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UNIVERSITY OF WOLLONGONG

DEPARTMENT OF ACCOUNTANCY

**STANDARD SETTING AND ECONOMIC
CONSEQUENCES:
AN ETHICAL ISSUE**

by

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Comments welcome. Please do not quote.

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PETER COLLETT

Standard Setting and Economic Consequences: an Ethical Issue

The Australian Conceptual Framework requirement that standard setters have to take into account the economic consequences of their decisions is examined, particularly in relation to the possibility that qualitative criteria like representational faithfulness might have to be sacrificed in doing so. The claim that the need for such a sacrifice does not arise because representational faithfulness is a notion which cannot be usefully applied to the evaluation of accounting information is analysed and found wanting. Problems associated with requiring standard setters to consider economic consequences are shown to be manageable only after the ethical implications of their task are identified and assessed.

Key Words: Economic Consequences; Ethics; Representational Faithfulness; Truth

The extent to which standard setters in accounting should be required to take into account the economic consequences of their decisions remains a difficult and contentious problem. In this paper it will be shown that one aspect of the problem arises in relation to representational faithfulness, a desirable qualitative characteristic of financial information identified explicitly in the American Conceptual Framework project and implicitly in the Australian one. Financial information is representationally faithful to the extent that what is conveyed by the information corresponds to the underlying transactions and events which it purports to represent. Giving weight to economic consequences seems to imply that sometimes standard setters must sacrifice, at least to some extent, the satisfying of qualitative criteria like representational faithfulness. However, if it is acceptable to make compromises in relation to representational faithfulness, it seems to follow that it is acceptable to sometimes *mislead* the users of financial reports.

Attempts to avoid this unpalatable implication will be identified. It has been argued that conceptual framework requirements notwithstanding, not only is it unnecessary to sacrifice representational faithfulness, it is not even possible. Representational faithfulness, it is suggested, is a notion which is not applicable to the evaluation of accounting information, and so the question of having to make a sacrifice does not arise. It will be shown that this argument is not persuasive. The apparent tension between the need to provide truthful or representationally faithful reports on the one hand, and the need to consider economic consequences on the other cannot be avoided in this way.

The Australian Conceptual Framework Statements will be closely examined to determine how the requirement to consider economic consequences is characterised in those Statements, and to clearly identify the difficulties that this requirement presents to standard setters. Reasons will be given for believing that the problem is fundamentally an *ethical* one, and that only by considering the ethical implications of the task does it become more manageable. An obligation to a particular group of users of financial information will be identified which obviates any need for standard setters to sacrifice representational faithfulness in the pursuit of preferred economic consequences.

THE ECONOMIC CONSEQUENCES OF STANDARD SETTING

By influencing the nature of the financial information that is provided by reporting entities, and hence the decisions which are based on that information, accounting standards do have economic consequences. There would be no point to standard setting otherwise, and standards would not generate the interest that they do unless they had an economic impact. Financial reports, and hence the standards upon which they are based, contribute to the efficiency of resource allocation and to the distribution of wealth within an economy. Apart from imposing direct information preparation costs on reporting entities, a new standard will have economic consequences through the behavioural changes that any altered flow of financial information induces.

Rappaport (1977, p.89) conveniently classifies the behavioural impact of accounting standards as follows. Information prepared in accordance with standards affects the behaviour of the intended recipients of financial reports such as shareholders and other investors, whose decisions, for example, influence security prices and therefore affect the wealth of market participants. The information also affects the behaviour of "free riders" such as unions, competitors, suppliers and customers for whom reports are not primarily intended but who nevertheless have access to them. Finally, standards affect the behaviour of the managers of reporting entities. For example, they may alter their investment strategies in anticipation of an adverse reaction to information that will have to be supplied to comply with a new standard.

A number of writers have strongly advocated that standard setters should consider economic consequences in their decision-making: 'without a knowledge of consequences...it is inconceivable that a policy-making body...will be able to select optimal financial accounting standards (Beaver 1973, p.56)'. In some cases the demand for consideration of consequences is far-reaching. Hawkins (1975, p.17) argues that since standard setters have the power to influence economic behaviour, they have an obligation to support governments' economic plans. May and Sundem (1976, p.750) claim that 'if the social welfare impact of accounting policy decisions were ignored, the basis for the existence of a regulatory body would disappear'.

It is made clear in the Australian Conceptual Framework Statements that it is appropriate for standard setters to take into account economic consequences or, as they are referred to in those Statements, "costs versus benefits". According to SAC 3, the assessment of consequences by standard setters is intended to be extensive: 'in the process of setting standards, standard setters seek to consider all costs and benefits in relation to financial reporting generally, and not just as they pertain to individual reporting entities (paragraph 45, emphasis added)'.

Importantly, the consideration of economic consequences by standard setters is characterised as a constraint to the achievement of the various desirable qualitative characteristics of financial information, implying that consequences may sometimes preclude standard setters from achieving the best possible realisation of these

characteristics. For the purposes of this paper, the most important of the qualitative characteristics identified in SAC 3 is reliability:

The reliability of financial information will be determined by the degree of correspondence between what that information conveys to users and the underlying transactions and events that have occurred and been measured and displayed. Reliable information will, without bias or undue error, faithfully represent those transactions and events (paragraph 16, emphasis added).

