginning to investigate other aspects of the political dimension in professional accounting standards setting processes.

Newman [1981A & 1981B] is one example which sought to study the relationships between the voting patterns, through coalition formation; and voting strengths, through power indices, in the FASB and its predecessor the APB. Newman's studies provide evidence that the major US accounting firms (the Big 8) possess disproportionately large voting strength, but the evidence on coalition formation was ambiguous. A criticism of Newman is elaborated in Anderson [1982] which argues that a study of coalition formation in isolation from the remaining aspect of the political process is necessarily inconclusive. Anderson suggests attention also be directed to pay-offs, ideology and agenda-setting. Clearly, Anderson's criticism is consistent with, and supports the criticisms above, of Porter [1979], Sharp [1979] and Klein [1978] on the grounds that the use of isolated concepts from other disciplines is potentially misleading.

It is clear that further research work in the US on the political dimension in professional accounting standards setting processes will be relevant to the present study.

A UK study [Hope & Gray 1982] has sought to investigate the power relationship between the constituency of the ASC and its policy outcomes. Relying on Lukes [1974] discussion of power, the study concentrates on the issue of determining policy which resulted in the publication of UK accounting standard SSAP13 "Accounting for research and development" in December 1977. After a brief and informal review of the written submissions received on the proposals, ED14 and ED17, the researchers seek to infer a strong relationship between a single industrial interest group, the aerospace industry, and the substantial changes made between initial proposal and final outcome. The study identifies the source of the vested interest, that is, the economic consequence, as being related to UK Government financed research and development contracts.

Hope & Gray [1982] is important because it provides evidence that

- 1 the US analysis has direct application to the UK professional accounting standards setting processes; and
- 2 the written submissions on UK proposals may be insufficient to completely explain the relationship between constituency preferences and final outcomes of the processes.

Limitations identified in the study include isolation of the written submission from all other aspects of the process; and use of one issue which may or may not be representative of the processes generally. Limitations of the study not identified by the researchers include the lack of rigour used in the analysis of the written submissions. This is particularly critical. No summary statistics are provided of the data presented in their Table 1 "Analysis of responses to accounting treatment and disclosure issues of ED14". This table is used as the basis for arguing that the industrial sector (distinguished from accounting firms and government departments) exerted a greater influence

over the outcome than other groups. It is well known that the chi-square statistic [Nie et al 1980, pp.243-245; Hamburg 1977, pp.312-335; Siegel 1956] is available as a measure of the significance of such a suggested relationship. Using chi-square, their results are not significant at the 0.20 level (chi-square = 13.26, degrees of freedom = 11). Additionally, the use of the concept of power as the primary theoretical construct on which to base the analysis and subsequent conclusions is problematic. This problem is discussed in greater depth in the present study in Chapter 12 "Political choice processes".

8.3 SUMMARY

The empirical studies of Hope & Gray [1982], Newman [1981A & 1981B], Porter [1979], Sharp [1979], Watts & Zimmerman (WZ) [1979], Burke [1978], Klein [1978], FAF [1977] and Watts [1977], have each investigated the political dimension in professional accounting standards setting processes. That dimension is political in the sense that preferences amongst individuals are not homogeneous and choices are made by some non-economic procedure designed to be responsive to those individual preferences.

In the overtly political environment of US regulation, vested interests adopt accounting theories to advocate their positions before Congress, the SEC and the FASB [WZ 1979]. An attitude survey has shown that, in general, the various interest groups that make up the constituency [FAF 1977] of the FASB approve of the role of the FASB as a policy-making body and participate in its processes willingly and positively [Burke 1978].

In the issue of determining US policy on segmental reporting ["SFAS14", FASB 1976] it was found that characterising the US professional accounting standards setting processes as an organisational decision-making process was useful [Klein 1978]. Further, that study generated evidence of

- 1 heterogeneity of preferences within the constituency; and
- 2 a partial relationship between the written expression of those preferences and the outcome of the process.

In the issue of determining US policy on troubled debt restructurings ["SFAS15", FASB 1977] it was again found that characterising the US professional accounting standards setting processes as an organisational decision-making process was useful, but that additional considerations of conflict resolution and of sociology of professions are important [Porter 1979]. That study generated further evidence of

- 1 heterogeneity of preferences, that is, conflict;
- 2 a partial relationship between written preferences and outcome;

and
3 strong evidence in support of an underlying assumption of self-interested behaviour.

The relationship between a political style and a scientific, or technical, style of policy-making process has been discussed as background to a further US attitude survey [Sharp 1979]. That study concluded that the political and scientific styles are inseparable. Further evidence of heterogeneity of preferences, and of perceptions, was generated along with new evidence of some homogeneity of preferences on the four higher-order issues following

- 1 the Government should not have a significant role in the accounting standards setting processes;
- 2 accounting standards should be left primarily to the company and its auditor;
- 3 the quality of accountants' work should be a private-sector responsibility; and
- 4 accounting standards should be based on a conceptual framework and on economic reality.

In a study of power and coalition formation in the US professional accounting standards setting processes, that is voting strengths and voting patterns, evidence has been generated that the US Big Eight professional accounting firms possess disproportionately great power but that this is not unambiguously translated into winning coalitions [Newman 1981A & 1981B].

The potential applicability of the US analytic framework to the UK has been demonstrated [Sutton 1980] but there is evidence that the relationship between written preferences and final outcomes may not be as strong in the UK as in the US [Hope & Gray 1982].

The choice process has been characterised by Porter [1979] and by Klein [1978] as being, in part, an organisational choice process. In this characterisation, concepts of decision-making and conflict resolution, to be found in the literature of organisation theorists, have been adopted. Extending this characterisation, Sharp has suggested that this choice process is both political and scientific in nature. Porter has suggested

that the professional dimension implies that scientific, or technical, choices will be kept within a profession but will always be subject to external approval, modification or veto.

The usefulness, and validity, of a self-interest assumption applied to participants in the professional accounting standards setting processes has been addressed in the studies of Porter [1979], WZ [1979] and Watts [1977]. In particular, these studies have found that the evidence is consistent with such an assumption; the results of Porter's study of bankers' participation in the US accounting for troubled debt issue, being noteworthy.

Some of the above work has been in the nature of an attitude survey. Importantly, emphasis has been placed on the nature and structure of the "constituency" of the professional accounting standards setting processes. For example, FAF [1977] argued that the US constituency was inadequately understood. Burke, Klein, Porter and Sharp each investigated the preference structure in response to the FAF argument. The contribution of these studies to theory construction is restricted because relationships between attitudes and behaviour are little understood [Bentler & Spekart 1979]. However, these studies have proven useful to the extent that they have provided evidence of the heterogeneity of preferences which underly the political dimension in professional accounting standards setting processes. Further, the studies of Porter [1979] and Klein [1978] have established usefulness of the technique of content analysis as applied to the written comments on Exposure Drafts submitted to the accounting standards setting body.

8.4 CONCLUSIONS

The empirical studies to date have provided a valuable introduction to the study of the political dimension in professional accounting standards setting processes, but a substantial contribution to theory construction is, as yet, undeveloped. In a sense, it is as if we know that the political dimension exists but we do not yet know what it means.

In particular, the contributions of other disciplines, from which some explanatory concepts have been adopted, have been inadequately explored. Rather, isolated concepts have been introduced with little discussion of their origins. The present study seeks to redress that defect in Part III "Review of literature from disciplines other than accounting and economics" in order to more fully appreciate their meaning and potential application to UK professional accounting standards setting processes.

The precedents set by Porter [1979] and Klein [1978] suggest that a fruitful empirical study based on UK data could be conducted by the use of content analysis of present written comments on Exposure Drafts. The preliminary work conducted by Hope & Gray [1982] on UK data has provided strong support for the usefulness of such an analysis. The present study addresses this task in Part IV "Evidence from the empirical study of UK data".

The major task of the present study, then, is to contribute to an elaboration of the "political dimension". To explore the complexity of the underlying models through the review in Part III and to explore the implications of the political dimension in action in Part IV.

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

**CHAPTER 9 CONCLUSIONS DRAWN FROM PREVIOUS RESEARCH IN ACCOUNTING
AND ECONOMICS**

**9.1 Conclusions drawn from previous research in accounting
and economics**

CHAPTER 9 CONCLUSIONS DRAWN FROM PREVIOUS RESEARCH IN ACCOUNTING
AND ECONOMICS

9.1 CONCLUSIONS DRAWN FROM PREVIOUS RESEARCH IN ACCOUNTING AND
ECONOMICS

The problem of investigating UK professional accounting standards setting processes has been substantially illuminated by the changing perspective of previous research studies. The description of the UK ASC provided above in Chapter 3 "The Accounting Standards Committee" encompassed not only an accounting activity of specific technical matters being resolved by a profession's own committee of experts, but also an accounting activity with economic, political and professional dimensions. Clearly, some of those dimensions are reflected in the literature.

The economic dimension is the most strongly represented in the US literature; the political dimension less so. However, the professional dimension seems not to be represented. No US study has sought to investigate the way in which the accounting profession, as a profession, influences the accounting standards setting processes. The reason for this apparent lack of interest in the implications of the professional dimension is perhaps not difficult to identify. The US institutional arrangement changed in 1973 when the FASB, as an independent body, took over the processes of setting accounting standards from the US accounting profession. Prior to that date, there was no serious US research interest in accounting standards setting processes per se.

Of importance to the problem of investigating UK professional accounting standards setting processes is the understanding that there are private gains available to those who both hold private information and can control the subsequent publication of that information. The existence of these gains arguably provides sufficient incentive for individuals to hold preferences in favour of some classes of accounting information as against other classes. Clearly, it is possible to characterise management as holding private information and so they have incentives to seek to control its subsequent publication. A professional accounting standards setting programme will necessarily restrict managements' freedom to exercise that control and so incentives exist for management to resist such a programme. The fundamental mechanism generating financial statements implies that some level of professional accounting standards is inevitable. The interesting question is how they are actually determined. Such is the economic rationale for participation in professional accounting standards setting processes.

The economic rationale for participation is not sufficient to explain the resultant choices of professional accounting standards. Firstly, the aggregation of individual preferences is indeterminate and, secondly, there exists no unique social preference function by which that indeterminacy can be resolved. It follows that the general problem of the present study (namely, the exploration of factors which might be used to explain the processes by which UK professional accounting standards are determined) can be characterised as an investigation of a social choice process in which non-economic criteria play an important part. Such is the rationale for the existence of a political dimension to professional accounting standards setting processes.

An important re-interpretation of the present study has emerged from the social choice literature, namely that, in one sense, the study contributes to an investigation of the structure of constraints on individual preferences. Given that there is no unique solution to the problem of choice amongst alternatives for accounting information, there is a natural and clear interest in the structure of the present, existing, solution. Two contributions have been made by the dissertations of Sutton [1980] and Johnson [1979].

Firstly, Johnson identifies different institutional arrangements under which professional accounting standards might be selected. Among the objectives of those arrangements, the usual economic criterion of Pareto-optimality is central although non-economic alternatives are clearly seen to be possible. Additionally, Johnson suggests the following areas for further research specifically based on existing professional accounting standards setting processes:

- 1 to what extent do existing professional accounting standards setting processes incorporate the Pareto-optimality criterion?
- 2 to what extent do existing professional accounting standards setting processes overcome incentives to misrepresent preferences?
- 3 to what extent do existing professional accounting standards setting processes incorporate a power dominated objective?

Secondly, Sutton has demonstrated that the theoretical frameworks being developed in a predominantly US orientated literature have potential application to the UK professional accounting standards setting processes. Sutton also argues that an adequate explanation of the professional accounting standards setting processes must take into account the political nature of those processes. Such an argument is supportive of the discussion in Chapter 5 "Professional accounting standards, the political dimension and economic consequences".

Some empirical studies to date have provided a valuable introduction to the study of the political dimension in professional accounting standards setting processes, but a substantial contribution to theory construction is, as yet, undeveloped.

In particular, the contributions of other disciplines, from which some explanatory concepts have been adopted, have been inadequately explored. Rather, isolated concepts have been introduced with little discussion of their origins. The present study seeks to redress that defect in Part IV "Review of literature from disciplines other than accounting and economics" in order to more fully appreciate their meaning and potential application to UK professional accounting standards setting processes.

The precedents set by Porter [1979] and Klein [1978] suggest that a fruitful empirical study based on UK data could be conducted by the use of content analysis of written comments on Exposure Drafts. The preliminary work conducted by Hope & Gray [1982] and Sutton [1980] on UK data has provided strong support for the usefulness of such an analysis. The present study addresses this task in Part IV "Evidence from the empirical study of UK data".

This area of research is yet in its infancy and some gaps are evident. For example, no researcher has attempted to systematically observe several stages of the UK professional accounting standard setting process; the only information we have to date comprises anecdotes from participants and bland procedural statements from official publications. No researcher has attempted to systematically test hypotheses over a broad range of accounting issues; the inflation accounting issue has provided a strong attraction and possibly introduced a systematic bias into the results to date. No researcher has convincingly studied the roles, or perceptions, of participants in the

process. Finally, only two studies have used the bank of data available in the UK as the letters of comment to the ASC. These letters are filed, on public record, at the Library of the Institute of Chartered Accountants in England & Wales. The two studies have addressed one issue each, one of which was inflation accounting.

Changes in professional accounting standards, such as the publication of Statements of Standard Accounting Practice by the UK professional accountancy bodies, have important wealth and welfare generation and redistribution properties. It follows that an understanding of how professional accounting standards decisions are made represents an important issue of social policy-making. The underlying economic processes are well understood. This contrasts with the underlying political processes, which are poorly understood and little researched by accountants.

Two questions arise naturally from the previous research

- 1 are the theoretical constructs, from disciplines other than accounting and economics, that have been identified in the previous research capable of contributing to a comprehensive explanation of professional accounting standards setting processes in the UK?
- 2 what is the relationship between the written statements of preference and the final outcome in the UK?

In order to begin to answer these questions, evidence of two types appears to be called for

- 1 evidence that the theoretical constructs from disciplines other than accounting and economics are adequately supported by the literature of these disciplines and have implications which are meaningful in the context of professional accounting standards setting processes in the UK;
- 2 empirical evidence of professional accounting standards setting processes in the UK.

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

A substantial investment is required in understanding the political processes. The remainder of the present study is devoted to systematically gathering those two classes of evidence through the two-fold approach of

- 1 reviewing analyses from the literature of disciplines other than accounting and economics. This investment is undertaken and documented in Part III "Review of literature from disciplines other than accounting and economics"; and
- 2 generating empirical evidence from professional accounting standards setting processes in operation in the UK. This investment is undertaken and documented in Part IV "Evidence from the empirical study of UK data".

A major contribution of the present study, then, will be to elaborate the "political dimension" by exploring the complexity of the underlying models (in Part III) and exploring the actual effects of the political dimension (in Part IV). Both of these can be interpreted, in one sense, as contributions to an investigation of the structure of constraints on individual preferences.

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

**PART III REVIEW OF LITERATURE FROM DISCIPLINES OTHER THAN
ACCOUNTING AND ECONOMICS**

**Chapter 10 Introduction to review of literature from disciplines
other than accounting and economics**

Chapter 11 Scientific choice processes

Chapter 12 Political choice processes

Chapter 13 Organisational choice processes

Chapter 14 Professionalisation processes

**Chapter 15 Conclusions drawn from review of literature from
disciplines other than accounting and economics**

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

CHAPTER 10 INTRODUCTION TO REVIEW OF LITERATURE FROM DISCIPLINES
OTHER THAN ACCOUNTING AND ECONOMICS

10.1 Introduction

10.2 Review of literature from disciplines other than accounting
and economics

CHAPTER 10 INTRODUCTION TO REVIEW OF LITERATURE FROM DISCIPLINES
OTHER THAN ACCOUNTING AND ECONOMICS

10.1 INTRODUCTION

In the preceding Part II "Review of previous reseach in accounting and economics" it was shown that the problem of investigating UK professional accounting standards setting processes has been substantially illuminated by the changing perspective of previous research studies. The description of the UK ASC provided above in Chapter 3 "The Accounting Standards Committee" encompassed not only an accounting activity of specific technical matters being resolved by a profession's own committee of experts, but also an accounting activity with economic, political and professional dimensions. Clearly, some of those dimensions are reflected in the literature.

The economic rationale for participation is not sufficient to explain the resultant choices of professional accounting standards. Firstly, the aggregation of individual preferences is indeterminate and, secondly, there exists no unique social preference function by which that indeterminacy can be resolved. It follows that the general problem of the present study (namely, the exploration of factors which might be used to explain the processes by which UK professional accounting standards are determined) can be characterised as an investigation of a social choice process in which non-economic criteria play an important part. Such is the rationale for the existence of a political dimension to professional accounting standards setting processes.

Some empirical studies to date have provided a valuable introduction to the study of the political dimension in professional accounting standards setting processes, but a substantial contribution to theory construction is, as yet, undeveloped.

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

In particular, the contributions of other disciplines, from which some explanatory concepts have been adopted, have been inadequately explored. Rather, isolated concepts have been introduced with little discussion of their origins. The present study seeks to redress that defect in this Part IV "Review of literature from disciplines other than accounting and economics" in order to more fully appreciate their meaning and potential application to UK professional accounting standards setting processes.

