How do we set the accounting standards? The topic has received much attention during the past 50 years. Perhaps the first step toward a satisfactory resolution of the problem is to recognize that the problem of standardization is not unique to accounting. There are approximately five hundred standard-setting organizations in the United States alone and many more in other countries, setting standards for everything from ships to shoe laces. In addition, there are international bodies that set standards for things such as radio transmissions that are applicable across the national boundaries. An examination of the standardization of accounting in the larger context of standardization of a variety of products and services may help us appreciate the costs, benefits, limitations, and economics of standardization.

After a brief review of the economics of standardization, I discuss criteria for choosing standards and the problem of devising social mechanisms to set socially optimal standards. I shall review the basic characteristics of six mechanisms—common law, market, referendum, legislature, judiciary, and bureaucracy. This theoretical overview of the economics and mechanisms of standardization prepares the groundwork for a critical examination of some stylized facts of accounting standard setting in the United States and leads me to make a few suggestions on how we might set standards in the future.

I. ECONOMICS OF STANDARDIZATION

It is costly to keep inventories, to gather information, and to negotiate contracts. Our inclination to cut these costs is one source of our desire to standardize.

Take, for example, the design of an electrical wall receptacle. There are many possible designs for this small fitting and in different parts of the world different designs are used. In North America the design of wall outlets for 110 volt house current has been standardized. It enables us to plug any of the numerous appliances and electrical devices into any outlet. Standardization of wall outlets and matching adapters leads to economy in the inventory of adapters and outlets. This is true of thousands of articles of daily use whose standardization we take for granted and without which modern life would be very cumbersome if not impossible.

Standardization is common not only for products but also for the language of communication. Air and maritime traffic and international mails are two obvious examples. English has been standardized as the international language of communication between aircraft pilots and ground control. A Soviet pilot approaching Paris airport must communicate with ground control in English. Cost of confusion due to miscommunication is simply too high in such circumstances.
We are familiar with the problems that arise from the absence of standardization. If only my Macintosh could talk to my IBM PC. A Soviet spaceship carried an experiment designed by a U.S. physicist, Professor Simpson, to measure the dust in the tail of Halley's comet. The professor discovered to his dismay that the Soviet computer systems and communications gear were designed using fundamentally different standards and months of additional work was necessary before the U.S.-designed equipment could work satisfactorily with the Soviet communication systems and transmit data to the Earth.

High cost, or infeasibility, of gathering information by some agents in society also induces creation of some standards as rules by which a social game is played. Standards that prevent many people from performing surgery, cutting hair, or teaching accounting are often justified on the grounds that they are meant for the protection of the uninformed patients, customers, or students who may find it costly or impossible to discriminate between the competents and the crooks. Such standards, the argument goes, protect the informationally weak and enhance social welfare by promoting mutual trust and reducing the need for private investment in gathering information. Since the argument often originates with the professionals who clearly benefit from its acceptance, its validity is suspect in specific instances but not in general.

In spite of these benefits of standardization and the costs and inconveniences caused by its absence, standardization is neither universal nor complete. We do have many different models of cars, many computer languages, many types of doctors, and even more than one type of electrical outlet. There are at least two reasons why standardization is rarely taken to the extreme. First, saving costs is not the only motivation an industry has to standardize; standardization can also be used as a mechanism to limit competition and restrain trade. Second, while standardization may save some costs, it may impose others. Anticompetitive effects of standards can be a major factor for many types of industrial products but this does not appear to be the case for accounting methods. The cost of standardization provides a satisfactory explanation for limitations on the extent of standardization, as far as accounting methods are concerned. Hence, we shall concentrate our attention on the cost motive.

The standard home or office electrical outlet is designed to safely carry a current of 15 amperes. Appliances that need less than 15 amperes of current could work satisfactorily with an outlet of a lighter design that need not use as much metal or insulation as provided in the standard device. A standardized device necessarily wastes resources by providing too much for some applications and too little for others. Hence the need for a few 220 volt outlets in some homes. No standardized product can be completely satisfactory for all purposes.

Standardization, by definition, raises the cost of deviant behavior and thus stifles initiative, experimentation, and innovation. Products or technologies that are standardized too early burden society with inefficient, costly, or less desirable systems. The system of weights and measures and the television broadcast technology in the United States are two good examples of this disadvantage of standardization.