The fact that the anticipated economic consequences of a proposed standard are presented as constraining the achievement of desirable qualitative characteristics seems to imply that it may be appropriate in some situations to produce information that is not representationally faithful so as to achieve a preferred outcome. Might consequentialist arguments, for example, for keeping certain obligations off the balance sheet, have prevailed had the likely impact on investment behaviour been considered sufficiently undesirable? In certain circumstances, requiring standard setters to consider economic consequences seems to justify a failure to provide faithful representations of financial position.¹

TRUTH AND REPRESENTATIONAL FAITHFULNESS

If it could be shown that conceptual framework requirements notwithstanding, representational faithfulness is not a notion that can be usefully applied to the evaluation of accounting information, then there would not be a problem of having to sacrifice representational faithfulness in the pursuit of preferred economic consequences. This strategy has been used, and relies on identifying a close conceptual link between representational faithfulness and truth. The term "truth" does not appear in the above extract from SAC 3. However, the use of the terms "correspondence" and "faithful representations" in that extract do nevertheless capture an important aspect of what we normally understand by the term "truth". Russell (1967, p.70) states that the view most commonly held is that 'truth consists in some form of correspondence between belief and fact'. Devitt (1984, p.26) states that 'the basic idea of a correspondence notion of truth is familiar: a sentence is true if and only if it corresponds to the facts (or to reality)'. For the purposes of this paper, it will therefore be accepted that the concepts of representational faithfulness and truth are equivalent.²

Why use the technical term "representational faithfulness" in the conceptual framework projects if it has essentially the same import as the more familiar term "truth"? Avoiding the term "truth" may have reflected an unwillingness to re-open the issue of whether truth is a notion that is too vague and subjective to have operational usefulness in the context of accounting. Yet it is that very belief, that truth (or its equivalent, representational faithfulness) has no part to play in the evaluation of accounting

information, which has been used to justify standard setters giving priority to economic consequences in their deliberations.

Consider these claims. Gerboth (1972, p.48) is critical of 'the naive notion that accounting is a search for a unique truth'. Buckley (1976, p.16) states that 'a blind groping for truth when none exists, continues to hamper the policy-making efforts in accounting'. In a currently popular Australian textbook, the view of accounting as a 'faithful representation of some underlying "true"...economic reality' is denied (Whittred and Zimmer, 1988, p.84). Rappaport (1977, p.92) refers to 'the anachronistic view that accounting is a field dedicated to the search for "true" income and "true" wealth, and (that) once discovered, the truth will become compellingly apparent to all but the unenlightened'.

Not all of these comments are made in the context of the debate about economic consequences but the implication is clear. If considered persuasive, such arguments would strongly support standard setters giving priority to economic consequences because questions of sacrificing truth or representational faithfulness would not arise. This is the stance taken by Rappaport. After denying the possibility of discovering truth in an accounting context, he argues that 'a responsible position of accountability calls for the explicit consideration of the economic impact of financial accounting standards by all accounting policymaking bodies' (Rappaport, 1977, p.98).

It is in this context that arguments purporting to show that truth is a notion which is irrelevant to accounting will now be examined. The aim is to demonstrate that the arguments are not persuasive, and that truth or representational faithfulness cannot be dismissed, at least on the basis of these arguments, as having no significance to the debate about economic consequences and standard setting. Three threads to the argument will be identified. When isolated and examined individually, they will be shown to lose much of their force.

ARGUMENTS AGAINST USING THE CRITERION OF TRUTH IN ACCOUNTING

Accounting representations lack empirical referents

It has been argued that accounting notions like "financial position" and "income" have no empirical referents and that therefore the issue of a faithful correspondence between measurements of "financial position" and "income" and some aspects of reality just does not arise. Typically, arguments along these lines make comparisons with other measurement processes which are accepted as successful. For example, Gerboth (1987, p.97) states that '...measurement in accounting is not measurement in the usual sense of the word. It is not application of measurement techniques to something that exists apart from those techniques. We do not walk up to income and slap a yardstick against it.'

Puxty (1983, p.25) does not deny that there is some mapping between accounts and actual events. He gives as examples the sales figure for a period and the cash account balance which he refers to as "real" measures. However, he says that no mapping occurs

with profit because it is not a physically existing quantity to be measured but rather a "mental construct" in the mind of an observer. Similarly, Ingram and Rayburn (1989, 58) deny that accounting reports are maps of reality. They too concede that accounting is concerned to some extent with an objective reality, but the reality is limited to the economic transactions of an enterprise such as the buying and selling of assets, and transfers of cash and obligations.

What can be said in response to these claims? The emphasis on physical measurement processes such as Gerboth's point about not being able to 'walk up to income', and the reference by Puxty to 'physically existing quantities', cloud the issue. Such points rest on an inappropriately narrow conception of what constitutes successful measurement of phenomena, and wrongly give the impression that the object of any measurement must be, in some sense, tangible and directly observable by the measurer. Many measurement processes require a minimum of physical involvement and involve no direct observation of the property being measured. They may rely on simply taking readings from some appropriately calibrated instrument; for example, the reading of radioactivity levels from a Geiger counter. In relation to accounting, as Chambers (1991, p.81) concedes, there is no physical yardstick, but that is not to say that accounting representations have no empirical referents. As Wolnizer (1987, p.89) argues, 'the financial features of firms ... cannot be observed directly; they are the consequence of action. For example, the solvency, gearing and profitability of firms cannot be examined or observed as directly sensible properties. They are, however, actual features of firms.'

The belief that there can be no referents for properties like income or financial position probably also rests partly on a failure to recognise that they are derived from aggregations of singular data, and as Wolnizer (1987, p.14) points out, it is the singular data that actually have the corresponding referents in the "real world". We might agree then with the view of Puxty (expressed above) that only an item like a cash account balance at a particular time represents a "real" measure because it does have an empirical referent, but it will be the aggregation of this measure, for example, with measures of other assets and liabilities, similarly corresponding to appropriate referents, that will enable us to say that a measure of financial position has an empirical basis.

