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Why Not Allow FASB and IASB Standards to Compete in the U.S.?

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SYNOPSIS: This paper discusses arguments for and against introducing competition into the accounting standard-setting process in the U.S. by allowing individual corporations to issue financial reports prepared in accordance with either FASB or IASB rules. The paper examines several arguments supporting the status quo, including (1) the FASB's experience and world leadership in making accounting rules; (2) the increased risk of a "race to the bottom" under regulatory competition; (3) the inability of most users of financial reports to understand the complex technical issues underlying accounting standards; (4) the possibility that IASB's standards will be diluted to gain international acceptance, allowing additional opportunities for earnings management; (5) the risks of the IASB being deadlocked or captured by interests hostile to business; (6) the costs of experimentation in standard setting; and (7) economies from network externalities. Arguments examined on the other side include how competition will (1) help meet the needs of globalized businesses; (2) increase the likelihood that the accounting standards will be efficient; (3) help protect standard setters from undue pressure from interest groups; (4) allow different standards to develop for different corporate clienteles; (5) allow corporations to send more informative signals by their choice of accounting standards; (6) protect corporations against capture of regulatory body by narrow interests; and (7) not affect network externalities at national or global scales.

Keywords: accounting standards; regulatory competition; international.

INTRODUCTION

This essay is written in the form of a debate between two individuals, M and C, over the appropriateness of introducing competition into the accounting standard-setting process. It is motivated by current discussions over whether standards promulgated by the International Accounting Standards Board (IASB) should be an acceptable substitute for those developed by the Financial Accounting Standard Board (FASB) in the U.S. At present, the Securities and Exchange Commission effectively allows the FASB to take the lead in formulating financial accounting standards for U.S. businesses.

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Expanding the set of acceptable standard-setting bodies will significantly change the financial-reporting environment.

The desirability of introducing competition in standard setting varies with the issue being evaluated. We evaluate the pros and cons of competition by organizing this discussion between M (for monopoly) and C (for competition) around several of the major issues commonly raised. We provide section labels to demark the discussion of distinct issues.

IF IT'S NOT BROKEN, DON'T FIX IT

M1: The FASB has done a good job of dealing with many complex accounting issues over the past quarter century. It is the unquestioned leader in setting financial accounting standards in the world. Its standards serve as the model for a large number of other countries; some countries adapt its standards to suit their local conditions. The FASB standard-setting process is "open," encouraging participation by all interested constituencies. The FASB does not shy away from taking up difficult, even unpopular, stands on tough issues. Even many opponents of its proposals came to support its actions. It has acknowledged expertise; it has an established tradition; it has a worldwide reputation for visionary leadership in setting standards. Why change things now?

THE WORLD HAS CHANGED

C1: I agree with much of what you said. The FASB's pronouncements are often used as a model by many other countries, as well as by the IASB itself. No other standard-setting body in the world comes even close to matching the FASB's achievements. An argument for change now need not be read as a criticism of the FASB's past accomplishments and leadership. However, we must also look at the present and into the future.

The economic map of the world has changed over the past quarter century, and it continues to change. The U.S. economy, its capital markets, and U.S.-based multinational corporations are still the largest in the world. However, even though the U.S. economy continues to grow, faster growth in other parts of the world elevates the relative importance of other economies, their capital markets, and corporations based outside the U.S. In addition, capital flows more freely across national boundaries now than in the past. As a result, an increasing proportion of the holders of securities reside outside the legal jurisdiction in which the issuers of the securities reside. For example, a corporation chartered in the state of Delaware has shareholders, plants, employees, customers, and vendors scattered all over the globe, diluting the meaning and relevance of its national identity.

If we assume that certain standards are useful for promoting commerce, cross-boundary commerce requires cross-boundary standards. This is what the IASB is trying to do in the field of accounting, for the U.S. and for the world economy. There are parallels between the IASB's efforts and the federal laws that regulate interstate commerce and securities in the U.S. Over a century ago, the state of New York dominated the U.S. economy, and the laws and practices of that state influenced business conventions throughout the country.[1] As the economies of the

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[1] See, for example, Carey's (1970) discussion of the importance of New York State's role in the development of accounting and auditing standards.

other parts of the U.S. developed, the national role of the state of New York diminished. Given the continuing development of the world economy, the FASB may not be able to continue its predominant role in determining national and international accounting standards.