10.2 REVIEW OF LITERATURE FROM DISCIPLINES OTHER THAN ACCOUNTING AND ECONOMICS

Two analyses lead to a consideration of literature in Chapter 11 "Scientific choice processes". Firstly, the argument that professional accounting standards setting processes are both scientific and political. Secondly, Chapter 12 "Political choice processes" will distinguish between rational policy, organisational process and bureaucratic politics as three different models of political decision making. It will argue that the rational policy model is the rational selection of an alternative from among a number of alternatives in order to maximise the objectives, or criteria, of a "decision unit"; this is the scientific choice model.

The chapter reviews the formal decision theoretic model of choice. Secondly, the role of measurement is explored and then related to the accounting environment. Finally, the problem of the non-uniqueness of decision criteria is addressed.

The increasing recognition being given to the "political dimension" in the literature on the professional accounting standards setting processes leads to a consideration of literature in Chapter 12 "Political choice processes".

Firstly, the chapter identifies a characterisation of political process as decision-making and reviews the implied models. Secondly, the study of political institutions is explored; and finally, consideration is given to the usefulness of the concept of "power".

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

Two analyses lead to a consideration of literature in Chapter 13 "Organisational choice processes". Firstly, the characterisation of the US professional accounting standards setting processes as being, in part, an organisational choice process. Secondly, Chapter 12 "Political choice processes" will distinguish between rational policy, organisational process and bureaucratic politics as different models of political decision making and argue that the organisational process model is implied in much political analysis.

The review identifies a classification of implied models of organisational choice. It then proceeds to explore the model of choice in ambiguity as of potential interest to the study of professional accounting standards setting processes.

Three analyses lead to a consideration of literature in Chapter 14 "Professionalisation processes". Firstly, the argument that professionalisation processes encourage professions to strive to keep technical, or scientific, decisions away from intervention by outsiders; such decisions being said to be subject to intervention by veto. Secondly, Chapter 12 "Political choice processes" will argue that the concept of morality has permeated much political analysis and that the concept may be implied in partial structurings of preferences in the process of professionalisation. Thirdly, Chapter 13 "Organisational choice processes" will argue that the "judgemental" choice process is linked to the professionalisation literature to the extent that choices are made by individuals in the roles of professionals in bureaucracies.

The review explores the framework implied by the notion of professionalisation, firstly, by tracing the development of a literature which defines a profession. Secondly, it explores characterisations of a professionalisation process; and finally, it investigates ways in which constraints on that process determine its possible outcomes.

CHAPTER 11 SCIENTIFIC CHOICE PROCESSES

11.1	Introduction
11.2	Decision
11.3	Measurement
11.4	On the accounting environment
11.5	On the uniqueness of decision criteria
11.6	Summary
11.7	Conclusions

CHAPTER 11 SCIENTIFIC CHOICE PROCESSES

11.1 INTRODUCTION

Two analyses lead to a consideration of the literature of scientific choice processes.

Firstly, in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes", it was shown that Sharp [1979] distinguishes between scientific and political styles of decision making. Sharp argues that professional accounting standards setting processes are both scientific and political.

Secondly, in Chapter 12 "Political choice processes", it will be shown that Allison [1969] distinguishes between rational policy, organisational process and bureaucratic politics as three different models of political decision making. Allison argues that the rational policy model is the rational selection of an alternative from among a number of alternatives in order to maximise the objectives, or criteria, of a "decision unit"; this is the scientific choice model.

The review first addresses the underlying formal decision theoretic model implied by the scientific choice process characterisation. It then uses some measurement theoretic arguments to help explore the relationship between this model and the accounting environment.

11.2 DECISION

"all organisms are constantly, day and night, engaged in problem solving" [Popper 1973, p.242, paraphrased by Mace 1977, p.272].

Formal decision theory views the choice process from a well defined problem-solving viewpoint. A problem is seen as an ambiguity in which a set, Q , of alternative actions is available to the problem solver. Additionally, there exists a body of knowledge, K , which can be applied to the ambiguity in order to generate a solution, $q(i)$ belonging to Q . No $q(i)$ can actually be specified until a criterion, θ , is imposed on the set of pairs $(q(i), K)$ belonging to (Q, K) (for example, White [1969, p.3]).

So then, a firm might be faced with a problem of disclosure in which alternative actions are

- $q(1)$ = disclosure of profits generated in geographical location X
- $q(2)$ = no disclosure of profits generated in geographical location X

The firm's knowledge set, K , includes a model of the behaviour of the local national government of X and this model predicts that the outcome of disclosure would be the imposition of penal taxes. The outcome of non-disclosure would be the avoidance of this tax burden. Further, the firm has a long term objective function which implies minimisation of all tax burdens and this objective function becomes the criterion by which the problem is solved. The important point here is that $q(2)$, or no disclosure of profits generated in geographical location X, is uniquely determined by the three element set (Q, K, θ) . In these cases the problem, Q , is said to be decidable. It often happens that a problem is not decidable, that is, there is no unique $q(i)$ belonging to Q which is deducible from (Q, K, θ) . Nevertheless, if one or more $q(i)$ can be eliminated as being ranked lower than the remainder of Q under criterion θ , then Q is said to be partially decidable. In cases where no such eliminations can be made, then the problem is said to be undecidable and selection of any $q(i)$

from Q is described, in the decision theoretic literature, as pure choice. So then, it is possible to distinguish between choice and decision. The former is not subject to the specification of a rule for uniquely determining the action to be taken and so cannot be delegated. Decisions, in this strict decision theoretic sense, can be delegated.

Symbolically, the decision is often represented by

$$(Q, K) \xrightarrow{\theta} q(i) \in Q$$

where

Q , K , and $q(i)$ have the above meanings;
 $\xrightarrow{\theta}$ means "implies"; and
 \in means "belonging to"

Accepting as axiomatic Popper's assertion that all organisms are constantly involved in problem solving is intuitively appealing for it can be seen, in all walks of everyday life, how it might apply. Each individual has the problem of when to get up in the mornings, how to travel to work, how to perform tasks at work etc. Similarly on a group basis, human activity can be characterised as problem solving. Much has been written about the behaviour of man in the organisational context. For example, Pettigrew [1973] studied the behaviour of individuals in a firm's development of its computerised system; an example of problem solving behaviour in the context of the organisation itself. Cyert & March [1963] characterise the firm as a collection of individuals and groups of individuals who each engage in problem solving behaviour. The aggregate effect of this collective, though not necessarily cooperative, problem solving is then seen as the firm's problem solving behaviour. Similarly, the selection of professional accounting standards might be as the rational decision of which characterised alternative to select given a criterion and a body of knowledge.

Every individual, group or organisation, then, is engaged in problem solving. In order to systematically solve problems, decision theory requires an ambiguity, a body of knowledge and a criterion. So, for any given problem it can be assumed that the ambiguity is given (otherwise there would be no problem) and that the criterion is given. Assuming that the criterion is given is considered as non-problematic, because if this were not the case then any subsequent search for a criterion would really constitute a sub-problem for which there must be some higher order criterion. The assumption essentially is that the ultimate criterion is well defined and the search for any second order (or problem-specific criterion) reduces to a search of the body of knowledge. The criterion, then, is assumed to be contained within the body of knowledge. We shall explore the implications of this assumption will be explored later.

What, then, constitutes the body of knowledge? Intuitively, it can be argued that this must be the body of facts available to us as input to our decision process. The only relevant facts will be those concerning the outcomes of each of the alternative actions available and the possibility of additional alternatives. Unfortunately, man lives in a complex and largely unknown world and so his possession of facts concerning the outcomes will be imperfect. In order to reduce this imperfection, and so reduce the uncertainty of the impact of the environment generally, man theorises and measures. In a perfect world, all that would be necessary would be to measure the outcome itself on some measurement scale consistent with the criterion function. The decision is then instantly determined, subject only to computational resource. A review of much of the decision theoretic literature demonstrates that this simplified approach to determining decidability has been the objective of many writers. This body of literature has been concerned with either constructing rules for measuring outcomes (for example, Ackoff [1962], Shackle [1961], Koopmans [1960], Chipman [1960], Debreu [1958], Luce and Raiffa [1957], Milnor [1957], Savage [1954],

Wald [1954], Neumann and Morgenstern [1953], Marschak [1950], Carnap [1947], Von Mises [1941]) or with devising criteria for deciding amongst outcomes whose measures are assumed to be available (for example, White [1969, p.28]).

It has been observed above that man lives in a complex and largely unknown world and so in the face of a potentially hostile environment he theorises and measures. By theorising, uncertainties are reduced as predictions are made about outcomes. Theory construction is an essential component of the development of the body of knowledge. It is useful to investigate the role of measurement in theory construction. This is undertaken in the following section.

11.3 MEASUREMENT

Ellis [1966, pp.125-126] argues that the construction of, and choice between, measurement scales is guided by a general need to generate models of the environment which are as simple as possible. It is important to note that it is always possible to generate many different measurement scales which measure the same property of whatever object happens to be of interest. However, in determining the relationships between various properties these measurement scales will give rise to formal expressions of these relationships which differ in their complexity. An example from the accounting environment can help to clarify this.

Consider the inter-period allocation of taxation costs (for example, Comiskey & Groves [1978]). There are (at least) two generally recognised methods of measuring the taxation cost in any given period, namely current and deferred. There are, of course, numerous different variations of these two basic methods and recognising this simply strengthens the argument here. In the late 1970's in the UK there was debate concerning the deferral method. This was generally known as deferred taxation and had been mandated by the accounting standard SSAP11 "Accounting for deferred taxation". SSAP11 recognised two different approaches to the measurement of deferred taxation, namely a deferral method and a liability method. In both cases an accrual was to be set up for the future reversal of a current timing difference. The controversy concerned whether or not all future reversals should be accrued. It was argued that there are some future reversals which are either so remote in probability or in timing that their accrual would make the financial statements difficult to interpret. Here then, we see an example of a desire for a measurement scale which would make theory construction, by the users of financial statements, less complex. As it happens, those who argued for change were successful and a new accounting standard, SSAP15 "Accounting for deferred taxation" was published in place of its predecessor.

Formal measurement theory (for example, Mock [1976], Ijiri [1975], Pfanzagl [1971], Vickery [1970], Ellis [1966], Torgerson [1958], Hempel [1952], Stevens [1946]), Bridgman [1931] and Campbell [1920], is concerned with the development of knowledge by observation of the real world, or more precisely, what we understand the real world to be. A real world is assumed to exist, it contains objects of interest each of which possesses properties and we speak of the properties of these objects. Relationships are assumed to exist between these properties and theory construction is the attempt to describe these relationships and formally express them in one language or another. Measurement is the association of the specified property of a specified object with a number (or measure) in such a manner that some relationships between those numbers and the associated measures of other properties preserve the relationships between the same properties of differing objects. Such a relation-preserving association is known as a homomorphism [Mock 1976, p.13 and Pfanzagl 1971, p.26]. Use of the numbers so generated in formally expressed relationships (that is, theory) enables the corresponding property of some, as yet unmeasured, object to be predicted by determining its own associated number (or measure). By the use of complex relationships between several properties then predictions can be made about properties which have not been measured at all during the prediction process. Some measurement of those properties will have been necessary at the theory construction stage.

These points can be illustrated by considering manufacturing costs. Say a firm has manufactured a product for several years and knows that fixed manufacturing costs are £50,000, variable manufacturing costs are £250 per unit, sales price is p per unit and that in the past profits have been equal to

$$\pounds(p - 250)q - 50,000$$

where q is the number of products sold.

Clearly, in developing this theoretical relationship the manufacturer has needed to measure fixed costs, variable costs, sales price, profit and quantity. However, in order to predict his profit next year all he needs to do is measure his next year's sales price and sales quantity. He may do this by some estimating procedure. Nevertheless, he has theorised the existence of a relationship between profit, sales price and sales quantity. These are all properties of his object of interest, which is his manufacturing process, and the numbers he assigns to them preserves the underlying relationships.

Having sketched the elements of measurement theory we can now proceed to consider the implications of the inter-relationship between measurement and theory construction. This consideration is based on Ellis [1966] who argues the following.

Stevens [1946] has distinguished between different measurement scales on the basis of their mathematical properties. He argued [p.678] that the empirical relationships preserved in a given measurement scale may also be preserved in a second scale when it can be shown that there exists a mathematical transformation from one into the other. For example, most accounting measurement scales give us the same information whether they are expressed in terms of pounds sterling or pence sterling. Also, the temperature scales of Centigrade and Fahrenheit give us the same information because one can be transformed into the other by a simple linear equation. The class of scales which preserve the underlying empirical relationships under a given mathematical transformation is said to be "invariant" with respect to that transformation. For example, it can be said that the Centigrade, Fahrenheit and Absolute (or Kelvin) temperature scales are linearly invariant.

Take the linearly invariant class of temperature scales. They have found much usefulness in the natural sciences because they each possess theoretical import in the sense of Hempel [1952, p.49]. That is, they possess some substantive meaning in relation to our understanding of the world. In Ellis' terminology, they generate simpler theories than their alternatives. However, Ellis shows [pp.90-103] that it is important to understand that although temperature is viewed in terms of this linear, and so equal-interval, property there is no implication about any underlying linearity, or equal-interval property, of the empirical temperature system. For example, there could have been generated a logarithmic temperature scale in which the absolute zero measure is minus infinity. This would have considerable intuitive appeal on the basis that physicists have demonstrated that it is impossible to ever reach the absolute zero of temperature although we can get closer and closer to it. However, the particular theories which have today been built around the linearly invariant temperature scales would be more complex if they were based on logarithmically invariant scales. For this reason the logarithmic temperature scale is not used. Similar arguments can be developed concerning the other, so called fundamental, scales of the natural sciences. Ellis [pp.104-110] considers the deceptive nature of the time scales and Einstein is well known for having changed perceptions of mass and length.

The implication of the above argument, then, is that the particular measurement scales which we choose have the effect of determining the form of our theories; and, conversely, once we have determined the form of our theories then our measurements are constrained by those theories. That is, we view the world in terms of our theories, but these do not necessarily reflect any static and permanent base for interpretation. Consequently the demand for measurements might change, not because their predecessors have been demonstrated to be wrong but because our theories of the world have changed. Also, the supply of

measurements might change because of changes in the technology of measurement and so, in turn, our theories might subsequently be modified. For example, Tinker [1980] and Williams & Findlay [1980] argue that neoclassical economic theory heavily underlies both current accounting measurements and theory. Further, Tinker argues that under a different framework of economic theory, such as political economy, then a different regime of accounting measurements would be likely.

Now, if the environment can be characterised as one of changing patterns of demand for, and supply of, measurement scales then we are led to enquire as to the existence of criteria for choosing between these scales. Above we have followed the decision theoretic argument to a consideration of measurement theory and found a fundamental criterion for such a choice. This is simplification of theory construction. However, this is problematic because, in order to operationalise that criterion, we need a body of theory before we can start the process of simplification. Such a body of theory arguably evades the social sciences today and consequently it follows that

there can be no strong, theory-oriented, criteria for choice amongst accounting measurement scales.

The decision and measurement theoretic approach leads us to expect to find theory oriented such criteria exhibited, at best, weakly amongst other criteria derived from non-decision theoretic arguments.

11.4 ON THE ACCOUNTING ENVIRONMENT

The accounting environment is one of largely ill-developed theories on which there is no universal acceptance of the supremacy of any one over the others [Hopwood 1983; Watts & Zimmerman 1979]. Economic theory is perhaps the nearly most developed discipline which impacts on the accounting environment, but the range of others is impressive. Disciplines such as sociology, managerial and organisational behaviour, political science and accounting itself are all fields in which there is a noticeable lack of any unified theoretical approach to understanding.

In such an environment, we would expect that developments and changes in each of the disciplines which can be said to have an impact on accounting would themselves have some consequence for the development of accounting theory. This can be illustrated by the way in which the development of the theory of organisational behaviour has changed the way in which accountants see the role of the formal accounting system within an organisation and its inter-relationships with informal information systems. Considering the number of disciplines which impact on accounting and the high rates of change within many of them, then we would expect the rate of change within accounting theory to be similarly high.

The argument of the preceding section predicts that there would be a changing pattern of demand for accounting measurement scales resulting from this changing theoretical background. Clearly, this shifting demand pattern can be observed. It can be argued that the shift within the inflation accounting debate towards a two-tier income statement with a gearing adjustment reflects the influence of developments within economic theory by Godley & Cripps [1975] and others in the 1970's (see, for example, Whittington [1981]). Also, the increasing demand for measures of

the cost society suffers as a result of the industrial activity of individual firms reflects an increasing understanding of the role of the firm in the natural ecology and in the social structure compiled with theoretical elaborations of the role of externalities in markets.

In addition to a constantly changing pattern of demand for accounting measurement scales we also observe a constantly developing pattern of supply. As was noted in the preceding section, supply changes can arise as a result of the dynamic nature of measurement technology. These changes are distinguished from any changes which might arise from demand shifts as hypothesised by Watts and Zimmerman [1979]. Technological changes in the accounting environment can arise from either external sources or internally. An example of an externally generated change might be the data processing revolution which has made available more complex management information systems than was possible in the days of manually maintained accounting systems. An example of an internally generated change might be the introduction of inter-period taxation allocation on the deferred taxation principle discussed earlier, or experiments by some in new fields of accounting [Skerratt (Ed) 1981, pp.180-184].

Given that the accounting environment can be characterised as one of constantly changing theoretical and technological relationships, it is an unsurprising aberration that accounting practices themselves are also constantly changing.