On the other hand, one must also concede what is obviously correct in the claim being examined. To the extent that representations of income or financial position, prepared at present in accordance with the rules and procedures of conventional accounting, rely on the expectations, intentions and opinions of managers, it is true that they are not empirically based. In relation to depreciable assets, for example, there are no empirical referents for values based partly on estimates of expected useful life and disposal value. As Wolnizer (1987, p.3) states, 'extant accounting rules render the financial representations of many assets, particularly non-cash assets, incapable of being empirically or independently tested'.

This is not the place to consider how conventional accounting practices might be changed. The important point is that in principle, representations of individual assets and liabilities, for example, and therefore aggregated financial properties such as financial

position, may be provided which correspond to appropriate empirical referents. That end is achievable by having independently verifiable, faithful representations of dated financial facts or events.

Accounting representations are partial

It has been argued that the information contained in financial reports cannot be representationally faithful because inevitably that information is only a partial and limited representation of reality, and so will distort reality to some extent. An example of this line of argument is provided by Prakesh and Rappaport (1976, p.12). 'Though one may plead for "economic reality" in accounting, every accounting description is nonetheless a description of some *facet* of economic reality (emphasis added).' Similarly, Morgan (1988, p.480) claims that: '...whatever perspective we choose to adopt, others are squeezed from view...our knowledge always falls short in representing the full texture of reality'. Kelly-Newton (1980, p.20) argues that 'the elusive truth of economic reality has been pursued, with little recognition given to the fact that various measurements of the same phenomenon communicate information regarding some *aspects* of the firm's operation (emphasis added)'.

Ingram and Rayburn (1989, p.58) use a map analogy to support this argument. They claim that accuracy in map-making is not an absolute quality since all maps, like any abstraction from reality, including accounting reports, must inherently distort that reality. It is important to note that this argument, at least as it is expressed by Morgan, and Ingram and Rayburn, represents a quite radical position in that it applies to all representations of reality, not just to those made in accounting.

One has to concede what is obviously correct in this claim. Any representation of reality, accounting or otherwise, does involve some abstraction from reality and so requires the selection of some aspects of reality for representation and not others. However, is this really the same as saying, for example, in the case of accounting, that any accounting representation of reality can only be distorted, incomplete and therefore not true or faithful?

The critics appear to be using a criterion to judge the ability to achieve representational faithfulness that is logically impossible to meet. If one succeeded, for example, in conveying information about all the aspects of a firm's reality -- what Sterling (1979, p.83) refers to as "full concreteness" -- then there would be no distortion, but it would no longer be a representation of reality anyway but rather a duplication of it. Following Carr (1988, p.87), there is a difference between expressing all the truth and expressing only the truth.

The important point is not that representations inevitably fail to capture all aspects of reality but rather that selected aspects of reality should be faithfully represented; that is, with a close correspondence between the particular aspects of reality being represented and the representation of them. The map analogy is again useful. Solomons (1986, p.93)

claims that a three-dimensional map is more representationally faithful than a two-dimensional one, because it more closely resembles that which it is representing. Now it might be conceded that because the three-dimensional map is less abstract, it is less of a distortion of reality. It necessarily encompasses more facets of reality. However, it is also reasonable to insist that while three-dimensional maps may be more realistic than two-dimensional ones, any map can misrepresent reality in an unacceptable way; for example, if a three-dimensional map depicts a mountain that does not actually exist, or if the lines representing roads on a two-dimensional map do not have the same relationship to each other as the roads themselves. In this regard, a two-dimensional map can be just as acceptable as a faithful representation of reality as a three-dimensional one.

Consider again the example of asset valuation. The problem is not to decide which one of the various options such as historic cost, replacement cost, or realisable value represents economic reality. Each of them can be thought of as representing an aspect of economic reality. Nor should we concede, as the writers quoted above seem to imply, that selection of one of these aspects will necessarily only present a partial, distorted view of reality. A preferable alternative is to accept that the representation of a selected aspect of reality will be unacceptable if it is not faithful; for example, if replacement cost figures are measured and presented in a dated report, and they do not correspond to the amounts that would have to be outlaid at that time to replace the assets involved.

Two qualifying points are necessary. First, in taking the position presented above, one does not mean to imply that representations have to be absolutely faithful to be acceptable. Measurement processes often involve degrees of imprecision which are unavoidable and must be tolerated. Second, whether a representation is acceptable or not will depend not only on the accuracy of the representation but also on the use to which it is to be put. With faithful representations of different aspects of reality possible, questions still arise about which aspects of reality are relevant to the users of financial reports, and should therefore be represented. As is made clear in SAC 3 (paragraph 19), these are issues of effective, rather than faithful, representation.

Importantly, as Chambers and Wolnizer (1990) make clear, discussion about the meaning of "truth", and whether it can be applied to the evaluation of accounting information, is usually conducted in the absence of any agreement about which aspects of financial reality should be truthfully represented. There is little agreement about what constitutes the "financial position" of an entity at a particular time, for example, so it is not surprising that uncertainty exists about how to obtain a representationally faithful measurement of that property. No doubt, this uncertainty has contributed to the belief held by some people that it is not ever possible to provide a true or faithful representation of a property like financial position.

Accounting representations are subjective

It has been argued that information in financial reports cannot be true or representationally faithful because the process of obtaining the information is inherently subjective; that is, that the information presented is as dependent in important ways on the observer/accountant as it is on what there is to be observed. It is influenced, for example, by how the accountant chooses to categorise and measure the properties or events that are observed: 'unfortunately, truth from an accounting perspective is not an empirical fact to be discovered; it is a subjective understanding to be manufactured and agreed upon (Ingram and Rayburn 1989, p.59)'.