I could make many arguments why it is desirable to allow the IASB to take the lead in formulating accounting standards in the U.S. Instead, I propose a more conservative course of allowing both the FASB and IASB standards to operate in the U.S. for five to ten years. With the insights generated by this experience, we could then decide whether to depend on either the FASB's or the IASB's standards, or to allow the standards developed by both to continue to operate in parallel.

COMPETITION MAY INDUCE A RACE TO THE BOTTOM

M2: Let us consider the suggestion that the U.S. allow each reporting organization to choose whether it wishes to publish its financial reports according to the FASB's or IASB's accounting standards. Presumably, firms will not be allowed to pick and choose among individual standards, and financial reports will be clearly labeled to inform the reader of the set of standards they conform to. However, I doubt if the average reader of financial reports has the accounting and financial expertise to distinguish between the information provided by financial reports prepared under the two sets of standards. How many people understand the meaning and implication of the UL (Underwriters Laboratories) stamp at the bottom of their toaster? And, using a toaster is easier than reading financial statements. I fear that allowing two sets of standards will induce a "race to the bottom," and erase the hard-won gains of financial reporting in the U.S. over the past half-century.

C2: What do you mean by a "race to the bottom"?

M3: A "race to the bottom" is a degradation of the quality and/or quantity of standards resulting from competition between standard-setting bodies.[2] It is closely linked to Gresham's Law—bad money drives out good money—and it applies to many forms of regulation. For example, in their quest to compete for depositors, countries such as Switzerland and the Cayman Islands simplified their banking regulations. Consequently, their banks became havens for illegitimately obtained money from all over the world. Similarly, some U.S. states and municipalities gave such large tax breaks to attract new businesses that their financial viability was threatened.

The same may happen to accounting standards if alternatives to FASB rules are permitted in the U.S. The financial reports of public corporations are prepared by their managers. Viewing accounting standards as a burden, managers prefer to comply with the least rigorous and demanding standards available. Requests for new accounting standards rarely originate from corporate executives who prepare financial reports. Whenever the FASB proposes a new standard, one can be reasonably sure that the Financial Executives International will resist the idea.[3] Moreover, managers seem to exploit whatever flexibility exists in accounting standards to present themselves, or their firms, in better light than indicated by their underlying performance.[4]

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[2] See Monks and Minow (1995) or Easterbrook and Fischel (1991) for further discussion of the "race to the bottom."

[3] See Parfet (2000, 484).

[4] As an example of analytical model of managers' demand for earnings management, see Dye (1988).

Moreover, the FASB pays for many of its operating costs through the sale of publications, and through contributions from various constituents, including firms subject to FASB's rules. Given the freedom to choose between alternative sets of standards, firms are likely to buy the publications of, and make contributions to, the body whose standards they adopt. In addition to this link between the adoption of standards and the revenues of the standard-setting bodies, there is also the question of the respect and authority that derives from having many firms comply with a given body's standards. In their attempt to attract a larger following, and knowing that the firms prefer the least-demanding standards, the standard-setting bodies will tend to issue standards that pander to the reporting firms. What is worse, you won't have to wait for arrival of actual competition among standard setters before observing a reduction in the quality of accounting standards; even the anticipation of competition will lower the quality of standards.[5]

C3: Won't standard setting actually improve with increased competition?

M4: It is difficult for me to imagine that FASB's Standard No. 106, *Other Post Retirement Employee Benefits,* for example, could have been issued in a competitive environment. It was fought tooth and nail by business firms, even though many critics of that proposal are now glad that the FASB persevered in spite of their original objections.[6]

The argument that competition is good because it pushes organizations to be more responsive to their constituents can be taken only so far. In some instances, markets break down, and the consequences of competition can be worse than monopoly. If air pollution standards were set locally by individual municipalities, each might seek to attract industry by lowering its own standards with the expectation that a significant part of the cost of pollution will be borne by the residents of neighboring towns. In order to avoid this "race to the bottom," these standards are set by the federal government at the national level.