11.5 ON THE UNIQUENESS OF DECISION CRITERIA

It was assumed above in Section 11.2 "Decision" that the decision criterion is unique and determinable. At an elementary level this causes no real problem in as much as for many decisions the criterion is an established part of the knowledge set. Such is the case for many decisions in the natural sciences and for some decisions in the social sciences. For example, a subordinate manager may be given a criterion such as maximisation of short run cash flows. However, it was shown in the preceding section that accounting measurement scale selection involves not only ambiguity of alternative actions, but also ambiguity of criteria. Further, it follows directly from Arrow [1963 & 1951] that, if criteria are characterised as preference functions then, a uniquely determined criterion is only a possibility where individual preferences are severely constrained [Riker 1980]. Clearly then, in a social environment we need to relax the assumption of uniqueness of criteria. This has a devastating effect on the application of scientific choice processes to social analysis because, whereas as we have seen measurement scale selection is only weakly determined in the case of a unique decision criterion of theory simplification, when decision criteria themselves are non-unique then the systematic determination of measurement scale selection may even become indeterminate.

11.6 SUMMARY

Formal decision theory characterises a decision as a selection of one alternative from amongst more than one, that is, in a situation of ambiguity. The selection is made by a unique and determinate criterion and is subject to an extant body of knowledge [White 1969].

Formal measurement theory is the elaboration of the framework by which the body of knowledge is determined and extended in the form of theories [Hempel 1952]. The evidence of scientific theory construction suggests that measurement scales themselves are selected against the criterion of theory simplification [Ellis 1966]. However, the accounting environment is largely one of diverse and ill-developed theories [Hopwood 1983]. Theory simplification can offer only a weak selection criterion in such an environment. Accounting measurement scale selection can not yet call upon formal measurement theory for the provision of a rational selection criterion.

Given the failure of formal decision and measurement theory to generate a unique selection criterion then the multiple criteria can be characterised as individual preference functions. Their aggregation into a unique preference function (or criterion) is indeterminate [Arrow 1963 & 1951].

11.7 CONCLUSIONS

If professional accounting standards setting processes are characterised as selections of accounting measurement scales, then clearly no recourse can be had to the formal scientific processes of choice between different alternatives. To a large extent this conclusion offers itself as a formal rationalisation for the adoption of a political dimension to the investigation of professional accounting standards setting processes. The corollary is that professional accounting standards setting processes are not strictly technical.

CHAPTER 12 POLITICAL CHOICE PROCESSES

- 12.1 Introduction
- 12.2 Decision making processes
- 12.3 Political institutions
- 12.4 Power
- 12.5 Summary
- 12.6 Conclusions

CHAPTER 12 POLITICAL CHOICE PROCESSES

12.1 INTRODUCTION

A consideration of the literature of political choice processes stems from the increasing recognition being given to the "political dimension" in the literature on the professional accounting standards setting processes. This was discussed in depth above in Chapter 5 "Professional accounting standards, the political dimension and economic consequences", but it is worth recalling here that contributions to that literature include Thomas [1983], Bromwich & Hopwood (Eds) [1983], Burggraaff [1983], Hope & Briggs [1982], Hope & Gray [1982], Solomons [1983, 1980 & 1978], Beaver [1981], Hakansson [1981], Hope [1979], Watts & Zimmerman [1979 & 1978], Henderson & Peirson [1978], Kirk [1978], Standish [1978], Zeff [1978], Watts [1977], Armstrong [1976], Horngren [1976, 1973 & 1972], Moonitz [1974] and Gerboth [1973A; 1973B & 1972]. Although this increasing recognition is clear, the accounting literature is limited in as much as it does not address the nature of models implied by such a characterisation. One or two ideas, such as "power" [Hope & Gray 1982] and "coalition formation" [Newman 1981A], have been identified but only in isolation from their underlying frameworks. This chapter seeks to redress the resulting imbalance.

Full justice can not adequately be accorded to the work of political scientists in this brief review. However, an overview of their literature is essential to a proper understanding of their theoretical constructs and the potential usefulness of those constructs in contributing to any theory which seeks to explain professional accounting standards setting processes. For the purposes of this review, the political science literature is characterised as being subdivided into three separately identifiable schools, namely those on decision making, political institutions and power respectively.

12.2 DECISION MAKING PROCESSES

One approach to the analysis of political events is taken by the decision making school. This school views complex events, such as the withdrawal of USSR missiles from Cuba, as the outcome of decisions. These decisions are assumed to be rational in the sense that they are susceptible to explanation. The problem is to discover that explanation. Clearly, such a framework has potential application to professional accounting standards setting processes if we characterise the professional accounting standards setting body as a decision making body in the sense that it decides which professional accounting standards shall be adopted. Such a characterisation has been proposed by LeRoy Lewis [1978], Gerboth [1973 & 1972], Hussein [1981 & 1977], Watts & Zimmerman [1979], May & Sundem [1976], Most & Winters [1977] amongst others.

Lindblom [1959] argued that professional administrators, charged with responsibility for a subset of political decisions, find the traditional "root and branch" approach of comprehensive rationality an impossibility in operation. The information demands of comprehensive rationality are beyond human capability and resources are limited. The alternative of "successive limited comparisons" is the only operational method of choice. Lindblom further argues that the incremental approach is the only desirable method in a political environment because it involves moves based on the status quo, so implicitly considering the feasibility, in political terms, of alternatives. Within this framework, Lindblom saw the objectives of the administration as being defined by policy plans rather than vice-versa. Also, attempts to rationalise the events leading up to a given action would always fail if viewed as being rational comprehensive. Rather, the incumbent administrator is the sole custodian of an historical rationalisation because only he has access to the irregular path of incrementalism. Lindblom's view of decision processes seems to be implicitly based on Simon's [1955] notion

of bounded rationality springing from limited knowledge.

Lindblom's thesis is further elaborated in Lindblom [1977 & 1965] to encompass not only "incremental" strategies, but also "disjointed incrementalism" and "partisan mutual adjustment".

Disjointed incrementalism is the use of incrementalism by subunits of the larger unit when those subunits are allowed to proceed independently of the other subunits.

Partisan mutual adjustment is the use of small bargaining games in which subunits determine their own actions either by internal bargaining or by bargaining with other subunits. The concept of partisan mutual adjustment is considered later in the discussion of Allison's concept of "bureaucratic politics". In his later work, Lindblom further argued that, as a mechanism for aggregating preferences, partisan mutual adjustment is sensitive to "power" distributions. He observes that in the US the preferences of major corporations are very much favoured by the process.

Padget [1980] criticises the incrementalist model by exploring more closely Simon's notion of bounded rationality. He argues that the concept is an appealing one for students of US government budget research, but questions the usefulness of the incrementalist model. The incrementalist model, as operationalised by Davis, Dempster & Wildavsky [1966], is a simple linear model in which a given proportion of the base, such as last year's budget, is adjusted by some incremental term. Padget argues that this is not sufficiently rich to capture some of the features of the US Governmental budgeting process and he advances a variation which he calls "serial judgement". In serial judgement, last year's budget is still taken as the base but next the decision maker determines the direction of adjustment, as either up or down, after which stochastically generated alternatives are serially assessed. The first

alternative to meet satisficing criteria is the one which is selected. Padget provides evidence in support of his model as against the linear incremental model, and notes that the serial judgement model generates a probability distribution of outcomes with a pronounced tail; the interpretation being that there is a non-zero probability of occasional radical outcomes.

Snyder, Bruck & Sapin [1954] (SB&S), in a seminal work, have argued that the foreign policy-making of governments can be viewed from a decision making perspective. They argue that a decision unit is capable of being identified, as either an individual or a small group, and that the decision unit can be characterised by a set of preferences and an information set. The determinants of foreign policy action are, then, the determinants of preferences and of information. These are said to be (a) spheres of competence; (b) communications and information; and (c) motivation [p.105]. The decision unit is seen to be characterised as an organisation and so the organisational decision theoretic literature of the day necessarily has been subsumed into SB&S's framework. Their view is essentially a rational comprehensive view, as is evidenced by their attempts to identify all the factors which determine each of their three fundamental determinants. For example, the determinants of motivation are seen [pp.153-173] to be captured by a consideration of

- 1 the functions and objectives of the total foreign policy-making structure and of any substructure;
- 2 the objectives of particular units;
- 3 socially defined norms and values internal to the decision unit;
- 4 socially defined norms and values external to the total decision-making structure and internalised in the decision maker;
- 5 material needs and values of the society or any segment thereof not internalised in the decision-making; and
- 6 personality.

Although not made explicit in their essay, SB&S seem to have an implicit general systems theory framework. Other examples of the general systems theory framework can be found in Gray [1981], Mattessich [1978], Tinker & Lowe [1977] and Bertalanffy [1968]. Such an implied framework is evidenced by SB&S's use of terms such as "objectives of the total foreign policy-making structure" and their discussion of the role of information and feedback [p.132].

Roseman [1967] has criticised SB&S. Firstly, he notes that the SB&S definition of the decision unit as an individual or small group was a dramatic break from the tradition of conceptualising the State as the decision unit. The effect of the break was to give researchers a new vocabulary and a new focus for attention; but the framework itself was devoid of a theoretical basis. The existence of a decision making event or process was posited, a string of potential variables identified, but no expression of relationships between these variables, no testable propositions. For this reason, Roseman argues that the SB&S framework is nothing more than a new definition of the focus of attention, important in itself but insufficient to support a body of research.

Bachrach & Baratz [1963] contribute to the decision making literature and their contribution has been recognised in the accounting literature by Gray & Hope [1982] and Sutton [1980]. Importantly, they introduce the concept of a "non-decision"; that is, a structural feature of the values of individuals which they call the "mobilization of bias" [p.641]. This has the effect of ensuring that some issues never reach the point of requiring decisions. Bachrach & Baratz argue that non-decisions can be studied in the same framework as that for decisions.

Allison [1969] is a seminal review of decision analytic explanations of foreign policy processes. Allison argues that all foreign policy analysis subsumes an implied model of decision and he exposes three such implied models, illustrating them in the context of the Kennedy administration's handling of the Cuban missile crisis in 1962. The main argument is that each of the three models focuses on different variables, has different information requirements for researchers, generates a different explanation of the observations and outcomes, and generates different predictions. The three models identified are as follows

- 1 **rational policy model**, in which the outcome of collective choice is interpreted as the rationally selected alternative among a range of alternatives. The selected alternative is the one which maximises the objectives of the decision unit and the problem for analysts is the discovery of the implied objectives. The research requirements of this model are said to be minimal;
- 2 **organisational process model**, in which the outcome of collective choice is interpreted as the execution of the standard operating procedures of participating organisations (the source of this view is credited by Allison to Cyert & March [1963]). The problem for decision maker and analyst is to discover which standard operating procedures are feasible in specific circumstances. The research requirements of this model are said to be high;
- 3 **bureaucratic politics model**, in which the outcome of collective choice is interpreted as the aggregate of the solutions to a large number of bargaining games in which individuals are the players. In this way, decision making is shared by all the players who each contribute only as much as circumstances and resources permit. "But the issues are of first order importance, Thus responsible men are obliged to fight for what they are convinced is right" [p.707]. This model, Allison notes [p.708], is not often found in the literature because the values of academic researchers and of politicians are so different as to make the "politicking" inherent in the model difficult for academics to accept. The "penchant for intellectual elegance" ensures that more structural models, such as the rational policy model, will be utilised preferentially. Also, the research requirements of this model are said to be higher than those of the other two.

Allison's rational policy model, elaborated best by Synder, Bruck & Sapin [1954], is essentially an implied model of rational choice. This implied model is considered more fully above in Chapter 11 "Scientific choice processes" of the present study.

Allison's organisational process model is essentially an implied model of organisational choice. This implied model is considered more fully below in Chapter 13 "Organisational choice processes" of the present study.

Allison's bureaucratic politics model, elaborated best by Lindblom [1977, 1965 & 1959], is essentially, argues Allison, that of the bargaining game; and the players in the games are individuals. There are many games and the supply of games is structured by "regular channels" and "deadlines", the latter forcing "issues to the attention of busy players" [p.708]. The characteristics of the player are important. Dominant is the player's location in the administrative structure, usually as the head of a significant department or organisation. This position affords the player

- 1 resources, which he can invest in securing his preferred outcome. Such resources will include his personal skills and the capacity for action which his organisation or department commands; and
- 2 perceptions and preferences, which will determine his interpretation of an issue and his potential for identifying possible outcomes.

Not only are the games channelled in the timing of their occurrence and in the selection of players to fit the game, but also the subsequent actions are channelled in determining who acts and how. Such channels being determined by the organisational distribution of task responsibilities and resources. Finally, the outcome is characterised as a stream of outcomes of individual games, the aggregate of which may not necessarily have been the subject of any one game, individual preference or even individual preception.

The above characterisation of Allison's bureaucratic politics model occurs elsewhere. Firstly, the use of a bargaining game is the same as that of Lindblom's [1965] concept of partisan mutual adjustments. Secondly, the "garbage can" model of organisational choice developed by Cohen, March & Olsen [1972] (CM&O), and considered in Chapter 13 "Organisational choice processes", is structurally the same. CM&O [p.2] acknowledge Allison [1969] as one of the inspirations for their model.

Lustick [1980] has re-considered the usefulness of the developments in modelling decision making choice processes which have moved away from the rational comprehensive, or synoptic, view. He uses Lindblom's concepts of disjointed incrementalism and partisan mutual adjustment as examples of a more general consideration of increased decentralisation of decision in a complex task environment. Lustick then identifies four conditions under which non-synoptic decision making can, at best, be discounted in comparison with synoptic decision making and, at worst, result in failure in the sense of generating inappropriate or even disastrous outcomes.

Firstly, complex task environments can be characterised as having causal links between issues or problems. If issues which are so linked happen to be of very different orders of magnitude, then decentralised decision making may be problematic because the risk exposure of the decision maker may be of a low order of magnitude whereas the risk exposure of a second, disjoint, unit may be increased by a higher order of magnitude. Lustick provides [pp.344-346] an example of environmental pollution caused by sulphur dioxide on the one hand and nuclear power on the other hand. The argument is that sulphur dioxide pollution is itself incremental and so individual polluters can be encouraged to experiment in finding the best solution knowing that individual failures represent an acceptable cost of searching for a long-run solution. On the other hand, in regulating the safety standards of nuclear power stations, policy makers are ill-advised to

permit decentralised decision making because the costs of even one failure could be very high. The pollution from a nuclear power station disaster is not incremental but rather step-like.

Secondly, again characterising the complex task environment as having causal links between issues or problems, Lustick focuses [pp.346-348] on the degree to which that environment can be decomposed. The argument is that if these causal links can be clustered into discrete groupings, either over time or over other characteristics of issues, then the environment is decomposable and the boundaries of the disjoint decision makers can coincide with the natural environmental boundaries. If, on the other hand, there is no such decomposition structure then decentralised decision making can be problematic because "error messages" will be difficult to interpret. Lustick provides [p.347] an example of the use of water resources. If water resources are decomposed, say in a naturally occurring set of numerous reservoirs, then error messages received by one unit can be rapidly interpreted as relating to that single water supply. On the other hand, if there is only one non-decomposable water supply, as in the case of one major river, then error messages received say downstream could relate to errors anywhere upstream from that point. The point of the argument being that the disjoint units are unable to learn from their experience, and such learning is part of the primary justification for decentralisation.

Thirdly, Lustick [pp.348-350] argues that disjoint incrementalism is a luxury that decision makers with limited resources cannot afford. Essentially, decentralised decision making is argued to be an investment of resources in trial and error coping strategies in which the costs of the failures can be absorbed. If these error costs cannot be absorbed, say in an organisation with no slack (in the sense of Cyert & March [1963]), then the value of decentralisation must be discounted. Lustick points to evidence that, at the time of the 1930's depression, many major

US corporations which have survived switched from a decentralised to a centralised decision structure.

Finally, Lustick identifies the unequal distribution of power as problematic for decentralisation models. Lustick's argument supports the Lindblom [1977] discussion of this problem in the context of the power balance held by US corporations and how it ensures their preferences are given priority.

Lustick's reconsideration of non-rational comprehensive models has been considered at length. He argues [p.344] that an evolutionary process will ensure that surviving decision strategies will be those which are matched to their task environments by moving along an "incremental-synoptic" scale to a point determined by the characteristics of that task environment. That in itself is not such a revolutionary idea (c.f. "contingency theory", for example, Otley [1980]). Lustick's contribution is to identify factors by which that environment can be characterised. Single dimensional complexity, however measured, is insufficient a characterisation. Also he implicitly alerts us to the need for some higher order synoptic explanation of the decision process. Such an explanation might be offered by the next section.

12.3 POLITICAL INSTITUTIONS

Some students of politics have been much troubled, and so stimulated, by Arrow's "Possibility theorem" [Arrow 1963 & 1951].

Frohock [1980] has argued that a long concern of political thought, namely morality, has a place in the interpretation and development of Arrow's work. Morality is presented as a core concept in early notions of the nature of values. This is contrasted with the value structure of individuals in Arrow's society. These individuals are seen by Frohock [p.382] as bearing the legacy of Hobbes, Mill and Bentham. Their values are isolated from each other in the determination of collective choice and such choice can be no more than the sum of the parts. Frohock's concern with the morality embedded in individuals' preferences stems from his desire to "avoid the impossibility results of Arrow's theorem" [p.373]. It is interesting to note that Frohock, following many other writers, refers to Arrow's Impossibility theorem, interpreting the theorem as a negative statement. On the other hand, Arrow called the theorem his Possibility theorem. Adopting the positive terminology invites consideration of the positive implications, namely the conditions which need to be modified (to an extent not analysed by Arrow) before collective choice is determinable. For the purposes of the present study it is unnecessary to invoke the concept of morality, but sufficient to recognise its potential as a partial structuring of preferences. If morality exists it is assumed to be captured by other routes, such as the consideration, in Chapter 14 "Professionalisation processes", of professions and the altruism attribute.