One must also consider the cost of devising, disseminating, enforcing, and updating standards. Standardization requires the creation and operation of a centralized institution whose costs must be paid for by someone. These costs can be substantial. Moreover, many standards are public goods in the sense that it does not cost more to allow one more party to use a standard.
and it is difficult to keep the benefits of standardization from those who are unwilling to pay for them. Just because standardization to an extent is desirable in some areas, it does not follow that it is good in all areas or that it should be carried to the maximum possible extent. Nor is it always possible to devise effective mechanisms to collect the costs of standardization from its beneficiaries.

**Optimality of Standards**

The costs and benefits of standards are unevenly distributed across members of a community; some receive a large share of benefits while others may carry a large burden of the costs. What kind of standard is socially desirable? There is no obvious answer to this question. Consider two possibilities.

One may argue that we should implement standards whose total benefits to all members of the society exceed the total costs borne by all the members. In other words, standards that increase the size of the "social pie" are desirable. This criterion implies that if depriving the poor of one dollar allows us to add one more Rolls Royce to the fleet of the rich, such action is socially desirable. Such a social welfare criterion is ethically unacceptable to many of us in the twentieth century.

An alternative to the social cost benefit criterion is the Pareto criterion. It is based on the idea that a standard that hurts anyone in the society cannot be acceptable as an improvement over the status quo. The Pareto criterion pays attention not only to the size of the social pie but also to its distribution among individual members of the society. It is hard to dispute this criterion on ethical grounds. However, its application places an almost impossible burden on those who set the standards. It is not easy to think of a law, rule, or standard that hurts nobody.

As a practical matter, it is necessary to compromise and consider both the total costs and benefits as well as the distribution of the costs and benefits of a standard across individual members of society. In other words, we cannot completely ignore the size of the pie. Nor can we completely ignore who gets how large a piece of it. Some standards get implemented because of their distributional consequences even though their net benefit may be negative. Some are justified on the basis of large net benefit to society even though some individuals may be hurt by the action.

**Problems of Identifying the Social Optimal**

Even if all agree upon a criterion for choosing standards, the practical task of identifying which one of the proposed alternatives best satisfies this criterion remains to be addressed. And it is a nontrivial task for several reasons.

First, standard setters do not know which standard is better and for whom. Data on preferences of people involved must be gathered or inferred by some means. We can do so by one of three ways: (1) ask people what they prefer; (2) infer what they prefer from what they do; or (3) logically derive the preferences from other things known about them. Each of the three approaches has its own shortcomings.

When we ask people what standard, if any, they prefer, they may not know or they may not be willing truthfully to reveal to us what they prefer. Suppose the practice or design proposed to be standardized is new and
unfamiliar to them. People often do not know if they prefer the new proposal to the current practice. It takes use and familiarity for a person to find out if a new proposal is good or bad for him. Mere technical description is simply not enough. Few people buy cars on the basis of blueprints. Even if they know what they prefer, it may not be in their own best interest to tell us what they prefer or why they do so. Responses to public surveys can often become an exercise in public relations and posturing. Market research conducted before the introduction of "New Coke" is a good example. The story goes that people prefer sweeter soft drinks in blind tests but are unwilling to admit that they do so.

One can try to infer from the past actions of constituents what their preferences are or try logically to derive these preferences from some theory about their behavior. Both these techniques are only as good as the theories employed in the process. As often as not, they lead one to wrong conclusions about what other people may like.

Second, it is costly to participate in the process of standardization. Constituents who respond to the invitations from standard-setting bodies are likely to be those who foresee either large gains or large losses for themselves from the actions of such bodies. Constituents for whom these amounts are small at the individual level but large in aggregate may organize themselves into lobbying groups provided that the cost of organizing is not too large. Others for whom the costs of organizing dominate the cost/benefits of standardization will simply not find it worth their while to participate in the process even if the number of such individuals is very large and in aggregate the impact of standards on their welfare is large. Volunteered participation in standard setting therefore tends to be unbalanced.

