Standardization of Accounting

Accounting standards are no different from many other kinds of standards in society. They prod individual behavior to something considered desirable by some criterion of social choice, or serve as guideposts for coordination among individuals. Benefits and costs are distributed unevenly, and few standards win the support of all. No mechanism for setting standards is beyond manipulation by interest groups who may capture them. The standardization of accounting affects not only the practice of accounting and auditing, but also what is taught in accounting classes. It is difficult to ascertain whether the origins of the wave of standardization that has swept the world of accounting since the 1960s lie in computers, in education of the previous generation of accountants, or elsewhere.

Rules and Economic Decisions

Accounting standards are a type of rules. Rules can be thought of as constraints to isolate permissible from prohibited behavior. Alternatively, we can think of rules as a system of rewards or punishments dispensed according to one’s choice of action. Our choice of perspective on rules determines the distinction between volunteer and mandatory behavior in the presence of accounting standards.

Rules as Constraints

Rules define a feasible set of actions. What is not permissible under rules cannot be considered a feasible alternative. If the LIFO method of accounting is not allowed by the rules, inventory accounting must be restricted to the non-LIFO methods. The social ethic dictates that legitimate rules of society be followed by everyone, and this ethical consideration prevents individuals from considering options that violate the rules.
Rules as Payoff Functions

If rules are viewed in terms of a private or economic ethic, instead of a social ethic, they appear not as constraints on the opportunity set of individuals, but as payoff or cost functions. The violation of rules incurs a cost. Therefore, an economic decision involves choosing an alternative that provides maximum net benefit, after reckoning the cost of violation. In this framework, rules do not exclude any alternatives from the feasible set. They merely render some alternatives more or less attractive than others by attaching a reward or cost to them. A large enough cost of violation induces all agents to shun the proscribed alternatives, and has the same ultimate effect as if these alternatives were excluded from the feasible set of actions.

Economic analysis of the law proceeds from the assumption that laws alter the payoffs associated with various courses of action. For example, the law does not prohibit murder. If one commits murder, the law specifies that certain consequences are likely to follow. In economic terms, the problem of legislation is to analyze the consequences of various penalty schedules for behavior and then select the schedule that yields the most desirable pattern of behavior by rational agents subjected to these schedules. Economists can only identify the kinds of behavior people will engage in under various penalty schedules. Which of the many possible patterns of behavior is preferred by the society is a value judgment that lies outside the purview of economics.

Penalty schedules consist of two parts; one part is directly legislated, the other is not. Law defines the penalty on violations, conditional on the violation being identified. Because of uncertainties inherent in the enforcement and judicial system, some guilty persons go free and some innocent persons are punished. The expected reward or penalty associated with each course of action depends not only on the law, but also on the enforcement and judicial system. Both affect the choices made by individuals.

From an individual's point of view, enforcement and adjudication uncertainty makes each course of action appear as a bundle of risk and return. The chances of being prosecuted and found guilty of a violation and the magnitude of penalty specified by the law for those who are found guilty vary, depending on the violation. Rules are important to a person only in the sense that they alter risk-return bundles attached to various actions, not in the sense that they exclude some actions from being considered at all.

This intrusion of economics into social ethics may offend some. Society may be better off if individuals treated rules and laws as absolute prohibitions, and not as costs and benefits associated with their actions. In economics, absolute prohibition means that the cost of violation is large. Due to the uncertainties of enforcement and adjudication, it may not be socially desirable to impose large costs on those few who happen to get caught in the enforcement net. Unless enforcement of the law is perfect and automatic, the imposition of large penalties on vio-
Voluntary and Mandatory Behavior

A choice among accounting methods is labeled mandatory if it follows the issuance of a new rule or standard from an authoritative body such as the FASB or the SEC. Otherwise, it is called voluntary. The distinction between voluntary and mandatory behavior has no economic substance. We discuss this general problem before returning to their relevance to accounting standards and practice.