Riker [1980, p.432] notes that an early tradition of study of political institutions gave way in recent times to a study of tastes and values, that is, preferences. Such study is attributed to a Christian belief in the sovereignty of belief and is said to be enshrined, in Benthamite "radicalism" [Bentham 1823], as a view of democracy as "a device to combine individual values into decisions of government". Arrow, arguing differently, implies that preferences need to be constrained in order to determine collective choice as an outcome of the social welfare function. Today's democracy is no more than one of a number of possible devices for constraining those preferences.

Riker [1980] traces the steps by which the study of tastes and values by students of politics has led, or has started to lead, to a renewed study of institutions. Drawing attention firstly to "the great amount of research on public opinion (which concerns the nature of tastes and values), political socialisation (which concerns the creation of tastes and values), and representation (which concerns the incorporation of tastes and values in public decisions)" [p.433], he then draws attention to the work of economists who, through their microeconomic price theory popularised an interest in, and search for, equilibrium concepts. Political equilibrium was soon discovered in Black's single-peakedness constraint on preferences in committee voting structures [Black 1948]. Riker reviews the subsequent work of McKelvey [1976], Fishburn [1973], Plott [1967] and Black & Newing [1951] and concludes [p.443] that the sufficient conditions identified to date for a stable voting equilibrium, based solely on preferences, are so restrictive that disequilibrium in the real world is assured. Further, that when equilibrium breaks down it does so completely. This characterisation of the political world is seen as significant by Riker because it implies

- 1 the political world is characterised by an inherently unstable preference structure; and
- 2 any observed stable equilibria must derive from institutions rather than from preferences.

Consequently, the study of institutions is advocated by Riker as crucial to an understanding of equilibria and of the mechanisms by which certain preferences can be systematically included or excluded, that is, constrained. In such a study Riker remarks that what is

"scientifically interesting is the interaction among the several participants in a system to discover the particular kinds of outcomes that are both feasible and likely, given a particular institutional arrangement". [p.444]

Such a framework of analysis does not admit the traditional attention of students of politics to the concept of "power". The concept of power is traditionally debated as meaning different things to different researchers and implies a well defined relationship of causation. In contrast, the institutional analysis is concerned with identifying structural patterns of preference constraint rather than inferring that, in some sense, intent or causation underlies those patterns. A more detailed consideration of the concept of power and its relationship to this study is provided below in Section 10.4 "Power".

Shepsle [1979] has considerably advanced the analytic framework for a study of the institutional preference constraining mechanism. Supporting Riker, Shepsle notes that equilibria of preference structures are dependent upon extraordinarily severe restrictions of preference [p.28]. To further explain the process of collective choice and collective action, Zeckhauser & Weinstein argue that

"The relatively infrequent appearance of cyclical majorities in functioning legislatures cannot be explained by some geometric property of individual's preferences.....matters such as procedural rules and institutional constraints provide key insights into real-world social choice phenomena" [1974, p.664].

In one guise, the problem of procedural rules has been the subject of study for a number of researchers, namely those interested in agenda control and voting strategies. Their problem has been, in one sense, the identification of agendas and voting rules which are strategy proof. For example, Satterthwaite [1975] and Gibbard [1973] both show that no pure voting scheme is strategy proof. That is, by forming coalitions or misrepresenting their preferences, some voters can always win. Plott & Levine [1978] and Levine & Plott [1977] modelled, and tested on a real-world decision, the influence of agenda design on the outcome of voting. McKelvey [1981] has demonstrated the existence of an optimal agenda, that is one which maximises the probability of a specified outcome occurring, and further developed a dynamic programming model for its determination. A development which could be of considerable importance to agenda-setters were it not for the fact that McKelvey has not been able to avoid the Gibbard and Satterthwaite results of non-strategy proofness; he has assumed naive voters, that is voters who do not vote strategically.

An important contribution from Shepsle is a model, of the institutional rule structure itself, which adopts the following definitions [1979, pp.31-35]

- 1 **committee system**, as a collection of subsets of the number of members of a decision making institution;
- 2 **jurisdiction**, as a set of orthogonal base vectors or dimensions which spans the space of alternatives;
- 3 **proposals**, as changes relative to the status quo;
- 4 **amendment control rules**, as modifications which a parent body may make to the proposal of a committee; and
- 5 **germaneness rules**, as the restriction of parent body modifications to some subset of all possible alternatives; for example, those which relate only to the jurisdiction of the committee generating the proposal (a jurisdictional germaneness rule).

From this set of definitions, Shepsle's analysis [pp.35-51] demonstrates that both preference-induced and structure-induced equilibria exist, and that the former is a subset of the latter, that is, there can be structure-induced equilibria that do not correspond to preference-induced equilibria but not vice versa [p.37]. An important assumption made in generating this result is that each "committee" only has "jurisdiction" over one of the orthogonal base vectors or dimensions. Shepsle notes [p.52] that Slutsky [1977] has extended this result to include jurisdictions over any linearly independent set of vectors which span the alternatives space; that is the committees need not be restricted to one dimension at a time, but no two committees can have jurisdiction over a common dimension. Slutsky notes "equilibrium need not be Pareto-optimal" [p.312] because, inter alia, information about preferences is incomplete in the sense that some points might exist which are preferred unanimously but which cannot be attained as a result of the jurisdictional restrictions. Buchanan & Tullock [1962] had already identified this problem and had suggested that "log-rolling", that is, trading votes across issues would tend to circumvent the jurisdictions. Two points arise

- 1 that log-rolling, by attempting to circumvent the very structure that has induced the equilibrium, may itself be destabilising; and
- 2 that a free-market in log-rolling trades, including cash payments, is likely to be inconsistent with many preference structures and so be itself "ruled out".

Mackay & Weaver [1978] address the application of structure induced equilibria as they are found in monopoly bureaus, that is public agencies charged with the exclusive supply of some public goods. Mackay & Weaver's concern is that the particular structure induced equilibria to be found accord, in many cases, "too much" (in some undefined sense) "power" to the agenda setters. Accordingly, they suggest changes to these institutions designed to ensure an increased variety in proposal generation.

Reflecting for a moment on one of Arrow's four conditions, namely that all logically possible orderings of the alternative states are admissible [1963, p.96]. The above argument implies that it is this condition which is being relaxed in order to generate equilibria of social choice. This can be summarised as equilibria of social choices are determinable by majority vote if the set of preferences over all logically possible orderings of the alternative states is constrained by an institution of rules allocating jurisdictions and amendment rules to sets of decision makers.

Many writers use the term "institution" to describe the set of rules itself and Riker notes "that institutions are probably best seen as congealed tastes" [1980, p.445].

Riker notes that the sort of study of institutions suggested above has been undertaken, independently, by students of the US Congress. Such students include Mayhew [1974], Rhode & Shepsle [1973], Manley [1970], Davidson [1969], Fenno [1966], Huitt [1954] and Truman [1951]. A brief, and informal, survey indicates a vast literature on this topic and so a richness of theoretical and methodological insight of immense value to students of the professional accounting standards setting processes.

An alternative approach to the problem of identifying stable preference constraints has been presented by Thompson & Faith [1981]. They assume the existence of a "punishment" relationship [1981, pp.372-373] defined on individuals such that every individual but one has somebody who can punish him. Under such a regime they conclude that "any solution to social interaction under truly perfect information is dictatorial in the sense of Arrow" [p.374]. Although Thompson & Faith argue to the contrary, this result seems to be a trivial one stemming directly from the assumption of punishment which, through a chain of punishment relationships, is equivalent to many intuitive definitions of dictatorship. Nevertheless, this dictatorial model is used by Thompson & Faith as the basis for a discussion of the histories

of human civilisations in terms of different dictatorial solutions brought about by different technologies of punishment. Such a discussion is at an exceptionally general level and seems not to be supported by other writers. In view of its generality, early stage of development and lack of intuitive appeal, the dictatorial model is not considered further in the present study.

12.4 POWER

The concept of power has been much debated by students of politics; examples include McLachlan [1981], Wrong [1979], Lukes [1974], Pfeffer & Salancik [1974], Salancik & Pfeffer [1974], Poulantzas [1973], Tedeschi & Bonoma [1972], Dahl [1970] McFarland [1969], Riker [1964] and Bachrach & Baratz [1962]. In addition, the concept has been introduced into the accounting literature by writers such as Gray & Hope [1982] and Newman [1981B].

Lukes [1974] provides a review of much of this debate and concludes that power is a concept of three dimensions, namely

- 1 power of making decisions in situations of observable conflict [p.15];
- 2 power of making non-decisions in situations of observable conflict; and
- 3 power of suppressing latent conflicts, that is real, but unobservable conflicts [p.24].

On the other hand, Riker [1964], which was not reviewed by Lukes, also provides a review of much of the debate and concludes [pp.343-345] that power is a concept most usefully analysed as being of two dichotomous dimensions, namely

- 1 whether the relationship is dyadic or n-person. That is, if the relation is between two persons or more than two; and
- 2 whether the relationship is ego-oriented or alter-oriented; that is, if the individuals are assumed to behave in their own self-interest or altruistically.

Riker extends this analysis by positing an equivalence between the two dimensions he has identified and two different concepts of causality. Here he distinguishes between

- 1 "recipe" causality, that is, a causes b; and
- 2 "if and only if" causality, that is, a and b are always associated with each other.

In the present study there is neither the opportunity nor the competence to critically evaluate the opposing views of power. It is nevertheless important to demonstrate how the concept relates to the analysis.

Firstly, the Lukes analysis adopts preference conflict as a necessary condition and distinguishes between observable conflict and unobservable conflict. Further, implicit in the Lukes' analysis is the notion of action enabling one or more of those preferences to dominate one or more other preferences. Such action is either overt, as in "making decisions"; covert, as in "making non-decisions"; or structurally induced, as in "suppressing latent conflicts". Clearly, underlying Lukes' notion of power then is a notion of causality. That, in some sense, by engaging in one of the identified types of action, a causes b. In this sense the conflict is redundant because it is implied in the causation process, that is, if preferences were such that b would have occurred anyway then a can hardly be said to have caused b. At this level of analysis there is a useful common factor between the Lukes and Riker concepts. They both imply causality, that is, demonstration of a casual mechanism is a necessary condition for the demonstration of a power relation. We are led, then to ask whether or not causality itself is a useful concept and are immediately drawn to a philosophical debate.

One solution to the problem of determining the nature of causality is to argue that it is a non-operational concept, that is we cannot observe causation. What we can observe is correlation, even strong correlation. But although we can infer a statement such as a is related to b, we can never say a causes b. We can never know that there is not some other, as yet unidentified, factor which has intervened to cause b or, alternatively, that b causes a. Such a problem is well recognised by students of statistical inference, for example Hamburg [1977, p.402]; and by others, for example Rosenthal &

Rosnov [1975, p.35], Kabovitz & Hagerdorn [1971] and Kaplan [1964]. The implication, then, is that we can never observe power. That is not to say that power, like causation, does not exist; simply that we cannot observe it and we should not be too ready to infer power, like causation, when we do observe strongly correlated variables.

Hempel [1952, pp.39-50] argues that theory construction is often facilitated by the use of non-operational concepts, that is, a concept which is strictly unobservable per se. The role that these non-operational concepts play is one of connecting together operational concepts. The physical sciences are rich with examples. In thermodynamics, "entropy" is strictly unobservable but acts to unify much of thermodynamic theory; in classical mechanics "momentum" is similarly strictly unobservable but serves to unify the theory. Perhaps "power" can play such a theory unification role in social and accounting theory. This may be the case; for, although it is strictly unobservable per se, the concept has clearly proven to be of value to many writers in political science.

For the purposes of the present study it is not necessary to adopt a power concept. Indeed, it can be positively unhelpful in its necessary implication of a causal mechanism which may not be well founded empirically. Social and accounting theory are nowhere near as rich and complete as theories of the physical sciences and the usefulness of a non-operational "connecting" concept can only be established if there is a body of concepts to be so connected.

12.5 SUMMARY

On the one hand, there is the literature which seeks to identify the process by which political decisions are made. The processes have been characterised as incremental and disjoint [Lindblom 1977 & 1959] and susceptible to occasional radical outcomes [Padgett 1980]. An alternative characterisation is that of comprehensive rationality [Synder, Bruck & Sapin 1954]. Debate has focussed on which of the two models is the "best fit". Lustick [1980] offers a "contingency theory" solution which suggests that environmental characteristics determine where a given political decision process is placed on a disjoint-rational scale. Allison [1969] suggests that decision processes might also be characterised as organisational in the sense that they suggest the automatic execution of standard operating procedures. The definition of a decision is extended by Bachrach & Baratz [1963] to include a "non-decision".

On the other hand, there is the literature which seeks to identify the existence of equilibrium concepts. Stimulated by Arrow's [1963 & 1951] "impossibility" result, the problem is to identify constraints on individual preferences sufficient to generate equilibria in political choice [Riker 1980]. The study of morality in politics once served this function implicitly [Frohock 1980] as did the study of political institutions [Riker 1980]. Black [1948] first identified a set of constraints sufficient for equilibrium. Shepsle [1979] models the sets of constraints as a committee system with jurisdictions, proposals, amendment control rules and germaneness rules. Within the Shepsle model, equilibrium results can be obtained and the trading of votes across issues, ("log-rolling") introduced by Buchanan & Tullock [1962], is seen by Slutsky [1977] as a useful adjunct. The interest by some researchers (for example, Levine & Plott [1977]) in agenda control is captured by the Shepsle model. There is a substantial body of empirical research addressing the study of institutions which closely resemble the committee

system. This body of research (for example, Manley [1970], Fenno [1966] and Truman [1951]) is concerned with the US Congress.

The concept of "power", much debated by political scientists [Lukes 1974; Riker 1964], is not an operational concept in the sense that its existence can be unambiguously observed.

12.6 CONCLUSIONS

A study of the literature of political choice processes has led to two separate, and important, sub-sets of political literature.

On the one hand, there is the literature which seeks to identify the process by which political decisions are made. The search has been much stimulated by developments in the organisational decision process literature. The study of that organisational literature below in Chapter 13 "Organisational choice processes" is a natural supplement to this finding.

On the other hand, an entirely separate body of literature exists which seeks to identify the existence of equilibrium concepts. The search is directed by the formal analysis developed from the seminal work of Arrow [1963 & 1951]. A significant body of literature which investigates the operations of the US Congress is beginning to be related to the formal analysis by key works such as Shepsle [1979].

The relationships between the above frameworks and the professional accounting standards setting processes have not yet been made explicit.

Firstly, the professional accounting standards setting processes could possibly be modelled as an organisational type of decision making process. The review in Chapter 13 "Organisational choice processes" seeks to contribute to this.

Secondly, the Shepsle [1979] characterisation of a political institution as a committee system appears to be closely related to the description set out above in Chapter 3 "The Accounting Standards Committee". In particular, the UK professional accounting standards setting processes are established as a committee system in which the various working parties of the ASC has its own jurisdiction based on a set of proposals contained in

an Exposure Draft. Implied amendment control rules might exist whereby the governing bodies are constrained in the modifications they can make. Again, implied germaneness rules might exist whereby some alternatives are excluded completely from consideration.

The Shepsle committee system framework was characterised above as a model of the way in which preferences are structured in order for stable equilibrium to exist. In particular, it was stated that

equilibria of social choices are determinable by majority vote if the set of preferences over all logically possible orderings of the alternatives is constrained by an institution of rules allocating jurisdictions and amendment rules to sets of decision makers.

So then, fruitful areas of research lie in the exploration and elaboration of this Shepsle committee system model. One area would be the refinement and formalisation of the description of the UK professional accounting standards setting processes as a Shepsle committee system. Another area would be the exploration of the way in which majority votes are constrained within the processes. This can be made operational by determining how majority votes are reflected in the outcomes of the process. In a sense, an exploration of this latter aspect constitutes the empirical part of the present study presented in Part IV "Evidence from the empirical study of UK data".

CHAPTER 13 ORGANISATIONAL CHOICE PROCESSES

- 13.1 Introduction
- 13.2 Organisational choice processes classified
- 13.3 Choice in ambiguity
- 13.4 Summary
- 13.5 Conclusions

CHAPTER 13 ORGANISATIONAL CHOICE PROCESSES

13.1 INTRODUCTION

Two analyses have led to a consideration of the literature of organisational choice processes.

Firstly, in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes", it was shown that both Porter [1979] and Klein [1978] characterised the US professional accounting standards setting processes as being, in part, an organisational choice process.

Secondly, in Chapter 12 "Political choice processes", it was shown that Allison [1969] distinguishes between rational policy, organisational process and bureaucratic politics as different models of political decision making. Allison argues that the organisational process model is implied in much political analysis.

Additionally, authors such as Hopwood [1983 & 1978], Cooper, Hayes & Wolf [1981] and Hofstede [1981] argue for an organisational perspective for the study of accounting.

The review shows that the models of organisational choice processes offer considerable promise for the investigation of the professional accounting standards setting processes; such promise being put forward as a suggestion for further research.

