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Pieter T. Elgers

Accounting Theory & Policy

A Reader

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PREFACE

Our aim in compiling this reader has been to provide an up-to-date and comprehensive set of readings in accounting theory for the upper-level undergraduate and graduate accounting student. The articles in this volume have a conceptual and pragmatic flavor, emphasizing the application of theory to practice.

There is a risk of rapid obsolescence for any compilation of current research articles. Moreover, instructors of accounting theory courses, present company included, tend to be highly idiosyncratic in the design of the accounting theory course. Nevertheless, we have been led by several convictions to the preparation of this volume. First, there is a need for a collection of readings that reflects the recent, thorough reassessment by accounting researchers and accounting policy-makers of the role of accounting theory in the setting of accounting standards. This reassessment has enabled a broadening of the domain of accounting theory as well as a sharper delineation of the limits of accounting theory in the policy-making process. Specifically, accounting policy decisions are increasingly acknowledged to be matters of social choice, involving a possible trade-off of the interests of one group against those of another group. From this perspective, accounting policies may be viewed appropriately as outcomes of a political process, and the arguments for or against a given policy may be phrased legitimately in terms of "whose ox gets gored." Accordingly, whether a given method of accounting is consistent with an underlying theory of income or value may not be a compelling argument in the policy debate. This appreciation of the insufficiency of traditional accounting theory has been accompanied by a broadening of the body of theory relevant to accounting, to include theories in welfare economics, political science, human information processing, macroeconomics, finance, and other areas pertinent to assessing the consequences of accounting rules.

Second, the organization of this book and the selection and sequence of articles has enabled us to express our personal, if not original, view of structure in accounting theory. If a coherent body of accounting theory has been developed to allow either the rationalization or the criticism of present accounting practice, then it should be possible to reveal the structure of that body of accounting theory by an orderly progression. This progression should move from (a) consideration of the basic nature of accounting theories (for example, as compared to theories in the physical or social sciences) to (b) the articulation of criteria by which

competing accounting theories might be validated or discarded, then to (c) the appraisal of various comprehensive theories, and finally to (d) the resolution of disputes such as those listed in the current agenda of the Financial Accounting Standards Board (FASB). It will not surprise many of our readers to learn that the progression outlined here has not been smoothly accomplished in this volume, reflecting in our judgment the present state of theorizing in accounting.

In sum, the papers included in this collection are likely to impress upon the reader that accounting theory is necessary though insufficient in the accounting policy-making process; that new theories and empirical findings in related fields have important implications for both the subject matter and the methodology of accounting theory; and finally that a formidable task awaits the accounting theorist attempting to apply a coherent frame of reference to the enlightenment of current accounting controversies.

Earlier versions of this set of readings have been used as the primary text in an M.B.A. elective course in accounting theory as well as a senior undergraduate accounting theory seminar. The M.B.A. course has stressed the first three parts of the outline. The undergraduate course, while incorporating selected portions of the earlier readings, has emphasized Parts III, IV, and V of the outline. Thus, while some instructors may desire to supplement this collection of readings with their own favored pieces from the periodical literature, and perhaps to revise the content of Part V ("Other Current Issues") to reflect changes in the FASB agenda, we believe that this collection will provide a useful basic or supplementary text for several years beyond its publication date.

This book begins with the basic foundations of accounting theory and policy, setting the stage for later coverage of specific issues. Part I focuses on the nature of accounting policy decisions and surveys the research strategies available for aiding accounting policy decisions. This section helps to define the role of accounting theory (or a priori research). Part II explores approaches to accounting theory, criteria for the evaluation of accounting-policy standards, implications for accounting policy of market efficiency and portfolio theory, and the issue of materiality. Part III deals with the nature of accounting income, the problem of allocation in income measurement, and various proposed alternatives to historical cost accounting. Part IV is concerned with extensions in corporate accounting disclosures: forecast reporting, human asset accounting, and social reporting. Finally, Part V examines such other specific issues from recent FASB agendas as solvency and liquidity, accounting recognition criteria and executory contracts, and intangible assets.

We selected the articles for this volume essentially in terms of how provocative and stimulating they were rather than for their compatibility with our own views. Length was not a critical factor in the selection process, because we were looking for significant contributions to accounting thought. Pronouncements of the Financial Accounting Standards Board and the Accounting Principles Board are not included in this volume under the assumption that the reader has access to a collection of such material. For other articles dealing with topics covered in this book, the reader should refer to the selection bibliographies.