When a person is prevented from choosing an action by a legal constraint, the choice is called involuntary or mandated by the law in the sense that, in the absence of the law, that person would have chosen a different action. In economics, laws and rules are seen as incentives and costs, and the distinction between voluntary and involuntary behavior is less useful. Consider a simple example of economic decision making. One day you find that the price of eggs has increased, while the price of milk has remained unchanged since your previous visit to the grocery store. Given the new prices, your inability to alter them in any significant way, and a fixed budget, you may decide to buy more milk and fewer eggs. Your taste for eggs and milk, combined with the change in your economic environment (prices), induces you to alter your actions.

Second, consider a change in the legal speed limit from 60 to 55 miles per hour. The new law does not render it impossible to drive above 60 mph; it simply makes it more costly, depending on the level of enforcement efforts (police patrol cars, radar equipment, etc.), the judicial system, and the penalties. Given your inability to change the law in any significant fashion and considering the new cost–benefit ratio, you might be inclined to drive slower. Fast driving may no longer be worth the added cost.

What is the difference between these two examples? Since the change in the price of eggs is beyond the immediate control of the economic agent, as long as the agent is driven by personal preferences, this change can be said to have forced or mandated the agent to alter grocery decisions. In this sense, not only the change in road speed is mandatory, but all economic actions, driven by wants and environment, are mandatory, and nothing is voluntary.

However, the lack of free will is offensive to our self-image. We may define the grocery decision to be voluntary in the sense that the consumption of milk and eggs is freely or voluntarily chosen, both before and after the change in prices, and preference is nothing but an expression of free will. The same argument applies equally well to the choice of driving speed. According to this view, all human behavior is voluntary and nothing is mandatory.

Fortunately, classification of behavior as voluntary or mandatory is irrelevant to economic analysis. In the economic context, the terms voluntary and mandatory are mere rhetorical devices or emotional responses that imply value judgments.
Those who benefit from an increase in egg prices may find it advantageous to argue that the consumer still makes a voluntary choice after prices are raised. Those who are hurt by the lower speed limits (e.g., truckers) might decry the new law as coercive. In public debate among opposing interests, labels of voluntary and mandatory may be convenient weapons of attacking adversaries. They contribute little to scientific analysis.

Accounting standards, like other rules or laws, alter the costs and benefits of various courses of action. The labels voluntary and mandatory are frequently used in accounting contexts, but their use diverts attention from the economic nature of accounting choices. If a change in the interest capitalization policy of a firm, following the publication of FASB Statement No. 34, is labeled involuntary or mandated, shouldn't we also call a switch to LIFO during periods of high inflation mandatory? If external imposition is the essence of mandatory change, the FASB or the SEC are no more external than inflation is. Perhaps the essence of mandatory change is that they help avert the consequences of not responding to changes in accounting standards, such as audit qualification. But then decisions about LIFO, too, would qualify as mandatory, because the costs of not using LIFO in the environment of inflation must be paid to the tax collector in hard cash.

It is tempting to argue that accounting standards impose high costs on violators with such certainty that, for all practical purposes, standards are constraints on the feasible set of accounting choices. However, standards that appear to be mandatory in this sense rarely are. This has been demonstrated in the adjustments firms have made in response to Statement No. 2 (which costs are classified as research and development, and in-house research versus contracting-out research work), Statement No. 13 (redesign of lease covenants), and Statement Nos. 8 and 52 (hedging of foreign exchange risk).

Classifying standard-induced accounting changes as mandatory obfuscates the economic nature of accounting decisions. It may be more fruitful simply to examine the effects of standards on the behavior of firms and agents.

**Economics of Rules and Standards**

Why have rules and standards? Why not be free to do what we want? What are the consequences of operating under rules? Standardization is widely practiced in all economic systems. Pieces of gold were cast into standardized pellets to serve as a medium of exchange millennia ago. All 110-volt electrical outlets take the same adapter. Appetites vary, but canned soup can be bought in only two or three different sizes at the supermarket. There are hundreds of standard-setting organizations in the United States, and thousands worldwide. Why is standardization so common?