Third, after gathering data on what various people like, the standard-setting body has to pull it all together and apply a social welfare criterion to determine which standard, if any, will best serve that society. The problem is that formal aggregation of data requires quantification of costs and benefits. This is rarely feasible, and almost never feasible for both costs and benefits with equal accuracy. For example, the cost of a standard may be quantifiable but the benefits may be so diffuse as to make it impossible to place a dollar figure on them. A concrete comparison of costs and benefits is often ruled out for this reason.

II. MECHANISMS FOR MAKING SOCIAL DECISIONS

The difficulties of choosing a social welfare criterion and of identifying the socially optimal standards are pervasive. We have had to devise, over the centuries, a variety of mechanisms to make social decisions. Roughly speaking we could classify such mechanisms into six categories, though as a practical matter, actual social decision mechanisms frequently combine elements of more than one of these systems. We shall call them common law, market, referendum, legislative, judicial, and bureaucratic mechanisms.

The common law or grass roots approach to making social decisions does not require a centralized mechanism; it is the ultimate in decentralization. It is also slow. It is ineffective in making highly technical choices that cannot be widely distinguished by laymen. Paciolo's accounting text could perhaps be seen as common law rules of accounting. Societies which do not have publicly owned enterprises seem to be reasonably well served by this system. However, introduction of more complex organizations, such as publicly held enterprises, places demands on
accounting systems that cannot easily be met by the common law approach.

Market mechanisms can provide efficient solutions for the problems of production and 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 themselves are public goods because once they are implemented all can share in their costs and benefits. One can conceive of a competition among alternative sets of rules of the market (e.g., the computerized stock exchange at Cincinnati vs. the New York Stock Exchange with a trading floor). These alternative sets are public goods and no exchange market can exist for them and the choice of rules or standards must be arrived at by some social choice mechanism. To the extent the form of exchange in the product market is left to be specified by the participants, they may be found to overwhelmingly prefer one form over another. In such cases, one may use the evidence from the product market to introduce a new rule limiting transactions to the preferred form. Current accounting standards leave many aspects of financial reporting to the discretion of those who prepare, audit, or read the results. If a standard-setting body used evidence about choices made by reporting entities as an input to their decisions, it might be said to have used the market mechanism.

In a referendum voters speak for themselves. Referenda as social decision mechanisms are effective when the formulation of alternatives is simple and readily understandable by the constituents. When the formulation stage itself becomes important or when the technical nature of the alternatives renders it difficult for a large number of individuals to comprehend their consequences, direct voting becomes ineffective as a mechanism for making social decisions.

In legislative systems, constituent groups select or elect their representatives to speak on their behalf. A legislature takes action only if it is feasible to do so within its rules of order. If, for example, such a body cannot find majority support for any of the proposals on the table and its 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 respective constituents. Attempts to protect one's own turf are not stigmatized in legislative settings.

The judicial model stands in sharp contrast to the legislative model in the sense that the members of the bench are expected to be impartial judges who listen to the partisan arguments presented before them and then decide on the basis of law or equity. Unlike the legislators, the judges are not supposed to have a partisan interest in the issues at hand. Also, unlike the legislative system, they must decide one way or the other on the issues presented before them. They do not usually enjoy the luxury to “pass”.

Judicial and legislative mechanisms rarely stand alone and are frequently accompanied by bureaucratic support. However, some standard-setting mechanisms are almost purely bureaucratic. I return later to some problems of bureaucratic mechanisms.

As we move from common law to bureaucratic mechanism, fewer and fewer people are directly involved in making decisions, more of the power of an organized state is brought to enforce the decisions, decisions can be made and enforced more expeditiously, and the chances of making serious errors increase. Historically, this has been the direction of change in the United States.
III. STANDARD SETTING IN THE UNITED STATES

An examination of accounting standard setting in the United States suggests use of a variety of social decision mechanisms during the past quarter century. The Accounting Principles Board (APB) followed a quasi-legislative model. Some twenty-one members of the Board served part-time on the Board while holding other full-time jobs. With the possible exception of some accounting professors, members had a defined constituency. As in other legislative settings, these members were often expected to, and even tried to, advance the interests of their firms or clients through their participation in the Board's activities. Advocacy of self-interest does not bear a stigma in the legislative setting. No "punishment" for such advocacy was built into the system. As in legislatures, the Board took no action unless sufficient support (two-thirds majority under its rules of order) could be garnered in favor.