The editors gratefully acknowledge the helpful comments furnished by the following professors on the outline for this book: Richard E. Baker, Northern Illinois University; Ahmed Belkaoui, University of Chicago; James Boatman, Oklahoma State University; John W. Cook, Georgia State University; Joel S. Demski, Stanford University; Edgar O. Edwards, Rice University; Bob Keeny,

Guilford College; Philip E. Meyer, Boston University; Maurice Moonitz, University of California at Berkeley; Richard L. Pannell, American Institute of CPAs and Fairleigh Dickinson University; Richard A. Samuelson, San Diego State University; David Solomons, University of Pennsylvania; Keith Stanga, University of Tennessee; and Gary Sundem, University of Washington. Our debt of gratitude extends to the authors of each of the articles contained in this volume and to the various academic and professional journals in which these articles originally appeared for permitting us to reprint the selections. We also appreciate the typing and administrative assistance provided by Patrice Richman and Glynis Gray at the College of William and Mary.

Robert Bloom, Williamsburg, Virginia
Pieter T. Elgers, Amherst, Massachusetts
April 1980

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I/INTRODUCTION: THE ROLE OF ACCOUNTING THEORY IN POLICY FORMULATION*

This book focuses on accounting theory and policy in a decision-making context, fully exposing readers to the dilemmas confronted by the accounting-policy decision makers—the Financial Accounting Standards Board and the Securities and Exchange Commission. Accounting theory is not an end per se. Theories reflect either descriptive or prescriptive behavior, the way individuals or firms actually do or should act. Accounting policy consists of developing accounting standards guided by a basic theoretical framework of financial reporting. It is important to understand accounting theory with an eye to examining accounting-policy decisions, which have economic, political, and social consequences.

In the sole article of this part, May and Sundem (1976) provide a way of examining the accounting policy-setting process. They contend that the most auspicious benefit of accounting-policy research is to assist in the formulation of theories for policy choices. Viewing such choices in a social context, May and Sundem point to the role of political organizations like the Financial Accounting Standards Board and the Securities and Exchange Commission in affecting social welfare. In light of our ignorance of individual and collective decision-making processes, a social ordering of accounting policies cannot be set forth according to the authors. Nevertheless, May and Sundem discuss various research strategies which may help to enlighten the policy decision. These strategies include security price-based research, a priori research, sensitivity of accounting time series, modeling individual and aggregate decision making, and behavioral research with regard to empirical studies on the association of accounting data with security prices.

*The editors advise reading the preface before proceeding further in the book.

Research for Accounting Policy: An Overview

ROBERT G. MAY AND GARY L. SUNDEM

A significant amount of accounting research is devoted to questions of accounting (financial reporting) policy. Such research is addressed to the alternative models, measurement rules and disclosure requirements that are or might be applied in current financial reporting by business enterprises. Such research accounts for much of the combined research efforts sponsored or undertaken by institutions such as the AICPA and FASB as well as for much of the independent academic research in accounting.

The purpose of this paper is to offer a model for organizing one's thoughts and efforts directed toward the process of accounting policy making and related research strategies. The motivation for attempting such a task is a conviction that results from individual accounting research studies must be interpreted as interrelated building blocks for accounting policy decisions. As Gonedes and Dopuch [1974] showed, virtually no research strategy used by accounting researchers to date is capable of selecting the most socially desirable accounting alternative. However, because Gonedes and Dopuch applied such a demanding performance criterion to accounting research (i.e., achieving a social ranking of alternatives), they leave an impression of great pessimism. Yet, as will be evident later, the most promising use of any given research strategy (data source) in the area of financial reporting policy is not in selecting optimal alternatives; rather, it is in contributing, *along with all other available strategies*, to developing theories that then may be used by policy makers to settle specific issues.

The paper begins with a description of accounting policy making as a social choice process. This discussion contains a brief enumeration of certain implications of the social choice dimension of accounting policy making; the second section presents a model for interpretation of research for accounting policy making; and the third section discusses the potential contributions of various research strategies.

ACCOUNTING POLICY DECISIONS AS SOCIAL CHOICES

For nearly half a century, the accounting profession has been concerned with forming accounting policy, i.e., deciding which measurement and reporting alternatives are acceptable and which are not. From the time the first standard audit report in 1933 referred to "accepted principles of accounting" [Rosenfield, 1964], the profession has taken upon itself the task of deciding what is accept-

The authors would like to thank the participants of the accounting colloquia at the University of Washington and Oklahoma State University for their helpful comments on earlier drafts.