**Benefits of Standards**

Standards save transaction and search costs. Without such costs, it might be optimal to use a 156-watt incandescent lamp in my living room and a 62-watt flo-
rescent lamp in the study. However, the costs of manufacturing, distributing, and retailing increase with the number of different sizes and types. Restricting our choice to, say, 25-, 40-, 60-, 100-, and 250-watt lamps carries the benefit of the lower price at which fewer sizes can be produced and sold. Consequently, standardization is widely practiced in manufacturing and construction industries.

Standardization applies to procedures, information, and news as much as it does to physical products. The standardized format of a newspaper makes it easier for the readers to locate the items of interest to them—stock quotation tables, exchange rates, and opinion pieces. A standard bus fare, unrelated to distance traveled, is cheaper to collect.

**Costs of Standards**

Although the benefits of standardization are shared by all, its cost must be borne by those persons whose preferred option is not chosen as the standard. The standardization of electric lamps to, say, five sizes increases the cost of nonstandard sizes. Those who are not adequately compensated for accepting a "suboptimal" solution to their problems oppose standardization.

Standardization affects innovation. The economic savings of standardization attract further development efforts to areas within the boundaries defined by the standards and help speed up innovation within these bounds. However, standardization raises the cost of radical innovation outside the standardized boundaries, and discourages it. Persistence of the inefficient QWERTY keyboard for roman-scrip typewriters is a good example of the conflict between standardization and innovation. More efficient keyboard layouts such as DVORAK are available now, but QWERTY standard is too deeply entrenched to be replaced easily.

**Distribution and Equity**

The immediate distributional effects of standardization can be quite inequitable. Those agents whose current products or practices are similar or close to the newly adopted standard earn a windfall, while others bear the cost of adjusting their products and practices to the new standard. Agents exert pressure to obtain standards so that their own adjustment costs are minimized.

Standards of quality specify the minimum acceptable level of quality. For example, Underwriters Laboratories issues standards for appliances, and the AICPA issues standards for accounting. The optimal standard from the point of view of each producer is equal to the quality of that producer's product, because such a standard maximizes the positive difference between the average quality of products that meet the standard and the quality of the producer's product.

**Adjustment to New Standards**

Introduction of standards induces agents to adjust their behavior. Ignoring this adjustment results in overestimating its effects. Windfall gains from the new standard dwindle as other agents change their behavior. Similarly, windfall losses
cause agents to find new ways of avoiding the harm inflicted on them by a new standard. Predictions of perpetual windfalls and dire consequences, frequently made during debates on accounting standards, are rarely realized.

Adjustments to change are neither quick nor costless. Agents need time to learn the new environment and to search for and select new rules of thumb. Frequent changes in standards impose the costs of adjustment. Once agents have adjusted their behavior to a new environment, they do not look favorably on moves to disturb the status quo. It is not surprising that managers oppose virtually all proposals for new accounting standards.

Economic Theories of Standards

Each set of consequences of standardization forms the basis for an economic theory of standardization. Briefly, standards can be seen either as a means of limiting competition, or as a means of supplying industry-wide public goods. What are these theories, and to what extent are they applicable to accounting standards?

Monopoly and Limiting Competition

Organizations that set standards can limit competition in two ways. First, independent of the specific standards they choose, such organizations provide forums that can be used to conspire in restraint of trade in the industry. Public accountants who play a prominent role in setting standards could have used the Accounting Principles Board or the Committee on Accounting Procedure for this purpose. However, their professional association, the AICPA, provides a more convenient forum for collusion to restrain trade in the audit industry. Several provisions in the AICPA's Code of Ethics limited competition through restraints on advertising and on the solicitation of clients and employees of competitors. Many of these provisions were dropped under pressure from the Federal Trade Commission and the U.S. Department of Justice. The FASB, consisting of more diverse elements, is unsuitable for this purpose.