A major feature of the APB, and arguably a major source of its problems as a legislative mechanism, was its lack of representativeness. The Board consisted entirely of the members of the American Institute of Certified Public Accountants (AICPA). Most of the members were from public accounting with token representation allowed for the securities industry and academia.

The Wheat Commission appointed by the AICPA in the wake of the investment tax credit fiasco blamed the dissatisfaction of some people with the performance of the APB on the lack of independence of its members. Since the lack of independence of the legislators from their constituents is the essence of the legislative process, the Commission in effect condemned the legislative process as a mechanism for setting accounting standards. Instead, the commission proposed its replacement by a quasi-judicial structure of the FASB. They failed to recognize that the APB's lack of representativeness was its major weakness. Accordingly, the FASB was born in 1973 retained the unrepresentativeness of the APB but not the inherent protective immunity of a quasi-legislative system. In fixing what they thought was a defect, the Wheat Commission had taken away a major strength of the accounting standard-setting system in the United States.

A second crucial change was made: the Board was burdened with the responsibility to find, pay for, and keep employed a large and more or less permanent bureaucracy. Though the individuals appointed to the Board have consistently met the highest standards of competence and commitment to public service, often at considerable personal sacrifice, the basic structural defects of the FASB continue to impede its effectiveness.

The quasi-judicial structure of the FASB placed on seven individuals the burden of having to make and defend difficult judgments on accounting standards. The judgments they make often damage the interests of at least some of their constituents who pay for the cost of maintaining the FASB's establishment. The members of the FASB have precious little armor to defend themselves except to say that they vote according to the best of their personal judgment.

Unlike the members of the FASB, the justices of the Supreme Court have the opportunity to rely on common, case, statutory, and constitutional law to support the positions they take. FASB has no such luxury available to it. Its attempt to develop a conceptual framework as the accounting equivalent of constitutional law founded on the rocks of its refusal to recognize the fundamental distributional consequences (i.e., the political aspect) of its actions. Legislative bodies do not have to defend their actions;
their representative character and the partisan attitudes of their members constitute a protective cover for them. The AICPA’s insistence that a clear majority of the members of the FASB be drawn from the ranks of practicing CPAs deprived the FASB of this vital cover in its infancy.

The first eight years of the FASB were characterized by a runaway pace of standard setting, aggressiveness (i.e., the willingness of the Board to recommend previously untried methods of accounting as exclusive standards), and a decline in constituent support. All three features can be traced to the fundamental structural characteristics of the organization.

The quasi-judicial structure of the Board made it difficult to refuse to issue standards on accounting matters brought before them. The guaranteed support of the disciplinary mechanism of the AICPA made the Board less cautious about whether their standards would be broadly accepted by their constituencies. The size of a permanent establishment of some hundred to hundred and fifty people made it even more difficult for them to refuse to issue a standard. Those who pay for this establishment expect to see performance. How else can a standard-setting body show performance?

There is something fundamentally incongruous about a permanent rule-making bureaucracy. Once you set up such an organization, you have to live with its cumulative output of rules. No such bureaucracy can afford the luxury of appearing to sit idle. Imagine, if you can, a period of a few years over which no new accounting problems that deserve to have a new standard issued are brought before the Board. Can the Board afford not to issue any rulings for a period of several years and expect various donors to continue to support a ten million dollar budget and employment of a large staff? The point is not that the members of the Board or the staff knowingly and deliberately engage in make-work; the point is that there exist strong incentives in the structure of a full-time board supported by a permanent staff to keep itself busy dealing with issues brought to their attention. Until the money or staff run out, there are no incentives to ask hard questions about whether a given project needs attention and what its priority level ought to be.

Indeed, the annual report of the FASB (and its parent organization, Financial Accounting Foundation) is built around the statistics of how many discussion memoranda, exposure drafts, or standards were issued during the reporting period and how many letters were received or how many hearings were held. These data, along with Gantt charts of project completion targets and punctuality figures, replace the revenue and profit figures of corporate annual reports as measures of accomplishment. Once such statistics are compiled and reported, it is only a small step to the illusion that more and faster is better. After all, bureaucracies, too, need measures of performance. Performance data for a rule-making bureaucracy consist of the number, pages, frequency, or promptness of the rules issued.