13.2 ORGANISATIONAL CHOICE PROCESSES CLASSIFIED

13.2.1 Introduction

Theories of organisational choice processes are integral parts of theories of organisations to the extent that the latter can be characterised as theories of how organisations choose the actions they take. For example, Weber [1947] was seminal in developing the concept of organisations as bureaucracies. A bureaucratic organisation makes its choices by recourse to rule and procedure formulated over time and as the result of a rational comprehensive decision process. Such a decision process was also discussed above in Chapter 12 "Political choice processes". A single organisational goal is assumed and all action is directed to achievement of that goal. Behaviour, beliefs, preferences and actions not consistent with the rational comprehensive decision process are, by definition, aberrant and to be eradicated by further rule and procedure. The power to enforce is assumed to be absolute. Taylor [1911] was equally important in elaborating this rational comprehensive decision process paradigm. Taylor's "scientific management" analysed human productive action in order to isolate and bureaucratised the essential productive component. Any non-essential action was ruled out and so, the critics of Taylor argue the productive process "de-humanised".

The works of Clegg and Dunkerley [1980] and Perrow [1979] trace the evolution of organisation theory from its early rational comprehensive paradigms to more subtle understandings of today. That is not to say that organisation theory is in any sense a genuinely evolutionary body of thought. Hofstede has argued that organisation theory is culture bound in the sense that theorists will reflect the values of their own culture in their explanations of the phenomenon of organisation [1981, pp.30-34]. Considerable change is taking place in the understanding of organisational choice processes. The earlier bureaucratic models of Weber and Taylor have been supplanted by behavioural models of

March & Olsen [1976], Cyert & March [1963], March & Simon [1958] and Simon [1955]. These latest models of the choice processes within organisations attempt to explain features of organisational behaviour which have, under earlier models, been hitherto regarded as pathological. For example, the concept of a unique organisational goal is no longer subsumed into organisational models, after Simon's [1964] notion of a set of constraints; individuals are no longer assumed to be rational comprehensive decision makers since Simon's [1955] notion of bounded rationality; organisations are no longer seen to be bureaucracies since Cyert & March's [1963] notion of coalitions; problems are no longer the sole basis for choices since Cohen, March and Olsen's [1972] "garbage can" model of choice; and action is no longer the outcome of choice since March's [1971] technology of foolishness.

In order to be systematic with regard to the apparent revolution and chaos of thought on organisational choice processes, it is instructive to follow Klein [1978] and adopt the seminal analysis of different types of decision provided by Thompson & Tuden [1959] (T&T). T&T argue that decision processes can be characterised by two variables

- 1 the degree to which the participants in the processes agree on the causal relationship between alternative actions and future states of the world; and
- 2 the degree to which the participants in the processes agree on their preferences for those future states of the world.

By taking the elementary dichotomous case of each of these variables, that is in each case participants either agree or disagree, T&T were able to generate [p.78] the four-celled matrix reproduced below as Figure 13.1 "Thompson & Tuden's typology of decisions".

FIGURE 13.1: THOMPSON & TUDEN'S TYPOLOGY OF DECISIONS

Beliefs about causation	Preferences about possible outcomes	
	Agreement	Disagreement
Agreement	Computation	Compromise
Disagreement	Judgement	Inspiration

Source: Thompson & Tuden [1959, p.78]

The above characterisation enabled T&T to focus initially on the structure of decisions; consideration of organisational structure was considered as conditional on decision structure. At risk of repeating T&T's own elaboration of the four decision cells, they will be discussed below. The T&T characterisation enables us to conceptualise organisational choice processes as following a pattern. It is, of course, possible to generate a less coarse measure of the degree of agreement than the simple dichotomous case. Such a refinement of measure may detract from the main objective of clarifying the problem and will not be considered here. Having identified a pattern, it can be seen how developments in the literature fit into this pattern.

13.2.2 Computation

Computation was identified by T&T as the decision strategy corresponding to agreement between participants on both (a) their preferences for future states; and (b) the causal relationships between actions and those future states. Such agreement implies sufficient information on other potential variables, such as the range of alternatives or technology. Under such conditions, decisions can be systematised completely and T&T argue [p.79] that the organisational form most appropriate to such a class of decision is Weber's bureaucracy. As noted earlier, Weber [1947] and Taylor [1911] represent the rational comprehensive decision process based organisation literature. The T&T computation decision structure implies the scientific choice process model considered more fully above in Chapter 11 "Scientific choice processes".

13.2.3 Compromise

Compromise was identified by T&T as the decision strategy corresponding to disagreement about preferences when there is agreement about causation. They envisage bargaining as being the appropriate mechanism for making these decisions. The compromise decision structure can be represented by both the political choice literature and the "bargaining" literature. The former is considered more fully in Chapter 12 "Political choice processes". The bargaining literature is extensive and, in general terms can be characterised by three main approaches, namely the game theoretic (for example Harsanyi [1962], Luce & Raiffa [1957], Nash [1953], Von Neumann & Morgenstern [1944]) the economic (for example Coddington [1966], Cross [1965], Pen [1952]) and the manipulative (for example Walton & McKersie [1965], Ellsberg [1959], Schelling [1956]). Such a three-way characterisation can be found in Young [1975] where much of the above has been collected.

In the organisation literature, Cyert & March's [1963] model of organisation as a collection of coalitions is captured by this compromise decision structure, as is Simon's [1964] notion of the constraining effect of a multiplicity of goals. The Cyert & March model is worth a little elaboration at this stage because of its importance in the literature and because it recurs later in our consideration of political choice processes. Cyert & March criticised the usual economic assumptions about the nature of the business firm as being essentially based on the rational comprehensive model. Cyert & March set out to describe how decisions are actually made in the firm. Seeing firms as coalitions of individuals, and of groups of individuals, each with their own conflicting goals, Cyert & March argued that the only way in which firms can manage the inherent conflicts is to treat them sequentially, that is in response to specific problems as they arise. Over time a firm develops the ability to become an adaptive institution in the sense that it learns from

experience and builds up a standard operating procedure which is, in a sense, the repository of the cumulative body of experience. Additionally, the firm in time develops "organisational slack", that is surplus resources, which act as a crucial buffer to both internal conflict and environmental shocks. The decision process itself is described in terms of Simon's bounded rationality model which is applied to decision problems sequentially. This sequential treatment of problems then is a core concept in the Cyert & March model.

13.2.4 Judgement

Judgement was identified by T&T as the decision strategy corresponding to agreement about preferences when there is disagreement about causation. They suggest that such decisions be made by "wise and knowing men", or "expert opinion", in a committee structured organisation. The judgement decision structure is perhaps best represented by the "professionalisation" literature so far as it concerns the role of professionals in bureaucracies (for example, May [1976], Montagna [1968], Vickers [1965], Freidson & Rhea [1963] and Ben-David [1958]). This literature, which is considered more fully below in Chapter 14 "Professionalisation processes", captures, for example, professional decisions in the law courts, universities and hospitals. It is clearly of potential application to the committee structured professional accounting standards setting processes described above in Chapter 3 "The Accounting Standards Committee".

The judgement decision structure further captures Simon's [1955] bounded rationality model. Simon's decision maker does not find preferences problematic, but does find causal relationships problematic because he only has sufficient information on which to construct probability estimates of future states.

13.2.5 Inspiration

Inspiration was identified by T&T as the decision strategy corresponding to disagreement about preferences and causation. They see this combination of disagreements as problematic and argue that in such circumstances appeal is usually made to some higher authority such as a god or other charismatic leader.

This inspirational decision structure T&T found perplexing, remarking "the group in this situation is nearing disintegration" [p.81]. In contrast, it is just this situation about which the recent developments by Feldman & March [1981], March and Olsen [1976], Cohen, March & Olsen [1972], and March [1971] have been concerned. This recent body of literature argues that organisations finding themselves in this environment are far from disintegration but have evolved decision strategies which make survival a feasibility.

13.3 CHOICE IN AMBIGUITY

Let us now concentrate on the fourth decision structure in T&T's analysis. We will no longer refer to this as "inspirational", for some of the analytical tools are available to justify a less perplexed approach than was the case in 1959. Rather, we will refer to "ambiguity" following March & Olsen [1976].

A brief consideration is in order to justify concentrating on this one case to the exclusion of the other three. Recall that this study is concerned with an investigation of how professional accounting standards for external financial reporting by organisations are chosen. The choice processes are embedded in a complex social structure in which there is interaction between several interest groups as described above in Chapter 3 "The Accounting Standards Committee" (for example, Hopwood [1983]). Trivially, there will be disagreement on the preference structure of these choice processes. Less trivially, there is disagreement on the causal relationships between choices and future states. But even that second disagreement seems to be a given of social systems. In Chapter 11 "Scientific choice processes" above, it was argued that much of social theory is inadequate to demonstrate strong causal relationships between today's choice and tomorrow's state of the world. In accountancy there is to be found no exception. Accounting professionals, by virtue of belonging to a profession, profess to have greater insights into such relationships than most. A survey of the theoretical accounting literature, such as Dopuch & Revsine [1973] or "Statement on accounting theory and theory acceptance" [AAA 1977], demonstrates, at its most charitable, this insight to relate to matters other than causal relationships. At a philosophical level, the social sciences just may not be amenable to the identification of causal relationships in the classical sense, but here is not the place to pursue that debate (see, for example, Sheldrake [1982]). Suffice it to note that where causal relationships are not identified, then disagreement on the

nature of those relationships is to be expected. Of course, such disagreement is not guaranteed. It is possible that by homogeneous education, socialisation, religion and the rest, we may come to homogeneous beliefs. But to assume heterogeneous beliefs is, today, realistic.

Indirect support for the interest in choice in ambiguity is also provided by the contributions to the accounting literature by Cooper, Hayes & Wolf [1981] and Hofstede [1981]. Both contributions argue that a model of choice in ambiguity is important to understanding the role of accounting information systems within organisations.

What, then, is the model of choice processes in ambiguity? Perhaps the most interesting recent development is the "garbage can" model of Cohen, March & Olsen [1972], hereafter CM&O, elaborated in March & Olsen [1976]. In the garbage can model, the organisational choice process is characterised as comprising four main elements, namely choice opportunities, participants, problems, and solutions.

Choice opportunities are central to the model and are occasions when the organisation is expected to make choices, or as CM&O state "these are occasions when an organisation is expected to produce behaviour that can be called a decision" [p.3].

Participants are individuals who participate in the choice process. No assumptions are made about their individual goals, or preferences; about their rationality; or about the degree or nature of their involvement.

Problems are issues which are considered to be problematic and may include ideological, social and personal issues along with the more conventional resource allocation issues.

Solutions are artifacts or ideas which can be viewed as answers to problems. No assumptions are made about the problem to which the solution may be an answer; or about whether or not a problem has yet been defined to which the solution might correspond.

The framework constructed by CM&O then assumes widespread ambiguity. The organisation is seen as not knowing what its problems are, what the solutions are that are available to match those problems, or who the current or potential participants are. Choice opportunities are seen as opportunities in the sense that the organisation has the opportunity to discover some of these unknowns, to discover who the participants are, to discover what the problems are and to discover what solutions are available. If a choice opportunity happens to result in a match between a problem and a solution, then it will appear to have made a decision; but no such matching is guaranteed in the garbage can model.

The concept of a choice opportunity, or, as CM&O call it, the "garbage can", can now be elaborated. An extreme example arises in the event of a natural catastrophe. Take a fire that destroys a manufacturing plant. A choice opportunity has come into existence. A string of problems arises: how to satisfy customers; how to replace lost production; how to ensure maximum compensation; how to make sure valued staff do not go elsewhere during reconstruction. Also a string of solutions arises: the latest technology can now be incorporated into the production process; the new production facility can be constructed in a different location with better transportation access; the belligerent trade union leader can be made redundant. Further, a string of participants materialises, as if from nowhere. The production engineer is the man with the suggestion for the latest technology; the local politician in the possible new location appears with "investment incentives"; the personnel manager who has had enough of the trade union belligerent. Yet, before the fire it is possible for none of these problems or solutions to have been active. The production engineer was coping with his outdated technology; the local politician didn't even know the organisation existed until he read about it in the press; the organisation was unaware of better transportation possibilities; and the personnel manager didn't dare mention the possibility of

ousting the trade union leader. All this of course is imaginary, but it is the basis of an understanding of a previously perplexing and intractable environment. Furthermore, choice opportunities arise in much more mundane ways

"contracts must be signed; people hired, promoted or fired; money spent; and responsibilities allocated" [CM&O, p.3].

The garbage can model is based on four independent variables

1 the rate of flow of choice opportunities;

The rate of flow of choice opportunities can be defined in terms of (a) the timing of its activation; and (b) the structure of problem access, that is the sorts of problems available to it. Clearly, there will always be some problems which cannot be considered "legitimate" in given choice opportunities; in the case of the fire damaged production plant the problem of determining an appropriate accounting policy for revenue recognition is likely to be not accessible to the choice opportunity.

2 the rate of flow of problems;

The rate of flow of problems can be defined in terms of (a) the timing of activation; (b) the structure of choice access, that is the sorts of choices under which the problem would be considered legitimate; and (c) the energy requirement, that is the total energy which participants would need to expend in order to "solve" the problem.

3 the rate of flow of solutions; and

The rate of flow of solutions can be defined in terms of (a) the timing of its activation; and (b) an energy discounting factor, that is the amount of difficulty associated with the identification and matching of solutions with problems. So, a heavily energy discounting solution would be a difficult solution to operationalise.

4 the rate of flow of energy from participants.

The energy availability can be defined in terms of units of energy per participant. A highly paid executive can be expected to contribute more energy than a local politician who in turn can be expected to provide more energy than a machine tool operator.

Having sketched the basic elements of the garbage can model, it is unnecessary to elaborate the model itself [CM&O, pp.17-24] here but rather, following CM&O, note that predictions from the model are in the form of characterisations of the organisation being investigated.

The following characteristics were presented by CM&O [pp.8-9]

- 1 decision style, being either decision by resolution, oversight or flight;
- 2 problem activity, being measured as the sum of the product of
 - (a) the number of time periods each active problem was attached to a choice; and
 - (b) the number of active problems attached to a choice;
- 3 problem latency, measured as the sum of the product of
 - (a) the number of time periods each active problem not attached to a choice; and
 - (b) the number of active problems not attached to a choice;
- 4 decision maker activity, measured as the total number of times decision makers have shifted between choices; and
- 5 decision difficulty, measured as the sum of the product of
 - (a) the number of time periods each choice was active; and
 - (b) the number of active choices.

In order to help keep track of the meaning of these characteristics, it can be seen that application of dimensional analysis (for example, Ellis [1966, pp.139-151] or Bridgman [1931]) reveals that, while decision style and decision maker activity are dimensionless, problem activity, problem latency and decision difficulty are all measured in time periods. So the greater the number of time periods the greater the problem activity, problem latency or decision difficulty of the organisation and, perhaps, its environment.

Now consider what benefits the "garbage can" model has to offer students of organisational choice processes. Substantially, the model fills, or attempts to fill, a definite gap in the literature identified as "inspiration" in T&T's [1959] characterisation of decision styles. The literature (a) is replete with models of T&T's computational decisions and compromise decisions; (b) has some evidence of discussion of judgement models; but (c) prior to the garbage can, had no formal models of ambiguity, although works such as Thompson [1967], Lawrence & Lorsch [1967], Lindblom [1959] and general systems theorists such as Bertalanffy [1968] were contributions. The garbage can model provides a framework for the understanding of hitherto intractable decision processes.

Consider further what benefits the "garbage can" model has to offer students of professional accounting standards setting processes. Firstly, it has already been noted above that the ambiguity of preferences and of causal relationships is a partial characterisation of the environment of the professional accounting standards setting processes. Additionally, the ambiguity of decision maker activity is consistent with the Barrett [1978] description of attendance at ASC meetings and with the Westwick [1980] description of Government involvement in the UK inflation accounting debate. The ambiguity of the relationship between solutions and problems is consistent with the Whittington [1983] description of the UK inflation accounting debate. None of this is to say that the "garbage can" model is a perfect model of the UK professional accounting standards setting processes. Rather there are sufficiently close parallels to justify exploration of the usefulness of such a characterisation.

Limitations of the garbage can model can be identified.

Firstly, the model does not fit easily into other bodies of literature. In particular, its framework appears to be inconsistent with that of economic theory.

Secondly, Thompson [1981] has produced evidence that in one specific decision process, embedded in an organisation of the type for which the garbage can model was developed, a simple rational utility maximising model has sufficient explanatory power. It is worth looking more closely at this conclusion. Thompson considered the result of another study in which it was concluded that PhD granting departments in US universities behaved as if they were maximising their prestige. Thompson conducted further tests of this hypothesis and re-affirmed its validity. Thompson concluded, as does Friedman [1953], that rational choice models, based on assumptions that patently do not accord with empirical findings, have sufficient explanatory power to justify their investigation and utilisation. The implication

being that other models, based on assumptions that do accord with empirical findings, are unnecessary elaborations. Of course, here we recognise a familiar debate (for example, Christenson [1983]) between instrumentalists and realists. Having drawn attention to this debate we will not pursue it here. Suffice it to note that where one draws the line between sufficient and insufficient explanatory power is simply either a matter of belief or, alternatively, the intended use of a theory. We live in a world of heterogeneous beliefs and utility functions. There is room for both. By implication then, Thompson's criticism of Cohen, March & Olsen is well founded, but for the purposes of the present study not relevant. The present study is founded on the belief that there is room for both approaches stemming from the heterogeneity beliefs and preference functions.