Some writers, in emphasising the subjectivity that they believe is inherent in accounting, actually make a point that applies to all empirical claims to knowledge. For example, Morgan (1988, p.477), in denying that accountants are objective appraisers of reality, says that 'all knowledge is a matter of perspective'. Similarly, Devine (1985, p.40) claims that 'facts are interpretations relevant to a viewpoint', and Hines (1987, p.33) argues that 'it has been shown that truth is not independent of time, place and viewpoint - there are many possible truths.' The subjectivity identified by these writers is said to exist at the level of the individual observer, depending upon his or her expectations, biases, and cognitive processes. Differences between how the world is apprehended may also derive from wider cultural factors: '...it (accounting) does not reflect fundamental or absolute truth, but rather reflects the mores, values and ideology of a particular society, at a particular time (Hines, 1987, p.31)'.

One has to concede that any attempt to acquire knowledge about the world will involve the participation of an observer who will inevitably take a particular perspective and choose certain concepts to order and arrange the observations which are made. It is impossible to discover the truth or falsity of a proposition by making direct comparisons between our representations of that reality and a mind-independent, unconceptualised reality. In other words, we cannot compare our representations with reality as it is in itself, independent of our apprehension of it. There is no absolute truth or representational faithfulness in that sense. It is also a fact that our attempts to represent some aspect of reality may be affected by preconceptions and biases, cultural or otherwise. This is consistent with Lukka (1990, p.246) who says in relation to accounting, '...accountings and calculations cannot have a simple one-way relation with the underlying things, whatever they are (emphasis added)'.

However, there are also a number of points to be made in response to this argument. Just because subjective factors influence the observation process, it does not mean that all observation statements are completely arbitrary. If observation is an interactive process, involving an observer and an independent reality, then reality constrains the possible knowledge claims that can be made. In relation to accounting in particular, subjectivity does not entail, for example, that any claim about the wealth or income of a reporting entity at a particular time is as valid as any other. Hines seems to acknowledge this point. She was quoted above as denying only the possibility of "absolute" truth in accounting. This is consistent with the claim she made in a subsequent

article: 'there is no such thing as the truth, but there is such a thing as stretching the truth too far' (Hines, 1988, p.253). This seems to imply that even if the subjective nature of observation meant that we can never claim absolute truth or representational faithfulness of an observation claim, we can at least sometimes know when a claim is false or representationally unfaithful.

This point can be related to the one made in the previous section about measurement imprecision. One factor which leads to variations in measurements is subjective differences between observers. There will necessarily be degrees of accuracy in accounting representations just as there are in any measurement activity. The process of assigning a figure to the wealth of a business, for example, obviously will involve some imprecision and many assumptions about which aspects of the business contribute to that wealth. However, that does not mean that representations of the wealth of a business which fall outside a certain range cannot be rejected. Presumably, this is what Solomons (1978, p.72) had in mind when he commented that '...whatever limitations representational accuracy may have in pointing us toward right accounting answers, it will at least sometimes enable us to detect a wrong answer'.

Similar doubts arise in relation to Hines' point about how accounting is dependent on cultural factors. This is best illustrated by the example that she uses of an Indian carpenter who is prepared to produce a number of chairs but insists on charging a greater price for each additional chair to compensate for his boredom (Hines 1987, p.31). Admittedly Hines only presents this as a whimsical example, but there is a point to be drawn from it. Suppose that this did represent a genuine cultural difference. We would probably not expect, as Hines claims, to find a monetary value placed on boredom in an industrial society. However, the point is that the cultural difference, as presented by Hines, is identifiable as such, and is not an obstacle to an accurate representation of the facts. We are still able to determine, for example, the price of the chairs, irrespective of the cultural factors that determined that price. This supports the more general point made by White (1983, p.10) that to be able to appreciate that another culture has certain values and beliefs that differ from our own also presupposes that we inhabit a common world with shared referents and properties. We could not begin to understand the beliefs of the other culture otherwise.

The preceding discussion has cast serious doubts on the various arguments that purport to show that truth or representational faithfulness in accounting reports is in principle unachievable. The general contention that no empirical claims to knowledge can be held to be true is not persuasive. There are useful and practical distinctions made everyday between true and false statements. The critics quoted above have not provided reasons why accounting information cannot be objective and true in the sense that those terms are used in everyday language. Similarly, the terms "wealth" and "income" appear to be used successfully to represent certain aspects of reality in everyday language, and it seems reasonable to view their specialised use in accounting merely as an extension of that everyday use. This is not to say, as has been pointed out, that all accounting reports are at present true or representationally faithful. Rather, no reason has been given for

believing that the objective of truth in accounting, as that term is commonly understood, is impossible to achieve.

The arguments do show that we cannot make claims to absolute truth or absolute representational faithfulness. However, to borrow a distinction used by White (1983, p.134), this demonstrates something about true propositions, rather than persuading us to deny their existence altogether. It is clear that many of the writers whose views have been examined realise that their conclusions are restricted in this way. But if that is the case, they must acknowledge that decisions about truth and falsity can still be legitimately made in this less than absolute sense. Propositions can be held to be true if they correspond to reality as that reality is apprehended by us. As White (1983, p.135) makes clear, establishing truth in this sense simply requires what we naturally accept to be rational behaviour; 'looking to the evidence of (one's) senses, to the evidence of the past, to the community's best established beliefs and theories, to its basic epistemic principles'.

It follows then that the tension between truth (or representational faithfulness) and the need to consider the economic consequences of standard setting cannot be avoided simply by denying the applicability of notions of truth (or representational faithfulness) to accounting. Before progress can be made in resolving this tension, the way that the Conceptual Framework Statements characterise the requirement to take into account economic consequences needs to be examined again more closely.