Second, standards themselves can be designed to limit competition. The most important threat to the stability of a cartel is hard-to-detect cheating by its own members. Setting standards for the minimum as well as the maximum limit on product quality is an attempt, not always successful, to cut the cost of monitoring by eliminating one dimension of non-price competition. Product compatibility and interchangeability standards (e.g., for cassette tapes) have this anticompetitive potential.

Accounting standards on disclosure have been limited to the minimum level of disclosure and do not specify a maximum level. Therefore, disclosure standards are free from anticompetitive potential on this account. However, emphasis on uniformity and comparability of accounting methods is similar to interchangeability standards in the manufacturing industry. We must evaluate their anticompetitive effect in the capital markets, because they may prevent individual firms
from trying to devise financial reporting methods that investors may find more attractive than the extant standards.

**Provision of Public Goods**

Product compatibility and interchangeability standards are pure public goods because (1) anyone can use the standard, without reducing the opportunity for others to use it, and (2) no one can be excluded from using the standards. Most accounting measurement and disclosure standards are public goods. Their promulgation and enforcement promote social welfare by reducing the resources that must be expended by the readers of financial reports to understand that data. This public good is produced through social coordination of choices made in individual firms.

For the sake of coordination, states must choose whether drivers should keep to the left or the right on the road. Accounting standards for measurement and disclosure involve more complex choices among options whose costs and benefits to various agents are neither identical nor obviously known. While coordination is one of its important elements, the standardization of accounting is not a pure coordination game, which Hardin discusses. Setting accounting standards also requires judgments about their relative efficiency.

**Accounting Standards**

Edey and Baxter identify four types of accounting standards: (1) standards of disclosure and explanation of accounting policies, (2) standards of uniformity of layout and presentation of financial statements, (3) standards of disclosure of specific facts and uncertainties, and (4) standards of accounting measurement.

The first type of standard is a higher-level standard. It concerns the disclosure of what accountants do. The last three types concern what accountants do to prepare the financial statements. The difference between the first and the latter three types is analogous to the difference between standards for labeling canned food and standards for the canned food itself. Higher-level standards are easier to defend. Even if standards for contents cannot be agreed upon, it might be possible to justify standards for labeling. Standards on disclosure and explanation of accounting policies have been less controversial than those on accounting policies themselves, as evidenced by the history of accounting for the investment tax credit, depreciation, inventory, oil and gas exploration outlays, and stock-based employee compensation.

**Enforceability of Standards**

Useful standards themselves must be enforceable, either implicitly or explicitly. If we cannot know, either before or after the fact, whether a firm complied with a standard, it has little effect. Two attempts by the SEC illustrate the point. The SEC encouraged firms to disclose their earnings forecasts and their underground re-
serves in the oil and gas industry and, by extending protection under a safe harbor rule, tried to overcome managers’ fears of being held liable for incorrect forecasts and estimates. Both experiments failed, because the managers had no incentives to publish any meaningful numbers and investors had no way of evaluating their accuracy.

**Market Argument**

In a world without accounting standards, each firm would arrive at a custom-designed accounting and reporting system through negotiations among the participants. Any conflicts among the agents would be resolved through direct negotiation and, where direct negotiations were not feasible, through the functioning of markets for the resources that agents contribute to and receive from the firm. For example, if investors want inflation-adjusted accounting data, managers have the incentive to provide such information as long as the value of such data to the investors exceeds the cost of preparing such data, and managers are the low cost producers of the data. For firms that choose to provide such data, investors will be willing to pay a higher share price (equal to the cost saving to investors from not having to produce inflation-adjusted data themselves or not having to buy it from other sources). This will lower the firm’s cost of capital and provide higher compensation to the managers. The scarcity of firms who are willing to meet the supposed investor demand for such data suggests that no such demand exists, and that requiring publicly held firms to produce and distribute such data is a waste of the firm’s resources. Standards benefit only those who earn their living by setting, policing, and enforcing them. The best accounting standards, according to this argument, are no accounting standards.

This market argument can be applied to the three lower levels of accounting standards and to the higher-level standards that concern the disclosure of accounting policy. If investors want to shoot craps in the stock market, there is no social reason to prohibit them from doing so through socially determined accounting standards.