Having detailed much of the basic garbage can model of choice processes in ambiguity, some of the elaborations that can be found in the literature can now be considered. One such is organisational learning in March & Olsen [1975]. There it is argued that ambiguity causes participants not to know whether the outcomes of past choice processes are preferred or not preferred because there is limited information and understanding of what the outcomes actually were. Accordingly, in future choice opportunities the availability of a bank of learning experience is limited and so reliance is placed on beliefs and the mechanisms by which beliefs are formed. Another elaboration is March [1971], in which the mechanism connecting choice with action is explored in terms of a "technology of foolishness". There it is argued that organisations facing ambiguous environments can learn to survive by adopting an experimental approach to action. In the face of little or no knowledge then an action selected arbitrarily (say from a set of proximate alternative actions) will not only suffice but also enable the organisation to test its environment. Even more information can be derived from a test in which the organisation acts openly hypocritically or foolishly; for then it is able to measure the

boundaries of its potential actions. Lindblom [1959] advanced similar arguments in favour of a scientific approach to "muddling through".

Yet another elaboration comes with Feldman & March [1981] who discuss the role of information in such an organisation. There it is argued that not only does information serve a rational, decision oriented function, but also a symbolic function. Clearly, organisations must make some more nearly rational choices, even if these are fairly low-order choices such as designing queuing procedures or engineering design. Equally, organisations also make choices in the face of ambiguity when information is of little or no direct use. However, there are incentives to accumulate information considerably in excess of the rational choice requirement. Such incentives include

- 1 surveillance of the environment for surprises;
- 2 maintenance of an office holder's power base where there is a division of labour between information gathering, by an "information gatekeeper", and information use;
- 3 strategic misrepresentation; and
- 4 symbolising that the gatherer possesses attitudes about rational choice which are socially and organisationally acceptable, so legitimising his, or his organisation's, position.

Pettigrew's [1973] study of a choice opportunity in an organisation demonstrated the use of information by an "information gatekeeper" as a source of power for influencing, in that case unsuccessfully, the choice process. A further elaboration can be found in March & Olsen [1976, Chap.3] in which the part-time nature of the participants is discussed. Attention by participants to a choice opportunity is seen to be a complex phenomenon itself. An entrance is simultaneously an exit elsewhere and so any understanding of the role of participants must concentrate on their time and attention budgets. For example, Becker [1965] has developed an economic theory of the allocation of time based on the opportunity costs involved; Schoorman, Bazerman & Atkin [1981], and others, have considered the phenomenon of interlocking directorates and some organisation

members will, no doubt, base their time budgets on the perceived benefits to be obtained from such interlocks.

As noted above, both Cooper, Hayes & Wolf [1981] and Hofstede [1981], have elaborated the notion of modelling choice in ambiguity in the accounting literature. Both contributions address the problem of explaining accounting information systems within the framework of organisational control. As such, they are not directly relevant to the purposes of the present study but rather support the claim of potential usefulness to be gained from modelling choice in ambiguity.

13.4 SUMMARY

The literature of organisational choice processes is diffuse but of potential significance to the study of professional accounting standards setting processes [Hopwood 1983 & 1978]. A useful way of characterising the literature is based on a 2x2 classification of the underlying decision structure. Such an approach suggests the following four classes of decision [Thomson & Tuden 1959].

The computation class of decision is represented by Weber [1947] and Taylor [1911]. Its underlying rational comprehensive framework is considered above in Chapter 11 "Scientific choice processes".

The compromise class of decision is represented by Simon [1964] and Cyert and March [1963]. Its underlying political framework is considered above in Chapter 12 "Political choice processes".

The judgement class of decision is represented by Vickers [1965] and Simon [1955]. Its underlying "expert opinion" framework is considered below in Chapter 14 "Professionalisation processes".

The "inspiration" class of decision is of most interest to the present study because it reflects most closely the environment of the professional accounting standards setting processes [Hopwood 1983]. This class of decision has since been modelled as a "garbage can" process with the four main elements of choice opportunities, participants, problems and solution [Cohen, March & Olsen 1972]. The "garbage can" model is not without its critics. In particular, it has been argued that the computation model is sufficient to capture the important features of many decision processes [Thompson 1981]. On the other hand, it has stimulated interest in the accounting literature [Cooper, Hayes & Wolf 1981; Hofstede 1981 and Hopwood 1978]; and some of its features seem to match the UK professional accounting standards setting processes.

13.5 CONCLUSIONS

It has been shown that there are different sorts of theories of organisational choice processes. Recent developments have moved away from theories centred on a rational comprehensive decision process, with their implied model of scientific choice process, in order to capture some of the hitherto more perplexing features of organisational behaviour. In an environment of ambiguity concerning preference structures and causal relationships choices become opportunities for re-interpreting the past; for re-defining or re-inforcing beliefs; for experimenting; or for asserting legitimacy; or all of these things. Under such a choice process, action will not necessarily follow preferences and choices may be made without problems being solved. Such a view of the world is tantalising and so calls to be tested in a variety of circumstances.

Nothing in the above has led to a substantive consideration of how professional accounting standards are determined. Yet what is clear is that the choice opportunity of the "garbage can" model could serve as a model for an accounting standards issue. Many of its features seem to match the UK professional accounting standards setting processes and the exploration of such a model offers itself as a potentially fruitful area of research.

CHAPTER 14 PROFESSIONALISATION PROCESSES

- 14.1 Introduction
- 14.2 Attributes of a profession
- 14.3 Professionalisation processes
- 14.4 Constraints on professionalisation
- 14.5 Summary
- 14.6 Conclusions

CHAPTER 14 PROFESSIONALISATION PROCESSES

14.1 INTRODUCTION

Three analyses have led to a consideration of the literature of professionalisation processes.

Firstly, in Chapter 8 "Empirical studies of the political dimension in professional accounting standards setting processes", it was shown that Porter [1979] argued that professionalisation processes encourage professions to strive to keep technical, or scientific, decisions away from intervention by outsiders. Such decisions are argued to be subject to intervention by veto.

Secondly, in Chapter 12 "Political choice processes", it was shown that Frohock [1980] has argued that the concept of morality has permeated much political analysis. The subsequent review argued that the concept is implied in partial structurings of preferences such as is the case in the process of professionalisation.

Thirdly, in Chapter 13 "Organisational choice processes", it was shown that Thompson & Tuden [1959] argued that four such choice processes could be distinguished. Of these, the "judgemental" choice process was seen to be linked to the professionalisation literature to the extent that choices are made by individuals in the roles of professionals in bureaucracies.

The review explores the framework implied by the notion of professionalisation.

14.2 ATTRIBUTES OF A PROFESSION

There is a considerable body of literature on the nature of the professions. This literature has not been brought together in any recent survey article, but the essential threads of thought can easily be traced back, at least, to Flexner [1915]. Flexner identified [p.1904] six criteria by which to test for the existence or otherwise of a profession. These criteria are

- 1 an intellectual operation with individual responsibility;
- 2 a raw material derived from science and learning;
- 3 application to a practical end use;
- 4 an educationally communicable technique;
- 5 self-organisation; and
- 6 tendency toward increasing altruism.

Since Flexner, the literature has tended to debate three different general aspects of professions.

Firstly, it has continued the search for a minimal set of criteria for the identification of a profession.

Secondly, the literature has tried to identify a dynamic model of the process of professionalisation. Such a model would tend to imply that the process starts with some occupational group which in time acquires the distinguishing characteristics of a profession. The existence of such a process is a matter of debate.

Thirdly, the literature debates, in one form or another, the sixth of Flexner's criteria, namely the tendency to altruism. This latter debate is often in terms of whether or not a specified profession is acting in "the public interest" either generally or in respect of some specified issue. Two examples of this latter debate are evidenced in

- 1 a UK Monopolies Commission report on the subject of "the general effect on the public interest of certain restrictive practices so far as they prevail in relation to the supply of professional services" [Monopolies Commission 1970]; and

2 the "consumerism" movement, often attributed to Ralph Nader in the US in the 1960's, which rapidly encompassed the work of the professions (for example, Bloom & Greyser [1981] for a recent review; Kennedy [1980] for the medical profession; Medawar [1978] for the general business community; and Stamp [1969] for the accounting profession).

Substantially, the matter of criteria for identifying a profession, is a search for a set of necessary and sufficient conditions which will define the term profession. Carr-Saunders & Wilson [1933] (CS&W), is a seminal work which considered a wide range of occupational groups and sought to distil the essence of professionalism. Its major contribution was to identify the chief distinguishing characteristic as

"the application of an intellectual technique to the ordinary business of life, acquired as the result of prolonged and specialised training" [p.491].

Additionally, CS&W was able to identify professional goals as including a protective motive aimed at distinguishing competence and fostering a study of the technique [p.319]. Further contributions to the literature have been made by Barber [1965], Hughes [1965], Wilensky [1964], Greenwood [1957] and Cogan [1955]. Lubell [1978] has synthesised this literature and developed a listing of some eighteen criteria or attributes. These attributes are reproduced below in Figure 14.1 "Lubell's 'Attributes of a profession'".

FIGURE 14.1: LUBELL's "ATTRIBUTES OF A PROFESSION"

- 1 Formal and educationally communicable body of knowledge
- 2 Stringent educational facilities
- 3 Control over educational facilities
- 4 Occupational licencing or certification
- 5 Self-regulation
- 6 Exclusive jurisdiction within a well-defined technological domain
- 7 Organised political influence
- 8 Varying degrees of privileged communication
- 9 Effective and enforcable code of ethics
- 10 Service ideal (altruism)
- 11 Social responsibility
- 12 Professional subculture
- 13 National and/or regional professional associations
- 14 Professional mystique
- 15 Occupational specialisation
- 16 Well defined system of colleague referrals
- 17 Delegation of functions with an organised professional hierarchy
- 18 Career commitment of members

Source: Lubell [1978, p.26, Exhibit A "The Attributes of a Profession"].

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Lubell's attributes of a profession constitute the most comprehensive listing of such to be found in the literature. However, as he points out, it has its shortcomings.

Firstly, no mention is made of attempts to standardise practice per se. Of the eighteen listed attributes, only self-regulation is in any sense close to such a standardisation programme. This is perhaps unusual in view of the existence of programmes of standard practices in the UK engineering profession since 1903 and in the US accountancy profession since 1914; both of which are discussed above in Chapter 3 "The Accounting Standards Committee".

Secondly, Buckley [1972] has generated an alternative set of criteria, namely

- 1 attributes which a profession offers; namely
 - (a) expertise; and
 - (b) altruism; and
- 2 attributes which a profession accepts; namely
 - (a) autonomy; and
 - (b) authority.

Thirdly, Barber [1965, pp.18-19] has argued that professionalism is a matter of degree. Barber's argument is essentially that there exists a scale upon which the degree of professionalisation of various occupational groups can be measured and interest centres on how close each group is to the maximal end of each dimension. In terms of Lubell's eighteen attributes then we have an eighteen-dimensional measure. This can be modelled as an eighteen-dimensional cube with each side ranging on a scale from [0,1] where 0 represents no evidence of the relevant attribute and 1 represents maximum evidence of the attribute. Non-professional occupational groups would be located near the origin in this "attribute-space" and increasingly professionalised groups tend to the opposite corner. Vollmer & Mills [1966, p.vii], Barber [1965] and Greenwood [1951] all argue that "profession" is an idealised concept and there is no occupational group which actually has the co-ordinates [1, 1,1]. They

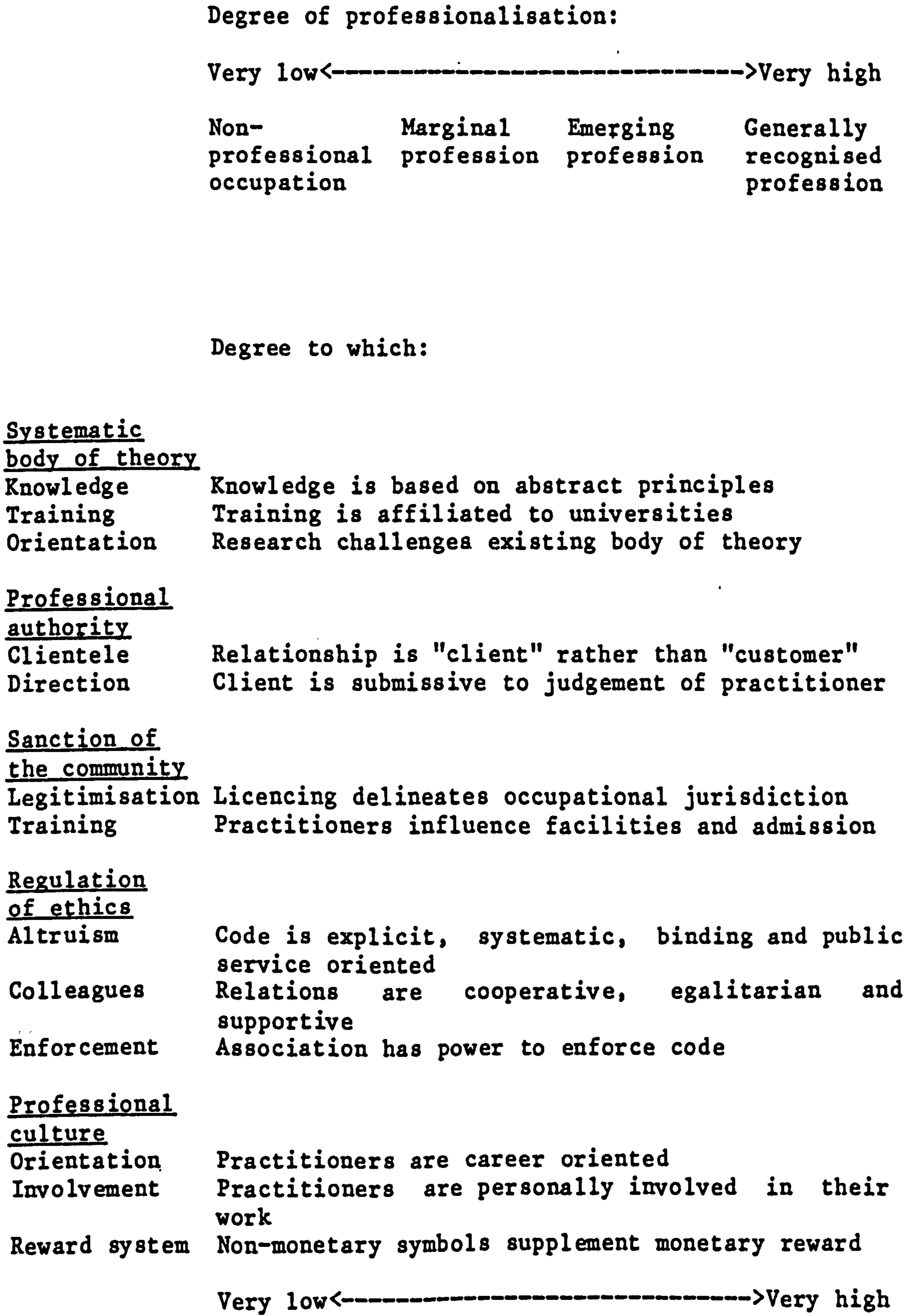
argue that the problem of interest is to determine where in this attribute-space each group is located and, in particular, how much they fall short of that ideal.

A further criticism of Lubell's eighteen attributes arises from his literature dredging method. Many of the other writers seem to be content with an attribute space of only four to six dimensions, recall Flexner's six criteria and Buckley's four. Also Barber [1965, p.18] used four, Greenwood [1957, p.45] used five and Sir Henry Benson [1980] used seven. The possibility exists, then, that Lubell's list suffers from redundancy.

14.3 PROFESSIONALISATION PROCESSES

The identification of attributes considered in the preceding section provides only a static model of the professional phenomenon. Now consider the matter of identifying a dynamic model of the process of professionalisation. Such an enquiry has been undertaken by Barber [1965, pp.22-24], Caplow [1954, pp.139-140] and others. This literature again has been synthesised by Lubell who developed a "Generalised professional continuum model" on which Figure 14.2 "Lubell's 'Generalised professional continuum model'" following has been based.

FIGURE 14.2: LUBELL'S "GENERALISED PROFESSIONAL CONTINUUM MODEL"



Source: Based on Lubell [1978, pp.30-32, Table 1 "A generalised professional continuum model"]

An examination of Figure 14.2 "Lubell's 'Generalised professional continuum model'" shows that structurally there is a great deal of similarity between the dynamic model and its static counterpart. In both cases a number of attributes are identified and the "true professions" are conceptualised as having maximised some straightforward function of those attributes. The only structural difference between the two models is that in the dynamic model the "occupational groups" start with minimal measures of those attributes and they, in some sense, seek to move through this multi-attribute space progressively from the minimal corner to the maximal corner. In this progression the groups are said to pass through stages as "marginal professions" and "emerging professions". One thing that the literature seems to be clear about is that this progression is purposive [Wilensky 1964, pp.141-146] and not simply the accidental outcome of some other unidentified process(es). For example, Hughes remarks that "professions are more numerous than ever before professional status, more sought after" [1965, p.1].

Both Wilensky [1964, pp. 141-146] and Caplow [1954, pp.139-140] develop more satisfying dynamic models than Lubell. Each has attempted to develop a description of the particular path which occupational groups trace through the attribute space as they progress. Contrast this with Lubell who simply argued (implicitly) that such a path, or paths, exist. In Figure 14.3 "Professionalisation processes" following, are set out the processes identified by Caplow and Wilensky.