CORRECTLY CHARACTERISING THE ECONOMIC CONSEQUENCES ISSUE

To this point in the discussion it has been sufficient to characterise the standard setting problem under consideration in a way that is consistent with how it is usually presented in the literature; that is, if economic consequences have to be taken into account in standard setting, then they may be inconsistent with, and will therefore have to be balanced against, factors of a completely different kind -- against certain theoretically or technically correct accounting criteria like representational faithfulness. Zeff (1978, p.63), for example, talks of the need for a 'delicate balancing' by standard setters between accounting considerations and the possible adverse economic and social consequences of their actions. In the Business Council Bulletin (March 1990, p.27) concern was expressed that standards, despite being theoretically desirable, might have undesirable economic consequences. For example, they may adversely affect the international competitiveness of complying firms: 'no matter how desirable a standard may be theoretically it should not be adopted if it is likely to put Australia at an international competitive disadvantage...(emphasis added)'.

However, close examination of Conceptual Framework Statements reveals a more subtle characterisation of the issue. It is stated in SAC 2 (paragraph 26) that the fundamental purpose of financial reporting, and hence the priority of standard setters, is to facilitate the decision-making of users of financial reports: '...the objective of general purpose financial reporting is to provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources'.

Other components of the Conceptual Framework completed to date detail criteria which it is assumed must be met to satisfy that objective. As already indicated, SAC 3 identifies attributes or qualitative characteristics such as reliability and relevance which accounting information needs to possess if it is to serve that objective. SAC 4 establishes definitions and recognition criteria for the elements of financial statements such as assets and liabilities that are consistent with the achievement of the objective.

It might be felt that such issues are exactly what is meant by technical or theoretical accounting considerations. However, the important point is that these criteria are not assumed to have any inherent or intrinsic value of their own. They are specified as worthwhile only to the extent that they contribute to the objective of general purpose reporting identified in SAC 2, and it is made quite clear in SAC 2 that this objective is worth pursuing because of the desirable economic consequences which will flow from its achievement; that is, that it will lead to a more efficient allocation of scarce resources: 'efficient allocation of scarce resources will be enhanced if those who make resource allocation decisions...have the appropriate financial information on which to base their decisions. General purpose financial reporting aims to provide this information (paragraph 13)'.

It is true that one other objective is identified in SAC 2: 'general purpose financial reporting also provides a mechanism to enable managers and governing bodies to discharge their accountability (paragraph 14)'. However, that goal too is later subsumed under the broader one of resource allocation efficiency on the grounds that users who are provided with information by accountable managers and governing bodies 'ultimately require the information for resource allocation decisions (paragraph 27)'.

As characterised in the Conceptual Framework Statements then, it follows that ultimately the choices which must be made by standard setters are between factors of the same type, that is between conflicting economic consequences, rather than between factors of different types, that is, technical or theoretical accounting factors on the one hand, and economic consequences on the other. The identified technical or theoretical accounting criteria are assumed to produce a desirable economic outcome, an efficient allocation of resources, and if anticipated economic consequences of a proposed standard other than ones related to that outcome are to justify relaxation of some of the accounting criteria then ultimately it must be because some sacrifice in efficiency of resource allocation is considered acceptable.

The point can be illustrated by using the example of lease capitalisation. Presumably, one of the factors at least implicitly considered by standard setters when this matter was dealt with was that by requiring the recognition of lease agreements previously ignored, financial statements would represent more faithfully the financial position of complying firms. Reports would therefore be more reliable according to the meaning of that qualitative characteristic as subsequently explained in SAC 3. On the other hand, standard setters may well have been under some pressure not to introduce such a standard because of the resultant costs that would have to be borne by some

parties. Complying firms, for example, may have expected to be perceived as riskier than before, and would therefore have expected to find it more difficult and costly to attract funds. In keeping with SAC 3, this is an economic consequence of legitimate concern to standard setters. Possible loss or diminution of competitive position is one of the costs which they need to consider (paragraph 42). However, it should not have been a matter of judging whether a theoretical or technical factor like representational faithfulness needed to be sacrificed to save some parties from unreasonable costs. Rather, it should have been a question of judging whether one economic consequence, the efficient allocation of resources that is supposed to follow from having financial information with characteristics like representational faithfulness, could be sacrificed to some extent to avoid financial hardship to particular parties, another economic consequence.

In one sense, the way that the issue is characterised in the Conceptual Framework is reassuring. It seems intuitively obvious that it is a simpler task to balance factors of the same type against each other rather than factors that are different in kind. However, the task is actually far from simple. The fact that standard setters apparently have to quantify the various potential economic consequences of their decisions creates immense measurement problems. It will be difficult enough to determine the possible impact of a proposed standard on individuals or groups. As SAC 3 (paragraphs 44 and 45) makes clear, information about the expected impact of a standard will need to be gathered from the various affected parties, and their assessments of the likely economic consequences will probably differ. The measurement difficulties are exaggerated because the economic consequences of a proposed standard will depend on the reaction of users of reports, so the process of assessing consequences will involve some double-guessing about responses. The reactions of the preparers of financial reports will have to be anticipated, for example, as they in turn attempt to anticipate the reactions of report users.

Assessing the impact of a potential standard on the efficiency of resource allocation is even more problematical. There may be intuitive appeal in the assumption that reliable and relevant financial information, for example, will contribute positively to an efficient allocation of resources. However, even if one accepts this assumption, it is doubtful whether anyone has sufficient understanding of the processes involved to achieve what seems to be expected of standard setters; that is, that they need to quantify the impact on resource allocation efficiency in cases where some sacrifice in the reliability or relevance of financial reports is needed to accommodate other economic consequences.

Importantly, apart from the measurement problem involved in assessing economic consequences, the Conceptual Framework Statements do not provide criteria by which conflicting economic consequences are to be balanced against each other. It seems then that standard setters are faced with insurmountable problems in incorporating economic consequences into their decision-making in a way consistent with the characterisation of the issue in the Conceptual Framework Statements. In the next section, the possibility of resolving this dilemma by explicitly recognising the ethical factors inherent in the standard setting task will be considered.