A special variation of the market argument is that the current law, in bundling the shareholders’ rights to vote and to receive residual resources and financial reports, unnecessarily constrains firms’ accounting choices and induces an inefficient allocation of resources. The law of corporate property rights could be redefined to unbundle the right to accounting reports from other shareholder rights, yielding a more efficient resource allocation. Then, the firm would only produce information that could be profitably sold to private buyers.

**Argument for Market Failure**

According to this argument, accounting standards must be socially determined and enforced with the help of sanctions and penalties for their violation. This will furnish correct and adequate information about the firm to various nonmanagerial agents, enabling them to make efficient decisions. Markets cannot be relied upon
to ensure that each firm, left to direct negotiation among its own participating agents, shall arrive at an efficient accounting system. Managers have too much power and control over the accounting system and, unless this control is constrained by socially determined standards, inefficient accounting methods will be chosen. Investors and other agents have little effective control over the behavior of managers who choose accounting methods to advance their own interests. Until accounting standards were issued to require publicly held firms to disclose inflation-adjusted accounting data, they did not make such disclosure. This nondisclosure is an example of the failure of market forces to yield efficient systems.

Efficient standards can be set, the argument goes, by a body of experts, supported by competent advice. An appropriate institutional mechanism can adequately identify the consequences of alternative standards and identify socially efficient options on the basis of external criteria, such as relevance, verifiability, understandability, timeliness, and neutrality.

A Synthesis

What should be the role of the market and voting mechanisms in determining accounting methods? Voting mechanisms are natural choices when a single option must necessarily be chosen by society. However, the selection of a single method of accounting for all firms is not necessary. It is not obvious that the use of a single method of depreciation by all firms is superior to the use of two or more methods. Perhaps markets can also help determine accounting methods.

Setting socially efficient standards is a demanding task for a centralized institution. It has to be designed to have a reasonable chance of yielding something close to the social optimum. A centralized planning mechanism must gather data on the cost–benefits and preferences of agents, as well as induce them to reveal information truthfully, without engaging in strategic behavior. This is an unattainable task. The standardization of accounting methods to the exclusion of market-based mechanisms offers no panacea.

Complete reliance on markets to determine accounting methods is equally infeasible. In spite of a popular conception of markets as a place where freedom reigns, all markets require an enforceable system of rules or laws that define property rights to be exchanged in the market, and for settling transactions. Since only a single set of rules can govern transactions in an orderly market, the rules for a market must be defined by voting mechanisms if they are to be democratic. Rules of organization distinguish a market from anarchy.

Just because it is feasible to create a market for a resource does not mean that such a market will exist. Nor will it function perfectly just because it exists. The costs of conducting transactions in a market must be exceeded by the gains made from trading for the market to exist. These costs must be sufficiently small for the market to approach perfection. The market argument just given makes two logical leaps: (1) the existence of a factor market is possible; therefore it must exist under any level of transaction costs; and (2) if a market exists, we can assume that its
outcome will be the same as if the cost of conducting transactions in the market were zero.

In the presence of market transaction costs, it is possible for accounting standards to improve social welfare. Due to imperfections in the properties of voting mechanisms, not all standards will be improvements on the solutions derived from imperfect markets. The rejection of extreme arguments for and against standards leaves us in the broad middle ground. The relative desirability of standards and market solutions to specific accounting problems must be worked out, item by item.

Institutions for Setting Accounting Standards

As we discussed in the preceding chapter, the criteria for social efficiency are weak and incomplete in theory and difficult to apply in practice, because different people know different things, they do not necessarily agree on what they know, and they do not necessarily reveal truthfully what they know. Institutions attempt to circumvent this problem by emphasizing procedures for decision making.

Models of Social Institutions

Social choice mechanisms can be classified into six categories: common law, market, referendum, legislative, judicial, and bureaucratic mechanisms. In practice, elements of two or more such systems are combined to design a social institution. Most of them have played some part in accounting.