FIGURE 14.3: PROFESSIONALISATION PROCESSES

Stage No.	CAPLOW'S PROCESS	WILENSKY'S PROCESS
0	-	Develop a full time occupation
1	Establish an association with restricted entry	Develop training facilities
2	Adopt a new name	Establish an association with restricted entry
3	Adopt a code of ethics	Agitate politically for reservation of functions
4	Develop training facilities <u>and</u> agitate politically for reservation of functions	Adopt a code of ethics

Sources: Wilensky [1964,pp.141-146] and Caplow [1954,pp.139-140]

It can be seen from Figure 14.3 "Professionalisation processes" that each writer was able to generate a different sequence of stages in the process of professionalisation but that both agree substantially on what those stages are. To generalise then, there is no unique path in the attribute space by which a group will progress from the minimal corner to the maximal corner. Rather, it is possible that there will be a set of paths in which each individual path corresponds to an occupational group. If this is the case, a more interesting question is to ask what are the determinants of each occupational groups own path. More specifically, given that an occupational group has reached a particular point in attribute space, what is it that determines its move on to another point. Here again Lubell's synthesis of the literature is of help. Lubell notes, following Wilensky [pp.146-150] and others, that there are a number of barriers to professionalisation. These barriers can be seen as constraints on the path in attribute space.

14.4 CONSTRAINTS ON PROFESSIONALISATION

Lubell [1978] classified barriers to professionalisation according to

- 1 whether or not they arise within the occupational group; and
- 2 whether they arise earlier or later in the sequence of professionalisation.

In Figure 14.4 following is set out Lubell's "Paradigm of barriers to professionalisation".

FIGURE 14.4: LUBELL'S "PARADIGM OF BARRIERS TO PROFESSIONALISATION"

Time frame	Internal constraint	External constraint
Earlier	Internal conflict	Competing occupations Legal barriers
Later	Internal conflict Technological limitations	Competing occupations Legal barriers Public opinion

Source: Lubell [1978, p.46 Table 2 "A paradigm of barriers to professionalisation"]

It can be seen from Figure 14.4 "Lubell's 'Paradigm of barriers to professionalisation'" that Lubell saw

- 1 internal conflict, competing occupations and legal barriers as persistent barriers to professionalisation, that is, as barriers which are always present; and
- 2 technological limitations and public opinion as terminal barriers, that is, as barriers which only arise in the later stages of professionalisation.

There is a problem in Lubell's approach, however, because it is difficult to see how progress is made by an occupational group on its path to professionalism if it is faced by persistent barriers. Rather, the notion of constraints will be used in preference to the expression "barriers to professionalisation". It is relatively clear that constraints could operate on the possible directions of the path through attribute space to the maximal corner, with those occupational groups not able to satisfy those constraints being denied any path which converges on the maximal corner.

As an example of how one of these constraints might operate consider Lubell's technological limitations, which he classifies as a terminal constraint. Initially, we should remark that it is the intellectual characteristic of an occupation which provides the opportunity for a terminal constraint rather than the technology itself, which changes and sometimes rapidly. Now, it is quite clear that there are some occupations for whom the intellectual characteristic or knowledge base is limited. This does not apply to, say, the clergy but it does apply to, say, motor mechanics. In the latter case, the knowledge base is limited in the sense that it is of a low degree of abstraction, training is not through university or affiliated colleges and the orientation of thought is not such that there are constant challenges to the existing body of theory. Clearly, in terms of the "generalised professional continuum model" of Lubell, set out in Figure 14.2 above, motor mechanics are at the "very low" end of each of the first three attribute scales. With this in mind, it can be seen that it matters not at all how much motor

mechanics organise and associate and develop codes of ethics. The intellectual limitations are such that they will never be able to acquire maximal measures on at least three of those attribute scales. So then, the path followed by motor mechanics over time through attribute space would start at the origin, that is, the minimal corner, and then progress approximately diagonally until it reached the intellectual constraint, in the form of a frontier on the surface, and from that point on it would be confined to that constraint surface. The constraint surface would be convex to the origin so that the path never reaches the maximal corner.

The nature of these constraints can be examined more closely.

Firstly, it is clear that some of the constraints are passive and unchanging in the sense that they are persistent and, for some, insuperable. We have seen how the intellectual characteristics of the occupation of motor mechanics is just such a passive constraint.

Secondly, it is also clear that some of the constraints will be active and changing in the sense that they are temporary and superable. Take, for example, the internal conflict constraint identified in Lubell's paradigm of barriers. CS&W argued that one form of internal conflict will arise when the practitioners begin to develop specialisms. If the professional association has not been constituted to recognise the existence of, say, newly emerging sub-crafts then as practitioners develop closer bonds within their own specialism they are likely to perceive that the universal orientation of the association is inadequate to meet their more specific needs. Internal conflict is likely to emerge as the specialists endeavour to generate changes within the existing constitutional arrangement or alternatively outside by the formation of splinter groups [CS&W, pp.320ff]. The UK engineering profession is an example of a complex federal structure of associations which are all bound by a single

constitutional arrangement. Recall that the UK engineering profession is of additional interest because, as was discussed above in Chapter 3 "The Accounting Standards Committee", it has its own standards programme. The UK legal and medical professions are examples of sub-crafts which were newly emerging in the 11th Century and which were unable to reconcile their needs with the existing professional structure of the day, namely the monopolistic clergy. The UK accountancy profession represents a current example to the extent that practitioners who work within industrial companies can be identified as a separate specialism (for example, Tricker [1983]).

This second, active and changing, class of constraints then is very different from the first in the sense that it offers a mechanism for change operating on the professions. Internal conflict and public opinion in particular are strong change constraints. It was shown, in Chapter 3 "The Accounting Standards Committee", public opinion of the UK accountancy profession in the late 1960's operated as a change agent. Competing occupations are often equally effective as change inducing constraints. In the UK an example is the medical profession which sought to establish a register of medical practitioners in order to distinguish members of the profession from other occupations which offer advice, and remedies, based on bodies of knowledge alien to the established orthodoxy. The medics succeeded in their arguments and the General Medical Council was established as the registration authority.

From the above arguments it can be seen that Figure 14.4, Lubell's "Paradigm of barriers to professionalisation" can be restated as Figure 14.5 "Constraints on professionalisation" following.

FIGURE 14.5: CONSTRAINTS ON PROFESSIONALISATION

Effect of constraint	Internal constraint	External constraint
Operates as a change mechanism	Internal conflict	Competing occupations Legal barriers Public opinion
Does not operate as a change mechanism	Intellectual limitations	-

Source: Original interpretation of Lubell [1978] (Reproduced above as Figure 14.4)

It can now be seen that the process of professionalisation, in which a profession and its members are continually driven in the direction of an idealised conception of profession, serves to constrain the preferences of individuals within the profession in a substantial and explainable manner.

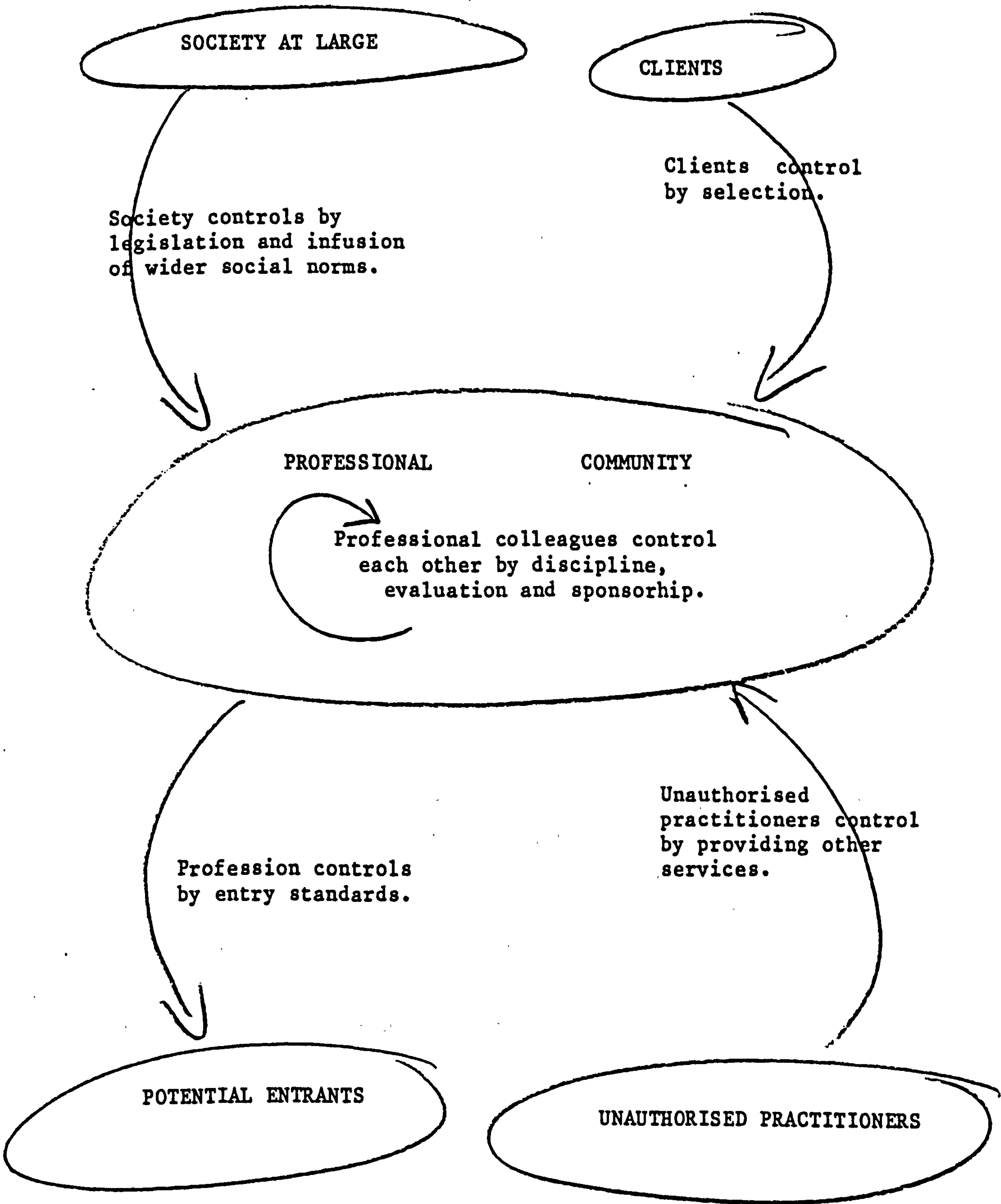
This is an important result because it relates directly to the material discussed above in Chapter 12 "Political choice processes". In that chapter it was argued, following Riker [1980] and Arrow [1963 & 1951], that when preference structures are heterogeneous then stable choice outcomes only exist when those preferences are severely constrained. So then, the literature of professionalisation processes throws light on one group of constraints.

The nature of some of these constraints will now be explored to see how the constraining of preferences takes place. This requires a move away from the level of abstraction on which were discussed the constraints operating on the profession as it moves through a conceptualised attribute space. Rather, the attributes themselves will be discussed to see how some of them operate on the individual members of a profession in constraining their preferences.

Hall [1948] has considered the stages of a medical career and has produced evidence that there exists a very complex socialisation process. This process starts early in the professional career, and often even before that through the medium of family and social contacts. At this early stage, Hall argues, an ambition is generated and this makes the prospective professional receptive to the institutional requirements he finds later.

Goode [1957] characterises professions as communities within communities. Amongst the several attributes of a community, he identifies in particular that its members are bound by a sense of identity; that they share a common set of values; and that the community perpetuates itself by using a training process which sends recruits through an adult socialisation process [p.194]. Goode argues that the attributes together comprise a complex social control process. For example, he notes that the more successful members are usually those who have adopted their expected roles and behaviour; that the continuing controls include not only formal enforcement of discipline and codes of ethics but also subtle control of "prestige and career advancement" [p.197]. Similarly, the client exercises a degree of control in the selection of practitioner and continuing threat of subsequent rejection. The state exercises a degree of control either by legislative or licencing requirements. Goode's elaboration of these control processes is important and is represented diagrammatically as Figure 14.6 "Goode's model of social control of professional communities" following.

FIGURE 14.6: GOODE'S MODEL OF SOCIAL CONTROL OF PROFESSIONAL COMMUNITIES



Source: Original interpretation of Goode [1957]

McKinlay [1973] presents a view different from that of Goode [1957]. Rather than being concerned with society's control of the professional community, McKinlay is concerned with the professional communities' control of society and in particular social change. Following Johnson [1972], he argues that the inventory approach to identifying the attributes of professions is deficient because it ignores the central theme of sociological enquiry, namely the understanding of power relationships. This main theme is implied to be less interested in formulating a definition of the particular institutional guise, for example as professions, in which the power relations exist but more in exploring how the power base arises and how it affects broader social relations. McKinlay's main observation is that professions are substantially "to be trusted in all things" [p.66] that is, caveat emptor (let the buyer beware) no longer applies but is replaced by credat emptor (let the buyer believe). McKinlay identifies four alleged sources of this power base of trust: firstly, the notion that professionals are responding to a "calling"; secondly, the altruism attribute; thirdly, the unique training and socialisation process; and fourthly, the inability of clients to properly evaluate the services being rendered. All of these are argued (pp.66-70) to be fallacious but, because they have been accepted uncritically, the professions have been accorded a major power base. That power base then enables the professions to exert substantial influence on social change. In particular, McKinlay argues (pp.78-80) that where social change originates from outside the professions then the professions can adopt one of three general strategies of "apparent support", "passive oversight" or "active obstruction". In each case he envisages that externally generated change is unwelcome.

The consumerism debate, referred to briefly above in Section 14.2 "Attributes of a profession", also implicitly identifies the existence of a professional power base. For example, Kennedy [1980] discusses options open to the clientele of the medical profession, as a group of consumers acting collectively, for eroding that power base in the interests of enabling the client to critically evaluate performance and enable redress where performance is substandard.

Burns & Haga [1977] offer yet another analysis of professionalism. Like McKinlay [1973], and Johnson [1972], they reject the inventory of attributes as an adequate characterisation of a profession. In their analysis, Burns & Haga adopt a reductio ad absurdum approach and ask what it is, at the limit, that enables the professional to command the continued custom of his client. Intimidation is identified as that limiting factor and they assert that it is available "whatever authority threatens a profession's autonomy, whether they be employers, clients or other occupations" [p.709]. Further, they argue that there are two necessary and sufficient conditions for an occupation to be identified as a profession, namely "cruciality", in the sense that the profession's services are crucial to the clients; and "mystique", in the sense that the technical expertise is seen by the clients as "incomprehensible and consisting of things that ordinary mortals, in their lay perception, cannot do" [p.710].

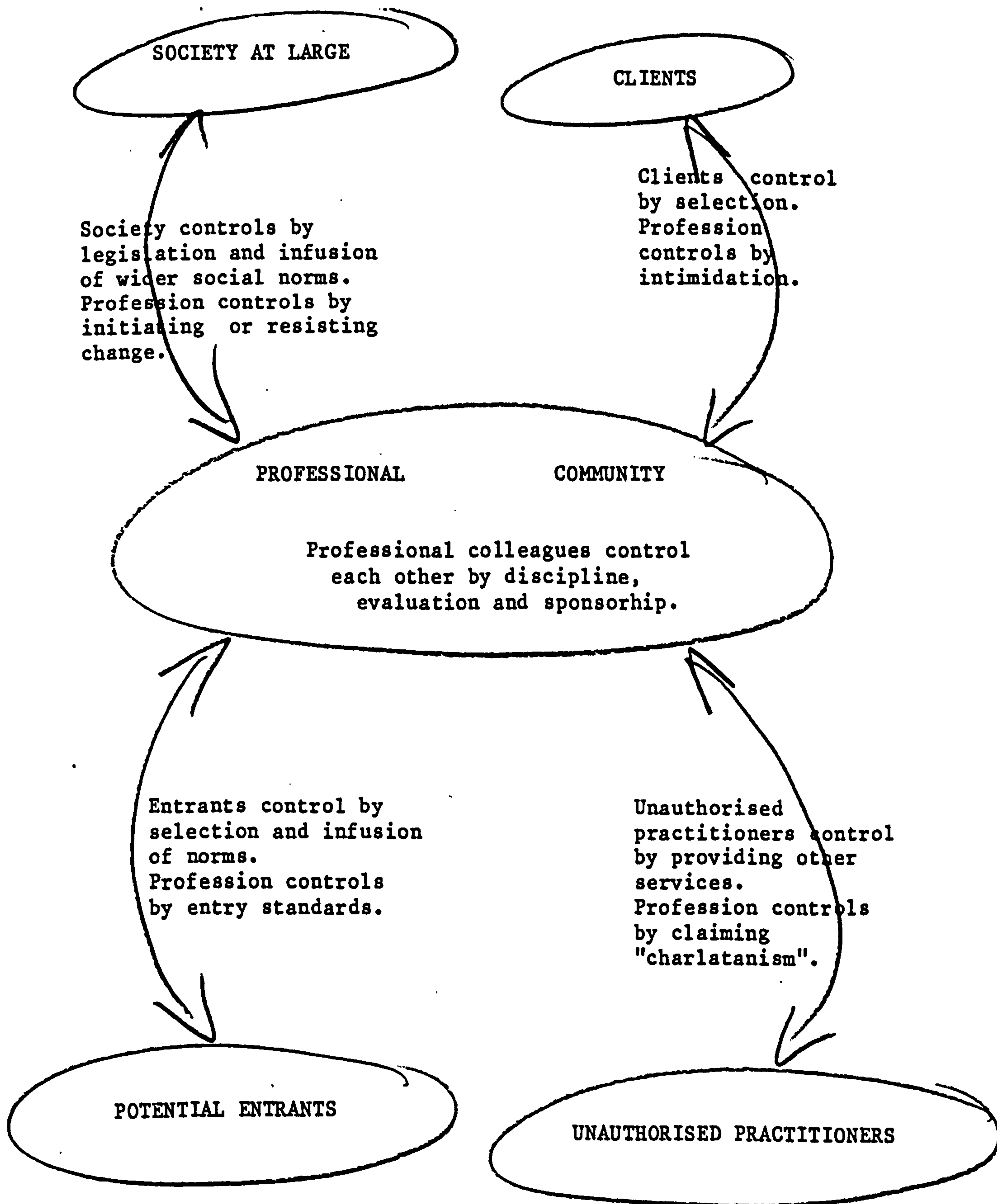
So then, the discussion has moved substantially from a view of the professionalisation process as tracing a path through attribute space towards maximal measures on attribute scales. Now being considered are fundamental social relations that exist once an occupational group becomes accepted, in a fairly general sense of acceptance, as a profession. There is a complex interaction of controls between the professional community and others.