THE ETHICS OF STANDARD SETTING

The responsibilities of standard setters can be thought of, at least in part, as being ethical. It is quite proper to assess whether standard setters have made the *right* or *wrong* decision in a particular case. To the extent that judgements of this type rest on the fact that standard setters are agents whose decisions affect the interests of a variety of parties, we can say that such judgements are ethical ones.

Different approaches can be taken to assessing a decision or action that has ethical implications. Under a teleological (or consequentialist) approach, a decision or action will be judged to be right if it contributes to the realisation of some intrinsically worthwhile and ultimate good. The characterisation of the responsibilities of standard setters in the Australian Conceptual Framework Statements, while not couched explicitly in ethical terms, has features consistent with this approach. Financial reporting is referred to as a *means* rather than an *end* (SAC 2, paragraph 11), and, as explained in the previous section, it is made clear that ultimately the aim in presenting financial information is to contribute to the goal of efficiency in resource allocation. Perhaps even that goal is best thought of as an intermediate means to an end, and that implicit in the Conceptual Framework Statements is the understanding that efficiency of resource allocation will enhance some (admittedly vague and difficult to define) notion of general community economic well-being.

An alternative to taking a consequentialist approach is to adopt a deontological one. Broadly speaking, under this approach, a decision or action is judged to be right to the extent that it is based on some intrinsically worthwhile rule or principle of action, or some notion of duties or rights, for example, rather than on the ultimate consequences which are expected to follow from the decision or action. Such an approach allows one, for example, to consider the ethical implications of the special status held by some people in their relationships with others:

... if all that mattered was consequences, then, in so far as these counted morally, all similar cases would count alike, regardless of any special relationships ... what deontology can do, while consequentialism cannot, is to make decisions described in terms of any such special relations to (an) agent obligatory or wrong as such (Mackie, 1977, p.158).

An associated point is that any consideration of how benefits are distributed between people must necessarily be absent from a purely consequentialist approach. There is a hint of a deontological consideration of this type in SAC 3, or at least a concern that such considerations are being ignored, when it is acknowledged that there is no guarantee that the costs involved in the provision of financial information will be borne by those who reap the benefits (paragraph 43). The fact that standard setters are required to consider not only ultimate resource allocation consequences but also, for example, the impact of their decisions on the competitive positions of *particular interested groups* also implies a deontological consideration.

It is clear then that standard setting is a task with ethical implications and that these implications need to be brought out into the open and clarified. In the previous section it was shown that the responsibilities of standard setters are characterised in the Conceptual Framework Statements in such a way as to avoid the need to balance opposites, that is, "theoretical" considerations and economic consequences, against one another. However, in doing so, a different tension between opposites arises, that is, in an ethical sense, between consequentialist considerations and deontological ones. Furthermore, in the previous section, it was shown that the "accountability" of managers and governing bodies, clearly a deontological consideration, is subsumed under the ultimate aim of resource allocation efficiency. This indicates an implicit bias in the Conceptual Framework towards a consequentialist approach.

Is that bias appropriate? The question of whether a consequentialist or deontological approach should be taken by standard setters needs to be addressed. While reasons have been given above for thinking that deontological considerations are often required, for example, where special relationships between parties exist and duties or obligations arise, there is still the possibility that they should be taken into account in conjunction with consequentialist ones. Mackie (1977) provides excellent reasons for accepting that even if the achievement of some ultimate good is considered desirable, there are sound practical reasons for taking a deontological approach to the assessment of immediate decisions rather than a consequentialist one. His reasoning can be applied directly to the standard setting situation, and provides some initial grounds for believing that even with the ultimate aim of providing financial information which enhances the efficiency of resource allocation and general economic prosperity, it is preferable for standard setters not to make their decisions specifically in relation to those consequences.

Mackie's first point is that any attempt to determine the consequences of an action is fraught with difficulties: '... any calculation of the consequences of an action beyond the most immediate and obvious ones, even if it were possible, would be absurdly wasteful of time and effort ... the question about all the differential consequences of this or that alternative is almost always intractable. (1977, p.155)'. As was made clear in the previous section, this is certainly true of the decisions that have to be made by standard setters.

Mackie also argues that if people operating in a social environment are to prosper as a result of their choices and endeavours, there needs to be some degree of regularity and reliability in the behaviour of other people with whom they interact: '... the majority of human actions should be guided ... by habit ... rather than by the calculation of any considerable range of consequences (1977, p.157)'. This point is relevant to standard setting. It would be unsatisfactory for standard setters to base their decisions on the calculation of ultimate consequences to any significant extent if the parties affected by their decisions are unable, in the pursuit of their goals, to make assumptions about the direction standard setters will take in the future. In other words, it would be unacceptable for there to be a lack of consistency between individual standards other than them being based on some general principle of pursuing preferred ultimate economic outcomes.

Consistent with these views, in the remainder of this paper it will be argued that standard setters ought to give priority in their decision-making to a deontological consideration, that is, to an obligation which they have to tell the truth to a particular class of users of financial information. They may anticipate that in meeting this obligation, rational decision-making by the users and various associated economic benefits will follow, but such considerations will not provide the justification for meeting the obligation. Necessarily, the analysis will not be exhaustive and it will not be possible to assess the interests of all groups affected by accounting standards. For the sake of simplicity, only the conflicting interests of two groups, the preparers of financial reports and the users for whom those reports are primarily prepared, will be taken into account. Despite this limitation, an important conclusion will be reached in relation to whether standard setters should consider sacrificing representational faithfulness in the pursuit of preferred economic consequences.