Robert G. May and Gary L. Sundem, "Research for Accounting Policy: An Overview," October 1976, pp. 747-763. Reprinted by permission of *The Accounting Review*.

able. The Committee on Accounting Procedure (1939–1959), The Accounting Principles Board (1959–1973) and the Financial Accounting Standards Board (1973–) have had major policy-making responsibility. Yet, after all of these years of policy making, the procedures for policy formulation are not always well understood.

Before proceeding to a detailed discussion of policy decisions, it is necessary to distinguish between accounting theories and accounting policy [Ijiri, 1975, pp. 9–11]. An accounting theory is a descriptive or predictive model whose validity is independent of the acceptance of any goal structure. Though *assumed* goals may be part of such a model, research relating to a theory or model of accounting does not require acceptance of the assumed goals as necessarily desirable or undesirable. On the other hand, accounting policy requires a commitment to goals and, therefore, requires a policy maker to make value judgments. Policy decisions presumably are based on *both* an understanding of accounting theories *and* acceptance of a set of goals. Research relating to accounting policy decisions must recognize and discern the aspect of the policy-making process at issue.

For the moment, we will discuss the unique aspect of accounting policy, namely, goal formulation. Several recent attempts have been made to delineate the goals or objectives of financial accounting [e.g., Arthur Anderson & Co.; 1972; Study Group on the Objectives of Financial Statements, 1973; Deffiese, 1973; and Accounting Standards Steering Committee, 1975]. Since the selection of a set of goals is inherently a value judgment, most debate about sets of goals is a debate about whose value judgments are best. This is an insoluble problem, as value judgments are neither right nor wrong, true nor false. The resolution of the problem of selection of goals must be solved by general agreement, not by proof of correctness. Therefore, the first step in a logical process of policy formulation is to obtain general agreement on the goal of financial accounting.

The statements of goals of financial accounting made to date suffer from two major problems: (1) they have not received general acceptance and (2) they do not provide a basis for selecting among alternative policies. For instance, a recent statement of goals asserts that "the basic objective of financial statements is to provide information useful for making economic decisions" [Study Group of the Objectives of Financial Statements, 1973, p. 13]. However, this is not a statement of a goal of financial statements, but merely a delineation of the domain of accounting policy decisions. That is, it states *what* accounting policy makers are to be concerned with, but it does not state *how* comparisons among alternative policies are to be made.

We suggest that an objective of maximization of social welfare (which may be implied, though not stated, in the above objective) is a necessary addition to the above goal statement.¹ While this is admittedly our value judgment, such a goal seems to provide a criterion for policy decisions and, to our knowledge, no one has expressed disagreement with it as an objective. In a letter to the AICPA, the SEC has expressed concern that accounting policy decisions be "consistent with the public interest" [Burton, 1973, p. 271]. Indeed, the Securities Acts clearly were motivated by a desire to prevent recurrence of the socially deleterious events surrounding the crash and ensuing Great Depression. More-

¹See Committee on Concepts and Standards; External Financial Reports [1975, pp. 42–44] for more details.

over, the U. S. Congress has intervened in accounting policy decisions at least once, in the investment tax credit decision, when it felt that an accounting policy decision was not in the public interest. Since accounting policy decisions that apparently are not consistent with the public interest can be reversed by a higher authority, it is apparent that either accounting policy makers (the SEC-FASB) at least must appear to pursue a social welfare criterion or have their power consistently preempted by the legislature, which presumably applies such a criterion. Thus, the political environment of accounting policy formulation implies acceptance of a social welfare criterion for accounting policy decisions as social choices.

It is possible for accounting policy decisions to be made by each individual or firm producing a financial statement, in the same way that policy decisions concerning any other economic commodity are made. A demand for accounting information exists because individuals wish to improve their investment decisions. This private demand would lead to production and sale of financial statements.

Although general public policy would apply (e.g., general antitrust policy would apply to the industry structures that evolved in the production and sale of private financial information about business enterprises), no special public accounting policy would be necessary to satisfy demand for financial information on the part of individuals. Research in financial accounting could contribute to such a laissez-faire environment by producing microeconomic information (e.g., predicting individual costs and benefits), similar to cost and market research relevant to the production and distribution of other goods and services.

But accounting information may have public value apart from its private value [Fama and Laffer, 1971; Hirshleifer, 1971; and Demski, 1974a]. Because accounting information may influence individual investor's assessments and, through these assessments, the structure of security prices, therefore the information may influence the distribution of costs of capital among firms and, through that distribution, the allocation of capital to various uses in the economy. The possibilities of both production and consumption externalities in information generation imply that regulation of accounting information production may lead to an allocation of resources that is pareto superior to that achieved by a free-market equilibrium allocation. Moreover, changes in information production induced by regulation may alter the value of securities portfolios and, through those values, the distribution of wealth among individuals. Either one or both of these potential influences adds a social value dimension to the regulation of financial accounting information.