Sale of the Board's publications at prices significantly above the marginal cost of printing and mailing makes things even worse. Approximately one-half of the Board's budget is earned from such sales. The origins of this system probably lie in a commonsense equity criterion; those who benefit from the activities of the Board should be the ones to pay for its fixed cost. This fixed cost is allocated among the constituents in proportion to their demand for publications simply because this demand is conveniently measured through the requests received at the publications office. However, this convenient and apparently harmless system induces perverse incentives at the organizational level. Those who have to worry about the Board’s payroll, rent, and utilities cannot help but keep a wary eye
on the revenue from the sale of publications. At its worst, publish or perish in academia keeps a few photocopying machines busy and the professors out of mischief; in standardization of accounting (or of anything else) the damage is more extensive.

Such a system of performance measurement does not serve the basic function of standard-setting organizations well. Recall that standards themselves can have positive or negative net social benefit and can have extensive distributive consequences. Proclamation of a standard per se has no social value unless the standard has been carefully tailored to meet a specified social welfare criterion. Indeed, a bias for action on the part of a standard-setting bureaucracy can impose substantial costs of adjustment and confusion on the constituents. FASB's performance and annual reports (over the years) revealed a bias for action during the first eight years of its existence when a more neutral stance might have been a socially preferred policy.

The bias-for-action culture at the FAF and the FASB led to relaxation of the voting requirements to approve a standard in 1977. The five-out-of-seven votes needed to issue a standard in the original charter of the Board were reduced to a simple majority in the wake of the oil and gas exploration cost controversies. The change lowered the threshold of consensus needed for the Board to act. The economics of standard setting took the back seat in the heat of public controversy. If four members of the Board can not convince three of their own colleagues about the merits of the proposed standard, how can they be so sure that society would be better off with such a standard than without it?

The bias-for-action culture also brought with it the aggressive standards of accounting—standards in which the Board recommended broad application of complex new accounting methods which had not previously been tried out in the field. By the mid-seventies the Board seems to have become confident enough of its ability to divine which of the previously untried methods of accounting are socially preferable to those which had already been tried out. Given the basic difficulties of learning constituent preferences and of aggregating these preferences, this was a tall order indeed. If constituent preferences with respect to known accounting techniques are difficult to find out, it is almost impossible to do so for newly devised complex techniques. The Board's overconfidence in its own abilities to do so led to such debacles as FAS 8 (foreign currency translation) and FAS 19 (oil and gas exploration costs).

By the early eighties, the cumulative effect of FASB's activism, induced by its structural design, began to show in the form of weakening constituent support. AICPA, which made the early mistake of demanding a majority membership in the FASB, ended up having to take the blame for the dissatisfaction many felt with the Board's performance. In recent years more room has been made for industry in the FAF and the FASB. However, fundamental structural problems remain. What, if anything, needs to be done?

IV. FUTURE DIRECTIONS.

We must pay attention both to the design of institutional arrangements and to setting our expectations of what we can reasonably accomplish through such an arrangement. Setting of the attitudes and expectations is important because the failures of the past have resulted just as much from unreasonable goals as from the structural weaknesses of the systems used.

Structurally, there is need for an incentive-compatible system for
setting standards. Such a structure should have incentives to try to identify and implement accounting standards which can reasonably be expected to enhance the welfare of the society on some broad scale. The structure should be such that it does not encourage the Board to act unless they have a strong justification for thinking that the standard is socially desirable. Nor should it aggressively promulgate as standards those methods of accounting with which accountants and investors have little prior experience. Conflict among parties should be openly discussed. No party should have to wrap in a veil of public interest its arguments which are intended really to protect its self-interest.

A quasi-legislative system which consists of part-time members who represent all relevant constituencies is appropriate to meet these objectives. The members would be free to argue for the interests of their own constituency in this forum. Support of substantially more than a bare majority (say three-fourths of the members) would be needed to issue a new accounting standard. Standards that do get issued can be expected to enjoy broad community support and are less likely to be undermined. No standard is better than the constituent support it receives. It may help to remind the FASB of this by weakening the support its standards receive from Rule 203 of AICPA's Code of Ethics.