Firstly, there is an identifiable structure of controls by which some of the component groups of society can control the professional community.

Secondly, the professional community itself has a power base which is sufficient for it to exercise its own control over some of the component groups of society.

It is clear that the literature suggests there exists a complex pattern of controls which, rather than being unilateral as suggested by Goode [1957], are bilateral. Such a model can be presented very simply in terms of a modification of Figure 14.6, based on Goode [1957]. In Figure 14.7 "A model of social and professional control" new arrows are added between the "professional community" and the other groups, in the opposite directions to the existing arrows. Also added is narrative to describe some of these new controls.

FIGURE 14.7: A MODEL OF SOCIAL AND PROFESSIONAL CONTROL



Source: Original interpretation of Burns & Haga [1977], McKinlay [1973] and Goode [1957]

From the above argument it can be seen that generally accepted professions exist within a complex structure of social and group controls in which the professions themselves have a substantial power base by which they are able to constrain the preferences of individuals outside the profession.

The above statement is very clearly illustrated in the case of the professional accounting standards setting processes. In the UK, Statements of Standard Accounting Practice operate to constrain the preferences of individuals outside the accountancy profession. In particular, they constrain managements of organisations to publish information as prescribed in those accounting standards. They also constrain others by the consequences of that information. The nature and effects of these constraints were discussed in depth above in Part II "Review of previous research", in particular in Chapter 5 "Professional accounting standards, the political dimension and economic consequences". In a sense, the discussion of professionalisation processes in the present chapter has led to a consideration of UK professional accounting standards setting processes by a very different route to that adopted by the main body of the present study overall. This discussion in itself is noteworthy as a potential alternative framework for the study.

14.5 SUMMARY

The early literature on professions was concerned with establishing characteristics which define a profession [Flexner 1915]. That literature then developed into a discussion of a process by which an occupational group gradually requires an increasing number of those characteristics [Caplow 1954]. Five stages to such a process might be

- 1 develop a full time occupation;
- 2 develop training facilities;
- 3 establish an association with restricted entry;
- 4 agitate politically for reservation of functions; and
- 5 adopt a code of ethics [Wilensky 1964].

Surprisingly, the literature does not address standardisation of practices per se such as is represented by the professional accounting standards setting processes in the UK and the US.

There are a number of constraints operating on the process of professionalisation which can determine the degree to which any occupational group acquires the mantle of professionalism. Some of these constraints operate as persistent barriers [Lubell 1978], whereas others operate as change mechanisms. These change mechanisms serve to constrain the preferences of individuals within the profession in a substantial and explainable manner through the operation of the professionalisation process [Goode 1957]. As such, the professionalisation process is an important example of a preference constraint structure [Riker 1980] discussed above in Chapter 12 "Political choice processes".

Additionally, the professions operate within a broader community in which the preferences of others can constrain the preferences of the professionals [Goode 1957]. Conversely, the preferences of the professionals themselves can constrain the preferences of others [McKinlay 1973]. The UK professional accounting standards setting processes are an important example of the way in which a profession constrains the preferences of others.

14.6 CONCLUSIONS

The framework represented in the literature of professionalisation processes is almost virgin territory in respect of its relationship with the UK professional accounting standards setting processes. The literature does not address the role of standardisation of practices, per se. In the most recent literature evidence can be found of extensions to the framework which might predict that professions possess mechanisms by which the preferences of non-professionals are constrained. The professional accounting standards setting processes are a major example of such mechanisms.

At the very least, the professionalisation process framework offers an alternative framework by which the UK professional accounting standards setting processes can be explored. As such the framework offers much scope for future research. Additionally, the framework might perhaps be used to provide explanatory variables which can be integrated into a unified framework by which the UK professional accounting standards setting processes can be explored. By either route, the potential appears to be considerable.

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

**CHAPTER 15 CONCLUSIONS DRAWN FROM REVIEW OF LITERATURE FROM
DISCIPLINES OTHER THAN ACCOUNTING AND ECONOMICS**

15.1 Conclusions

CHAPTER 15 CONCLUSIONS DRAWN FROM REVIEW OF LITERATURE FROM
DISCIPLINES OTHER THAN ACCOUNTING AND ECONOMICS

15.1 CONCLUSIONS

A formal rationalisation for the adoption of a political dimension to the investigation of professional accounting standards setting processes can now be stated. By characterising professional accounting standards setting processes as selections of accounting measurement scales, then no recourse can be had to the formal scientific processes of choice between different alternatives. This result follows from the finding that these formal processes are based on unique and determinate criteria. Such a criterion is not available to professional accounting standards setting processes because of the characterisation of preferences as multiple criteria. The corollary is that professional accounting standards setting processes are not strictly technical; a result already found in the accounting literature [Demski 1973] and reviewed above in Part II "Review of previous research in accounting and economics".

In the political choice process literature, the Shepsle [1979] characterisation of a political institution as a committee system appears to be related to the description of the UK professional accounting standards setting processes set out above in Chapter 3 "The Accounting Standards Committee". In particular, the UK professional accounting standards setting processes are established as a committee system in which the various working parties of the ASC has its own jurisdiction based on a set of proposals contained in an Exposure Draft. Implied amendment control rules might exist whereby the governing bodies are constrained in the modifications they can make. Again, implied germaneness rules might exist whereby some alternatives are excluded completely from consideration.

PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES IN THE UK

The Shepsle committee system framework was characterised as a model of the way in which preferences are structured in order for stable equilibrium to exist. In particular, it was stated that

equilibria of social choices are determinable by majority vote if the set of preferences over all logically possible orderings of the alternatives is constrained by an institution of rules allocating jurisdictions and amendment rules to sets of decision makers.

So then, fruitful areas of research lie in the exploration and elaboration of this Shepsle committee system model. One area would be the refinement and formalisation of the description of the UK professional accounting standards setting processes as a Shepsle committee system. Another area would be the exploration of the way in which majority votes are constrained within the processes. This can be made operational by determining how majority votes are reflected in the outcomes of the process. An exploration of this latter aspect constitutes the empirical part of the present study presented in Part IV "Evidence from the empirical study of UK data".

Embedded in the political choice literature is Allison's [1969] characterisation of a political choice process as an organisational choice process. There are different sorts of theories of organisational choice processes. Recent developments have moved away from theories centred on a rational comprehensive decision process, with their implied model of scientific choice process, in order to capture some of the hitherto more perplexing features of organisational behaviour. In an environment of ambiguity concerning preference structures and causal relationships, choices become opportunities for re-interpreting the past; for re-defining or re-inforcing beliefs; for experimenting; or for asserting legitimacy; or all of these things. Under such a choice process, action will not necessarily follow preferences and choices may be made without problems being solved. Such a view of the world has not yet led to a substantive consideration of how professional accounting standards are determined. Yet what is clear is that the choice

opportunity of the "garbage can" model could serve as a model for an accounting standards issue. Many of its features seem to match the UK professional accounting standards setting processes described above in Chapter 3 "The Accounting Standards Committee", and the exploration of such a model offers itself as a potentially fruitful area of research. The professional accounting standards setting processes might be modelled as an organisational type of decision making process.

The framework represented in the literature of professionalisation processes is almost virgin territory in respect of its relationship with the UK professional accounting standards setting processes. The accounting literature does not address the role of professionalisation processes in the standardisation of practices. Similarly, the professionalisation literature does not address the role of standardisation of practices, per se. In the most recent professionalisation literature evidence can be found of extensions to the framework which might predict that professions possess mechanisms by which the preferences of non-professionals are constrained. The professional accounting standards setting processes are a major example of such mechanisms.

At the very least, the professionalisation process framework offers an alternative framework by which the UK professional accounting standards setting processes can be explored. As such the framework offers much scope for future research. Additionally, the framework might perhaps be used to provide explanatory variables which can be integrated into a unified framework by which the UK professional accounting standards setting processes can be explored. By either route, the potential appears to be considerable.

In summary, then, four major disciplines of literature have been reviewed with the aim of elaborating their potential relevance to the UK professional accounting standards setting processes. The four disciplines are scientific choice; political choice; organisational choice; and professionalisation process. They have been reviewed because previous research has identified each as being of potential usefulness. Previous research has not undertaken any comprehensive review of the disciplines with a view to exploring the limitations and potential benefits of theoretical constructs adopted. Rather, there has been a tendency to adopt isolated constructs naively. The present review sought to reduce that limitation.

The four disciplines clearly offer four quite different frameworks by which professional accounting standards setting processes can be analysed. As yet the accounting literature has generated no rational basis for choosing amongst these frameworks. Rather, individual research studies are likely to adopt one framework to the exclusion of others. Nevertheless, some contribution can be made in the present study by demonstrating the possibilities and limitations of an integration of, or selection from, the frameworks.

Firstly, it has been noted that the scientific choice framework cannot be usefully adopted in the accounting environment. It is necessarily selected out.

Secondly, the political choice framework seems to suggest two major sub-frameworks. These are the committee structure framework and the organisational process framework. These almost correspond to a structuralist/process classification often found in other disciplines. Again, no rational basis for selection amongst frameworks appears to exist. Even the present study, in the empirical sections presented below in Part IV "Evidence from the empirical study of UK data", can be viewed as having adopted either the structuralist or the process

frameworks. In the structuralist view, the results below provide evidence of the outcome of the preference constraint structure suggested by Riker [1980]. In the process view, the results provide evidence of the outcome of just one stage of a multi-staged process.

Thirdly, the organisational process framework seems to be dependent on the choice made at the political choice framework level. Selection of the committee structure framework seems to exclude any sort of process sub-framework or super-framework; but such an assertion could prove to be ill-founded if future research studies demonstrate this not to be the case. The most fruitful role for the organisational process framework seems to be as a sub-framework of the political choice framework along the lines of the Allison [1969] suggestion. Such a combined framework would appear to hold considerable scope for development.

Finally, there is the professionalisation process framework. The implications of the various aspects of the professionalisation process for the understanding of professional accounting standards setting processes appear to be profound. For example, the Goode-McKinlay description of a complex inter-relationship of social and professional controls seems to match the description of the UK professional accounting standards setting processes set out above in Chapter 3 "The Accounting Standards Committee". The role of intellectual constraints described by Lubell seems to match some of the debate in the UK and the US about the role of a "conceptual framework".

From these observations, it is possible to suggest a promising comprehensive framework within which to conduct future studies of professional accounting standards setting processes in general and the UK processes in particular. Such a framework would adopt as its primary structure the role of the accounting profession. This would provide, in particular, an history of the development of the accounting profession; so demonstrating the path which it seems most likely to be following. Within this framework of professional development, the role of a programme of professional accounting standards setting processes can be elaborated and, importantly, some objectives imputed. The structure of those objectives would most likely be complex and an interesting question would focus on the nature of any "rules of thumb" adopted by the key participants in seeking to implement those objectives. Conflict minimisation has already been proposed in the present study above in Chapter 7 "Other economic processes"; the role of conflict minimisation needs substantial development.

Having elaborated the role of a programme of professional accounting standards setting processes within a framework of professionalisation process, research studies could address the specific nature of these professional accounting standards setting processes. The political choice framework thus becomes a sub-framework of the professionalisation framework, with either the committee structure or the organisational process frameworks operating as sub-sub-frameworks. Such an outline would provide a suitable basis for a research programme and is charted in the following Figure 15.1 "Proposed framework for the study of professional accounting standards setting processes".

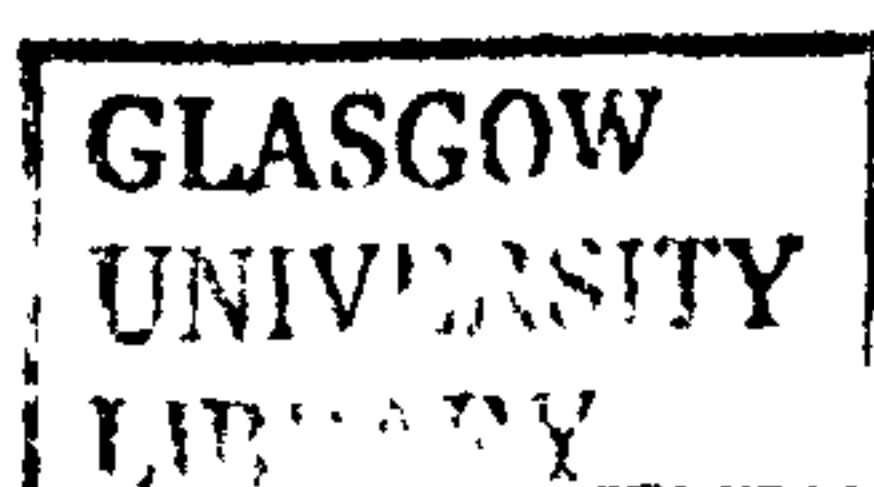
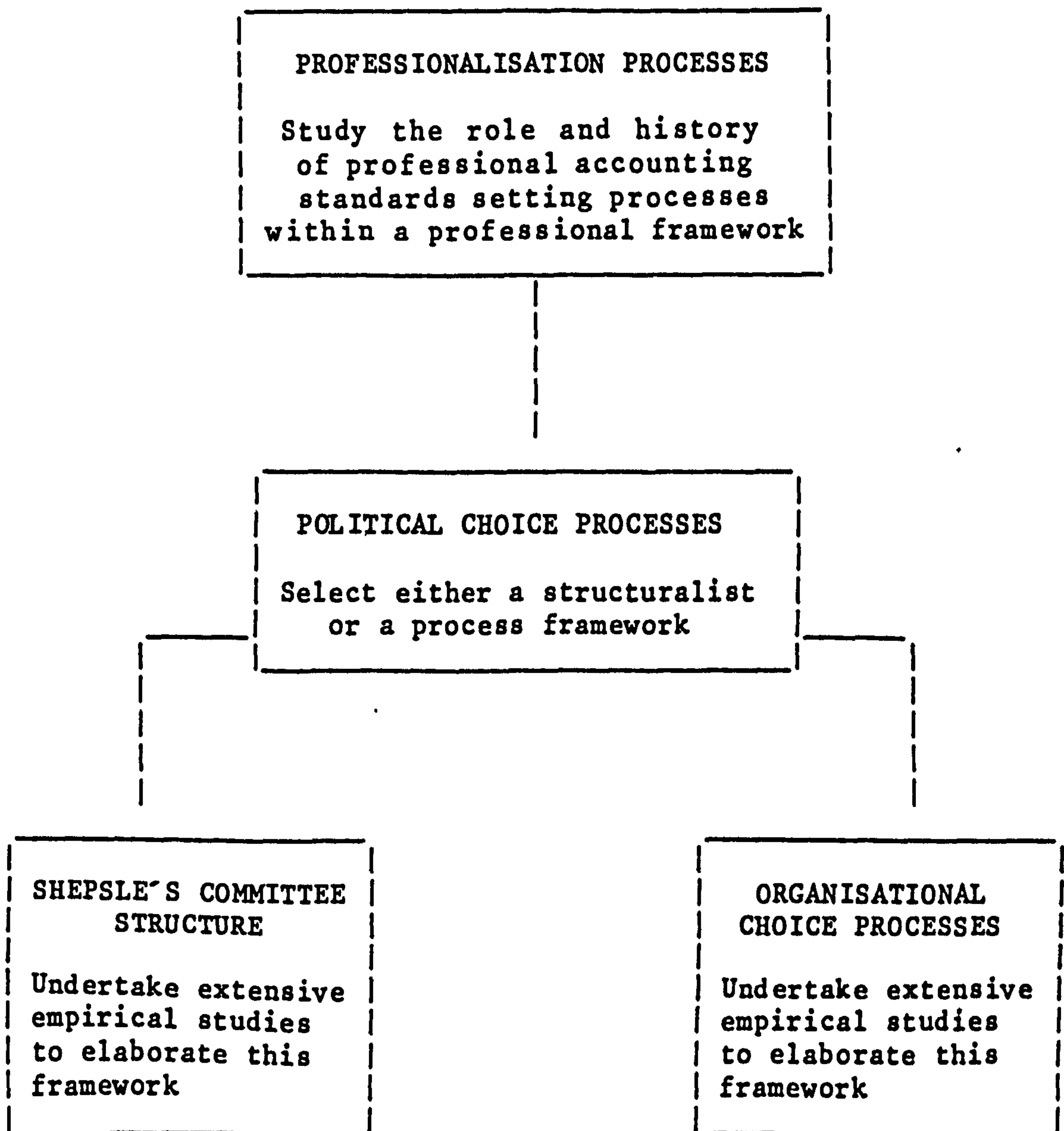


FIGURE 15.1 PROPOSED FRAMEWORK FOR THE STUDY OF PROFESSIONAL ACCOUNTING STANDARDS SETTING PROCESSES



Source: Original