A necessary (but not sufficient) condition for regulation to create a socially *better* allocation of resources and/or distribution of wealth is that it *at least* be capable of producing a *different* allocation and/or distribution than would be attained in a free market.² There are several reasons that this condition may

²The social desirability of any piece of regulation will depend on the amount of and ownership of resources used to decide on and enforce the regulation as well as the reallocation of resources and redistribution of wealth brought about by the regulation. Henceforth, we will not be concerned about the desirability of any particular regulation, but we will accept the result that regulation is potentially desirable. The dilemma of comparing the social desirability of alternative allocations is discussed in Demski [1974a, pp. 227-228].

be met. First, regulation can impose production of information on entities with comparative advantages in producing the information (usually perceived to be the business enterprise in the case of financial accounting information). However, these entities do not necessarily have a private incentive to do so. In this way, it may be possible to alter the information set employed privately by investors in forming their preferences for various securities by altering the distribution of costs of information [May and Sundem, 1973]. Such alterations may affect resource allocation and wealth distribution directly by changing the production opportunities of other (external) information suppliers, even though their effect on the security price structure is minimal. Second, since optimal investment strategies imply interfirm comparisons, some external economies in information processing may be achievable through imposition of certain uniformities in financial accounting information produced. This may mean lower costs of acquiring information for investors and other decision makers. Third, to the extent that a policy apparatus lessens the probability of major financial scandals, it may contribute to the general perception of risk over a vast number of risky investments and, therefore, the level of savings and investment in the economy as a whole.

Accounting information is like many other commodities produced in our economy today: the private market for such information is modified by explicit public policy (regulation) decisions. The decisions to produce and consume accounting information are influenced by the FASB, SEC and other regulatory bodies. As noted earlier, in practice as well as in theory, the social welfare impact of accounting reports apparently is recognized. Therefore it is no surprise that the FASB is a political body and, consequently, that the process of selecting acceptable accounting alternatives is a political process. If the social welfare impact of accounting policy decisions were ignored, the basis for the existence of a regulatory body would disappear. Therefore, the FASB must consider explicitly political (i.e., social welfare) aspects as well as accounting theory and research in its decisions.

In a democratic-capitalist society, it is virtually unassailable in principle that social policy should be sensitive to individual preferences.¹ However, Demski [1973] has shown that, in general, the characteristics of accounting information per se (e.g., relevance, objectivity) do not reflect the preferences of individuals affected by the use of the information. This implies that policy makers must go beyond comparing alternative policies regarding the degree to which their outputs conform to certain purely technical or aesthetic standards, e.g., "true economic value," "true income," relevance and objectivity. That is, accounting policy makers must employ a decision model that is sensitive to individual preferences. Such a decision model is called a collective choice rule.

Unfortunately, selection of a collective choice rule is complicated by two very formidable difficulties. First, it has been proven that it is impossible to

¹This notion was expressed most succinctly by Quirk and Saposnik as follows:

"In principle, one could conceive of a whole host of theories of welfare economics, based upon differing sets of value judgments concerning the manner in which the term "desirable" state of the economy or economic system should be defined; in practice, essentially all of modern welfare economics is based upon one fundamental ethical postulate. To borrow Samuelson's phrase: In evaluating states of the economy, individuals' preferences are to count." [1968, p. 104].

construct a collective choice rule that satisfies even a minimal set of general conditions.⁴ Second, notwithstanding the impossibility of constructing a completely satisfactory collective choice rule, it seems reasonable to assert further that it is extraordinarily costly, if not impossible, to construct a social decision-making system that could assess the consequences for and preferences of every individual who might be affected by a given accounting policy decision.⁵

Clearly, the above discussion presents a paradox. On the one hand, we would like to have a systematic way for accounting policy makers to choose among alternatives based on individual preferences. At the same time, no such systematic way exists that satisfies even a relatively few desirable properties. Moreover, as a practical matter only limited knowledge of individual preferences is feasible.

One way to face this challenge is to explore applications to accounting of the concepts of social choice that have evolved in welfare economics and decision theory. Some initial efforts in this direction were Demski [1974a and 1974b], Gonedes and Dopuch [1974] and May and Sundem [1976], but the issues are far too formidable to resolve here. Research into the selection of an appropriate collective choice rule for accounting policy decisions is one of the most difficult tasks facing accounting researchers. We will proceed on the assumption that no satisfactory resolution of the issues will abandon completely the ethical judgment that *individuals' preferences are to count* in accounting policy decisions.