Two associated points need to be considered first. One relates to the recognition by a number of writers that since standard setting involves making choices between the conflicting interests of different groups, then the process is necessarily a political one. Gerboth (1973, p.479) makes the point in this way. 'When a decision-making process depends for its success on public confidence, the critical issues are not technical; they are political...In the face of conflict between competing interests, rationality as well as prudence lies not in seeking final answers, but rather in compromise - essentially a political process.'

One has to concede that there is a political aspect to standard setting. It might even be possible for standard setters to employ a politically justified rationale that happened to coincide with an ethical one. For example, it might be thought politically expedient as well as ethically justifiable to give *equal* consideration to the interests of all parties affected by the decisions of standard setters. However, it is likely that standard setting boards will have to make compromises geared more to appeasing the most powerful interest groups, and it will be contended in this paper that the interests of one group, certainly not the most powerful one, merits the special attention of standard setters. The purpose of the analysis in this paper is to identify an ethically correct foundation for the decisions of standard setters rather than to examine the ways in which their decisions may have to be amended as a matter of political necessity.

The second point relates to the question of neutrality, another qualitative characteristic identified in SAC 3. It might be thought that the requirement that standard setters satisfy this criterion offers sufficient protection for users of financial information without complicating the issue with ethical considerations. There is considerable confusion about the issue of neutrality. Some writers deny that neutrality can be achieved in relation to standard setting. For example, Bromwich (1985, p.81) makes the following claim. 'Generally, it can be said that accounting standards are not neutral. They will affect variously different members of society.' While true, this is not the sense in which neutrality is defined in SAC 3. In that Statement, neutrality implies that financial reports should not be presented in a way that is designed to generate particular behaviour in the users of the reports: '...financial reporting should, if it is to be reliable, be free from bias

(that is, be neutral). It should not be designed to lead users to conclusions that serve particular needs, desires or preconceptions of the preparers (paragraph 21)'. The reason why this criterion does not offer sufficient protection to users is that neutrality, just like representational faithfulness, is characterised in SAC 3 as subject to the constraint of "costs versus benefits", that is, it is only a means to an end that apparently may be sacrificed in attempting to achieve that end. For this reason, there is still a need to explicitly identify the ethical responsibilities of standard setters.

A useful starting point for drawing out the obligations of standard setters is the *prima facie* duty or obligation of fidelity identified originally by Ross (1930, p.21) and applied to accounting by Ruland (1984, p.227). Ruland argues that the accounting profession is obliged to present truthful or representationally faithful information to users because it has made an implicit promise to do so. According to Ruland, the promise exists generally as part of any information provider/receiver relationship. An examination of the history of the profession, with its emphasis on stewardship and independent verification, reinforces Ruland's belief that the obligation also exists specifically in the case of accounting. It follows that any purposeful misrepresentation in accounting reports must be wrong because it violates this obligation³. Standard setters can be considered to fall under the umbrella of the term "accounting profession". They are subject to the obligation since they play a part in determining the nature of the accounting information which is provided to users.

There are reasons for believing that the identified obligation to users is especially strong in the case of one particular sub-group of users, that is, those users such as small investors who depend on published reports for their information needs. Their position is a vulnerable one, and they are entitled to financial reports that suitably meet their decision-making requirements. To satisfy this entitlement, financial reports need to be representationally faithful. The special status of this group of users has not gone unnoticed: 'general purpose financial reporting focuses on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs (SAC 2, paragraph 7)'. Henderson and Peirson (1988, p.10), focusing in particular on small investors, argue that this group, which has little bargaining power or influence, needs more help than large institutional investors. 'Small investors are forced into a less diversified portfolio because of limited resources with the result that they are in a more vulnerable position when compared to institutional investors.'

How might the obligation to the identified group of users be balanced against the interests of other groups affected by the decisions of standard setters? Consider the competing interests of dependent users and the preparers of financial reports. It is likely to be in the interest of preparers of financial reports to face a minimum of restrictions. They will prefer to limit the amount and type of information that they are required to provide, and will want to make a favourable impression on report users. On the other hand, it will be in the interests of dependent users to have as much representationally faithful information disclosed as possible, at least to the point where that information can be usefully assimilated.

Why should an obligation to dependent users take priority over the interests of the preparers of reports? Why not accept that the groups are equally entitled to have their interests taken into consideration, and that any burden associated with standard setting should be shared between the affected groups? After all, the obligation to users of accounting reports upon which the position taken in this paper rests was originally presented only as a *prima facie* one. Some writers insist that the interests of the preparers of reports have to be considered by standard setters as well. "Fairness to account users must be counterbalanced by fairness to account *producers*" (Harris, 1987, p.86).

One may concede that the burden should be shared between the parties in relation to *how much* representationally faithful information to provide; in other words, in relation to how many aspects of financial reality are to be represented to users. Similarly, and consistent with the denial of any absolute truth or representational faithfulness in a previous section of this paper, one might also concede that preparers of reports do not have to be relentless in the pursuit of precision in their measurements. Provision of information is costly so it seems reasonable that standard setters should compromise in this respect.

However, there are reasons for rejecting the possibility of compromise to the extent that it implies that information which is not representationally faithful might have to be presented, for example, to elicit some behavioural response from users that is preferred by the preparers of reports. The crucial point is the permissibility of deceit that is implied. Unless advised to the contrary, users of financial reports will be naturally inclined to interpret the information contained in a report as a reasonably accurate depiction of a firm's position and performance; that is, as representationally faithful. They will not expect that the accuracy of the information has been compromised to accommodate political pressures, for example, nor to elicit from them a certain desired response. To the extent that representational faithfulness was ever sacrificed, users who believe reports are representationally faithful would be deceived. Users who are dependent on published reports would be most affected.