The membership of a quasi-legislative body has to be reasonably representative of various segments of the economy who are affected by its action. At the very least it will require equal representation for corporate managers, the investment community, and public accountants and a variety of regulatory bodies whose functions overlap with the standards issued by the FASB. Others may have to be invited to join to work on accounting standards of special interest to them. If such a broad representative body were to fail, the failure would not be blamed on one narrow group. The public accountants have carried that burden in the past. A broadly representative body will spread that burden.

Just because the butcher and the baker may not be able or willing to serve on a standard-setting body for accounting, the idea of representativeness need not be laughed at. It is still possible to put together a body of technically competent people who are reasonably representative of the broad interests who are affected by accounting standards with appropriate adjustments on an issue-by-issue basis.

This body need have no significant permanent bureaucracy beyond a skeletal staff. The body does not have to meet regularly; only when necessary to address the issues brought before it by its members or by others. It does not have to have a large budget; it needs money only to pay for travel and for the cost of maintaining a small support staff and office. It does not have to issue an annual report listing as its accomplishments the new standards set during the reporting period.

Fortunately, FASB's experience is already pushing it in this direction. In recent years, more and more of the action has shifted to the Emerging Issues Task Force, whose structure is essentially quasi-legislative. My proposal will only promote this evolution to a more advanced level and formally recognize the advantages of a quasi-legislative structure and the dangers of a permanent rule-making bureaucracy.

Important as the structural recommendations are, the setting of attitudes and expectations is equally important.

First, the setting of standards is not a mere technical matter. Technical expertise is of course important to setting of standards but it is not sufficient. Standards, in accounting as in other areas, involve consideration
of social efficiency (which is a technical matter) and of distribution of wealth (which is a political matter). As in all political matters, people can differ without any one being wrong. The quasi-judicial structure of the FASB, combined with a large technical staff, has tended to give a technical flavor to its task and for many years the FASB remained reluctant to recognize the political (i.e., distributional) aspects of its charge. A quasi-legislative system will shift the emphasis toward the political part without damaging the technical part. The members of the new structure will still be required to have a high level of technical competence as in the past.

Appointment of disinterested parties (e.g., accounting professors), who presumably have no identifiable political interests as a class in setting of accounting standards, to a standard-setting body tends to detract from the political aspects of its task. They need not be voting members of such a quasi-legislative structure and could continue, as in the past, to provide valuable advisory and technical support as members of the staff.

Second, no standard is indispensable. People can and do live without standards of many types. Absence of a standard is rarely catastrophic; people adjust their behavior to the status quo. On the contrary, issuance of a standard can be a catastrophe. The performance of a standardization organization can no more be measured by the number of pages of standards issued than the success of a parliament can be judged by the number of laws passed. There is no connection, not even an approximate one, between the two. Is an active parliament a good parliament? Is an active standard setter a good standard setter? We must get rid of the habit of carrying the positive image of “proactive” behavior from the personal to this institutional domain.

Refusal of a standard-setting body to issue aggressive standards means delay in standardizing accounting for newer types of business transactions and phenomena. It is no more reasonable to expect that accountants can instantaneously come up with efficient standards for newer types of business transactions than that physicians can come up with a cure for AIDS or that engineers can fix the space shuttle overnight. The imperfection of our knowledge generates the necessity to conduct field testing of a variety of solutions to new problems. Forcibly speeding up the process imposes the large costs of making mistakes, changes, and resultant confusion in financial markets. Accountants who worry that the Securities and Exchange Commission may not accept a slower pace of response to new issues only need to remember, and remind the SEC of, the reserve recognition accounting.

Third, no matter what institutional mechanism we devise to set accounting standards, our ability to identify socially superior solutions is, and will remain, limited and imperfect due to several reasons I discussed earlier. We cannot observe other people's preferences; people's preferences depend on what they know and their past experience, which change continually. When new solutions or standards are implemented, people adjust their behavior to the new situation. Therefore, an understanding or observation of how people change their behavior in response to new standards is indispensable to devising socially efficient standards. The more aggressive a standard is, the less likely it is that we can completely understand its consequences. Perhaps the practice-based orientation of accounting standards widely used in Canada and in other countries of the world does make sense after all; a shift in emphasis from aggressive toward more practice-based standards should be considered. Given the fourteen-year experience of the FASB going out on a limb with aggressive standards,
some modesty with respect to our ability to devise new accounting methods which are socially preferred standards may not be out of place.