A MODEL FOR ACCOUNTING POLICY DECISIONS

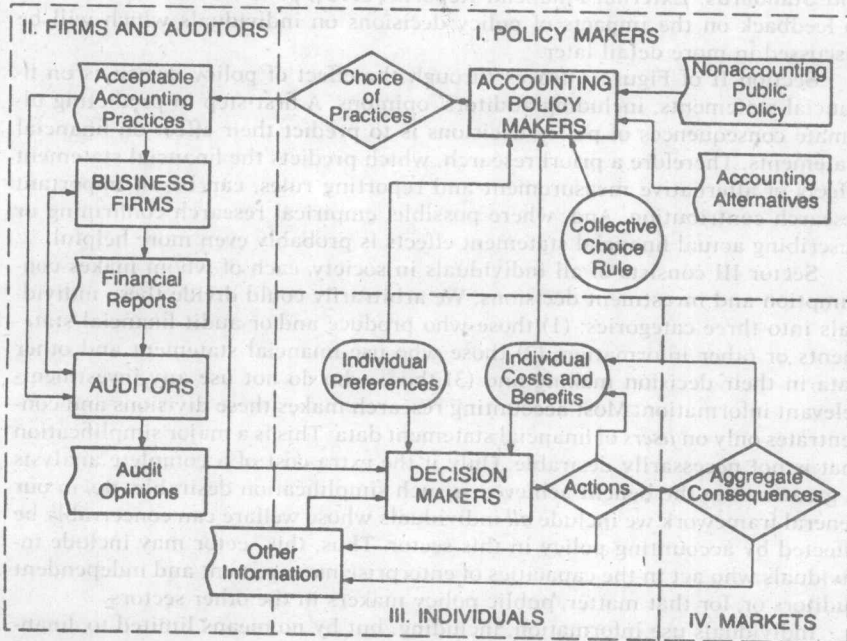
Our model of accounting policy decisions now has a goal—maximization of social welfare—and a social decision process employing some collective choice rule (currently, the FASB with their operating procedures) for selecting among accounting alternatives. This section completes the model by describing the framework for research in accounting theories to support the accounting policy decisions. This framework is shown in Figure 1; this figure provides the basis for the subsequent discussion of potentials for and limitations of accounting research.

Notice that Figure 1 is subdivided (by the dotted lines) into several sectors, including (1) business firms and auditors, (2) individuals, (3) markets and (4) accounting policy makers. These sectors are not meant to be mutually exclusive in the sense that no individual may be represented in more than one. Rather, they are intended to represent individuals in various distinguishable roles relevant to the discussion. Notice that there is a counterclockwise flow in the figure. This represents the general direction of impetus or influence in the accounting policy-making process, at least in principle, and necessarily abstracts

⁴Arrow's original proof, which applies to collective choice rules that represent orderings of social states, first appeared in Arrow [1951]. Arrow's theorem was first cited in the accounting literature by Demski [1974a]. The conditions, the proof and its implications are described in very readable style in the unstarred (non-mathematical) chapters of Sen [1970] and in Quirk and Saposnik [1968, Chapter 4].

⁵A social decision-making system, as the term is used here, is intended to include a collective choice rule plus the necessary institutional apparatus to implement the rule.

FIGURE 1
The Accounting Policy-Making Process



from the many potential countercurrents and forces. We will discuss each of the four sectors individually, indicating briefly some of the kinds of research that are appropriate for that part of the policy process. Then we will discuss the overall framework of accounting research for policy decisions.

Sector I represents the formal accounting policy decision system. Accounting policy makers are shown explicitly, but there is no implication that they must exert an influence on the choice of accounting practices allowed. They could allow a laissez-faire environment to exist, with financial accounting statements treated as a nonregulated commodity. However, the potential social welfare impacts of these statements and the current institutional structure suggest that some regulation is likely, so the framework is more consistent with the existence of specific accounting policy makers with some power to enforce their policy decisions. It is also consistent with the current political environment within which the FASB and SEC operate—one in which accounting policy decisions must be acceptable to a broad set of individuals and not merely consistent with "accounting theory."

Accounting policy makers must specify the set of acceptable accounting practices, which depends on the collective choice rule and social decision system they use (which were discussed in the previous section). It also depends on the accounting alternatives available; development and refinement of these alternatives is an important area for research. Nonaccounting public policy is also