The common law or grass-roots approach to making social decisions is the ultimate in decentralization. It is also slow. It is ineffective in making choices among technical alternatives not understood by lay persons. Pacioli’s accounting text could be seen as common law rules of accounting. Societies that do not have publicly owned enterprises are well-served by this system. The introduction of more complex organizations, such as large publicly held enterprises, places demands on accounting systems that cannot easily be met by the common law approach.

Markets can provide efficient solutions for problems of production and the distribution of private goods. Standards for the traded goods define the rules of the game by which the markets are governed. As rules of the game, product standards are public goods because all agents can share in their benefits once they are implemented. It is possible to have two or more markets, operated by different rules, compete against each other. Various stock exchanges in the United States compete in this manner. These alternative sets of rules are public goods, and no exchange market can exist for them. The choice of rules or standards is made through other social choice mechanisms. Current accounting standards leave many aspects of financial reporting to the discretion of those who prepare, audit, or read financial statements. If a standard-setting body used evidence about choices made by reporting entities in making its decisions, it might be said to have used the market mechanism.
In a referendum, voters speak for themselves. Referenda are effective when alternatives can be simply stated so that they are readily understandable by the constituents, such as limiting members of parliament to four elected terms of office. When formulating alternatives itself becomes important, or when the consequences of technically complex alternatives are not easily comprehended by the constituents, direct voting is not effective as a social choice institution. The technical nature of accounting precludes the use of referenda to set accounting rules.

Constituent groups select or elect their representatives to speak on their behalf in legislatures. A legislature takes action only if it can agree on something within its rules of order. If, for example, majority support cannot be mustered for any of the proposals on the table, and the legislature’s rules of order require a majority support to pass a resolution, no resolution is passed. Debate in legislative bodies is frequently partisan, because the representatives are expected to, and do, argue in favor of the interests of their constituents. Attempts to protect one’s own turf are considered ethical in legislative settings. Several elements of legislative structure characterized the manner in which the Accounting Principles Board (1959–73) was constituted and functioned in the United States.

The judiciary is different from the legislature. Judges are expected to listen to partisan arguments and then impartially decide on the basis of law or equity. Unlike legislators, judges are not supposed to have a partisan interest in the issues placed before them. Also, unlike the legislative system, they cannot just agree not to do anything. They must decide one way or the other on the issues presented before them.

Judicial and legislative mechanisms are frequently accompanied by bureaucratic support. Some standard-setting mechanisms are purely bureaucratic. The FASB, for example, combines elements of judicial and bureaucratic mechanisms. Bureaucracies face the difficult problem of control. Frequently, they are motivated by maximizing their measured and reported performance. In the absence of performance data of some type, bureaucracies may waste resources. However, defining performance criteria (e.g., the number of standards issued) is almost as bad, if not worse, because bureaucracies may be induced to pursue such criteria independent of the effect of their actions on social welfare.

The Force of Standards

As we move from common law to bureaucratic mechanism, fewer people are directly involved in making decisions, and more of the power of an organization, whether governmental or private, is harnessed to enforce the decisions. The involvement of fewer people in the process makes it possible to move quickly and decisively to change the standards. For example, it is possible for the SEC to issue a ruling on an accounting issue in a matter of days, while the FASB would take months, if not years, to arrive at a decision. This faster response time is associated with a greater chance of making errors because some relevant consideration may escape the attention of the limited number of people who make the decision.
The effectiveness of standards depends on how they are made, as well as on how they are enforced. At one end of the spectrum, standards may be enforced by an implicit social or professional obligation to conform to the norms of the community (as is often the case with common law). At the other extreme, an agency may be empowered to enforce standards through an explicit threat of punishment for those who fail to conform (as is the case with the pronouncements of the SEC). The enforcement of standards through such organized agencies does not necessarily yield a more desirable result, for two reasons. First, the threat of substantial punishment induces violators of the standards to spend more time and resources to conceal and defend their actions. More lawyers are hired to pick holes in the wording of standards. Second, this nit-picking feeds back into the process of setting standards, pushing them to becoming more detailed and technical. Since the 1960s, there has been a tendency in the United States to enforce standards through more explicit threats of sanctions. The result of that threat is increasingly detailed and technical standards.