One might respond that this objection can be avoided by making it clear to users exactly how and when representational faithfulness had been compromised. Solomons (1978, p.71) acknowledges this possibility. 'It is perfectly proper for measurements to be selected with particular political ends in mind or to be adapted to a particular end if it is made clear to users of the measurement what is being done.' However, in an important respect, such an admission would be self-defeating. In making it clear to users that representational faithfulness had been sacrificed in a particular case, the attempt to manipulate their reactions would become obvious, and the desired behaviour would be unlikely to follow. There would be no point, for example, in making a decision not to require lease capitalisation because an unwanted flow of resources between sectors of the economy would follow, but at the same time disclose to investors that balance sheets did not faithfully represent all the liabilities of affected firms. Users would obviously then become suspicious about the riskiness of the firms involved anyway. They might attempt

to adjust for the bias contained in the reports, but would presumably attach little credibility to the reports as presented.

There is another way to view this issue. The claim that all affected parties such as the preparers of reports are entitled to have their interests taken into account in deciding on a standard, and not only dependent users, assumes that the position immediately prior to implementing the standard was equitable. If, however, users were being misled prior to the standard -- for example, because certain liabilities were being kept off the balance sheet -- then the argument that the interests of preparers of reports were being neglected in the standard setting process would lose its force.

This point raises again the political aspect of standard setting and the concern expressed by some writers that the preparers of financial reports might come to dominate the standard setting process. Preparers of reports certainly represent a more organised and powerful force than users such as small investors who are dependent on published reports. Dopuch and Sunder (1980, p.15) suggest that this power makes it unrealistic to base standard setting on the primacy of the user because it does not reflect 'the economic reality of the power of suppliers in the accounting market place...'. This view is supported by Kelly-Newton (1980, p.158) who insists that a 'myopic concentration on the user' is an unsatisfactory basis for policy-setting. However, in response, it can be argued that the interests of preparers of reports do not need to be accommodated by standard setters because standard setting should ultimately constrain the exercise of their power and regulate their behaviour. As Miller (1985, p.30) argues, the right of preparers to influence standard setters should be forfeited:

In the context of standards setting, the simple fact is that the purpose of the process is to constrain the behaviour of statement preparers. Simply put, the process is designed to protect users against the perfectly normal tendency of preparers to make accounting policy decisions that allow them to look as good as possible.

It might be argued that the identified obligation to dependent users does not need to be met because in the absence of standards, firms that did not provide information that was representationally faithful would eventually be identified and shunned. However, ensuring that reports are representationally faithful is justifiable in the same sense that consumer protection legislation is justifiable. Consumers may eventually identify suppliers of unsatisfactory goods or services but many would be unfairly disadvantaged in the process, and legislation is designed to avoid that harm occurring. Similarly, standards should be designed to ensure that dependent users are not unfairly misled by reports that are not representationally faithful. This is what Beaver (1973, p.52) means when he says that the role of reports is essentially 'pre-emptive', that is, to prevent people who are not dependent users achieving abnormal returns by trading on inside information. Presumably, it is also what Solomons (1983, p.107) means when he refers to the need to prevent short-run damage to investors.

CONCLUSION

The task faced by standard setters is an extraordinarily difficult one, especially in relation to the requirement to consider the economic consequences of their decisions. In this paper it has been argued that ethical considerations have a useful role to play in the standard setting process. An obligation of standard setters to ensure that representationally faithful information is provided to users, particularly dependent ones, has been identified, while the need to balance that obligation against any anticipated economic consequences has been shown to be unjustified.

No doubt, many people would take for granted that the primary responsibility of standard setters is to the users of financial reports, particularly those who cannot command access to the information that they need, and so would not find the position developed in this paper surprising or controversial. However, the crucial point is that the Australian Conceptual Framework Statements do not explicitly recognise this priority, do not acknowledge the ethical nature of the standard setting task, and unnecessarily complicate that task by requiring standard setters to consider all the economic consequences of their decisions.

FOOTNOTES

1. The case of accounting for oil and gas exploration costs in the U.S.A. is pertinent, and illustrates that the issue under consideration is not just a hypothetical one. SFAS 19 made the successful efforts method of accounting for those costs mandatory and proscribed the full cost method largely because the latter was thought to obscure failure and relative risk. In other words, the successful efforts method more faithfully represented performance and financial position. However, in response to political pressure and a persuasive economic consequences argument, that standard was later rescinded and both methods permitted. It was claimed that SFAS 19 was contrary to national economic policy in that it would suppress competition and would lead to less exploration and development of reserves. For more information on this case, see Wolk *et al.* (1984, pp. 455-475).

2. In making this simplifying assumption, less intuitively appealing alternatives to the correspondence theory of truth, such as the coherence view, are being disregarded. Associated questions such as whether, under a correspondence view of truth, "truth" *means* a correspondence between propositions and facts, or whether a correspondence with facts should only be thought of as a *criterion* for deciding whether a proposition is true, are also being ignored. Questions about truth that arise in relation to analytical propositions such as those of mathematics or those which are true simply because of the meaning of words, are not relevant to this paper. The concern is restricted to truth as it applies to empirical claims to knowledge.

3. Ruland ultimately reaches a similar conclusion to the one reached in this paper but the route by which he reaches his conclusion is different. Rather than accepting practical reasons for rejecting a consequentialist approach, he attempts to weigh the consequentialist and deontological considerations involved in standard setting against one another. For example, he prefers to acknowledge that standard setters have some responsibility to produce good economic consequences but that this responsibility is weaker than the identified obligation to users of reports. It is only a negative responsibility in the sense that any consequences will not flow directly from the actions of the standard setters themselves but from the actions of others such as the users and preparers of reports.

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