The Capture of Institutions

The actual operation of social institutions does not always conform to the intent of their original designers. Even though the rule makers may invite and encourage all constituents to participate in the process, only those who benefit sufficiently from participation can be expected to do so. For others, it may not be economical to participate individually. They may act collectively if (1) the costs of organizing are small, (2) these costs can be collected from the beneficiaries, and (3) somebody takes the initiative to do the organizing. When such organizing does not take place, which is often the case, social institutions are captured by interest groups that have the greatest stake in them, more often by default than by design. In the United States, the Committee on Accounting Procedure and the Accounting Principles Board were committees of the AICPA. For the first few years of its life, the Financial Accounting Standards Board also had to have a majority of its members from the auditing profession. The SEC does not seem to have been captured by any single accounting interest group so far.

The Effects of Standards

Instead of preparing a meal from scratch, we often find it efficient to use some standard, partially processed ingredients. Likewise, in constructing a house, it is often efficient to use some prefabricated parts. Accounting standards are like prefabricated parts for the construction of the contract set. The existence of standards reduces the cost of search and negotiation that participating agents must incur to arrive at agreed-upon contracts.

On Accounting Systems

The standardization of financial accounting makes it possible to design the contract sets in modular units. This system of modules is more evident in external re-
porting where these costs are relatively high. The Uniform Commercial Code and various labor laws accomplish a similar use of modules in contracts between buyers and sellers, and between employees and employers, respectively. For other contracts, it is possible, or even necessary, for the agents to negotiate the contracts one-on-one. This is especially true for contracts of various managers in the firm. Accordingly, there have been few standards set in that area of accounting.

**On Accounting Education**

The standardization of accounting affects what is taught in accounting classes and how it is taught. As Baxter predicted, this effect need not be, but often is, harmful to the quality of accounting education:

> [The official recommendations on accounting] naturally appeal to the feeble type of teacher, who finds it easier to recite an official creed than to lead a brisk argument. . . . If an official answer is available to a problem, why should a teacher burden his examination candidates with other views? . . . Thus the recommendations tend to rob our young men’s education of its power to enrich and stimulate. . . . [T]heir minds will be less fit to solve the new problems of tomorrow; and such fitness is no bad test by which to judge an education.  

The proliferation of accounting standards in the United States, since the sixties has led to greater emphasis on official pronouncements in accounting textbooks. There is no other reason for the elephantiasis that afflicts intermediate accounting textbooks.

Official and authoritative stipulation of the meaning of terms used in accounting also tends to place unnecessary limits on the finer shades of meaning that can be explored in classrooms to understand a concept, as opposed to memorizing a definition. Kitchen points out:

> Stipulation by authority is not without disadvantages and foremost among these is the risk that clear and original thought may be inhibited in the degree that authoritative definitions receive unthinking acceptance, to the extent that they set an official stamp on some particular dogma, or in so far as they lean towards over-simplification and ambiguity.

These negative effects of standards on education are not unavoidable, but teachers of accounting have to be especially vigilant to avoid them.

**On the Auditing Profession**

The standardization of accounting makes the job of auditors easier and reduces the role of auditors’ judgment in certifying financial statements. It becomes easier and less costly to train auditors to perform their task. The downward trend in the price of auditing services may be an indication of this effect. Standardization replaces the judgment element of expert auditors’ work by technical knowledge. Since it takes a long time to develop judgment, this may appear to be an advantage. How-
ever, in the long run it will reduce the price other agents are willing to pay for the auditors’ services.

Summary

Accounting rules and standards can be seen as incentives to induce various agents to behave in a manner expected by others. Standards, per se, cannot be good or bad. Each must be examined for its effect on the welfare of various agents in society. We need to balance the advantages of setting and enforcing standards against the costs and other consequences they impose on society.

Notes


Additional Reading