In any case, as I mentioned earlier, the process for setting accounting standards in the U.S. already has many desirable attributes: it is transparent and subject to detailed public scrutiny. Moreover, it is highly responsive to its constituents, which include both the investing public and the business community. Making the process more responsive, by allowing competition between standard-setting bodies, is only likely to create inappropriate pressure for lowering standards.

COMPETITION NEED NOT BE EQUATED TO "RACE TO THE BOTTOM"

C4: After hearing your argument, I agree that unbridled market competition is not a perfect solution to the problem of standard setting. We should look at the restraints that exist in the system to keep the potentially undesirable consequences of free competition under control. We also need to review the benefits of a limited amount of competition in this field.

If we allow competition in the creation of accounting standards, we will not do so in a vacuum. Acceptance of IASB standards in other countries is subject to the approval of local authorities. So is the approval of any changes in GAAP in the

[5] This is similar to how the threat of competition from firms not presently in a market can discipline the prices set by firms already in the market. See, e.g., Baumol et al. (1982).

[6] See Parfet (2000, p. 484).

U.S. Even today in the U.S., the SEC reviews all proposals and pronouncements of the FASB before deciding to support them. We will certainly continue this process if we allow IASB standards to compete with those of the FASB. If the SEC judges that either body is trying to "race the other to the bottom," it can withdraw its support and undermine the credibility of the offending standard setter. This threat will restrain the tendency of standards to "race to the bottom."

Moreover, all markets do not necessarily "race to the bottom." Competing bodies for standardization and certification of products and membership exist in many fields, such as engineering and education, in virtually all countries. The resulting standards are not necessarily watered down.[7] Producing sloppy standards enhances neither the reputations of those who set or comply with the standards nor the demand for their services. The same is true of competition among the 50 states in the U.S. with respect to corporate charters (see Dodd and Leftwich 1980).

I am also not convinced that managers always prefer or select the most aggressive reporting behavior permitted under prevailing rules. Conservatism has a long-standing and respected tradition among accountants and managers. Some firms and their managers attach considerable value to being known for reporting "high quality" earnings and are rewarded by the capital markets with lower cost of capital. In 1993, Daimler-Benz of Germany chose to adopt the stricter and more transparent U.S. standards in the hope of gaining these benefits.[8] Firms that adopt aggressive reporting behavior often experience large drops in value when the investing public becomes aware of their aggressiveness, and the managers of such firms sometimes get fired. Managers have substantial incentives to protect their reputations by adhering to conservative reporting practices. In short, there is an implicit demand by managers of public corporations for quality accounting standards and disclosures.[9]

M5: Although some of the details of your argument make sense to me, I want to return to the analogy between competition among accounting standard setters and competition among jurisdictions in setting pollution standards mentioned previously. In both cases, the problem is the existence of "externalities," or "spillover" costs or benefits arising when one party's actions result in uncompensated gains or losses to other parties. Pollution creates an externality except in those rare instances where the polluter reimburses those harmed by the pollution.[10] When individual jurisdictions set pollution standards, they capture the benefits of relaxed pollution

[7] There is historical evidence that competition for members among accounting groups need not destabilize membership standards. In the United Kingdom, and in Canada, three institutes of accountants compete in overlapping markets. The membership requirements of these institutes do not seem to be progressively slackening over time. This should not be surprising: these institutes must worry about the reputation of their members and the demand for their services when setting the height of the bar for admission. Setting the bar low enhances neither their reputations nor the demand for their services.

[8] "[Y]ou have to have access to global capital. That means listing on the leading stock markets. And it means presenting your financial accounts to the standards of the transparency demanded by investors" (Jürgen Schrempp, Chairman of Daimler Benz to Graham Bowley ([1997]).

[9] William Parfet (2000, 481–482), the chairman and CEO of MPI Research, Inc., said about managers' behavior in preparing firms' accounting reports, "To use a sports analogy, we want to win, but we want to win playing by the rules."

[10] When no individual has property rights over the fish in a body of water, unregulated competitive fishing leads to depletion of stocks. This is a classic example of inefficient use of a resource in presence of an externality, and often goes by the name "the tragedy of the commons." See, e.g., Stiglitz (1997).

restrictions. These benefits include attracting businesses seeking to avoid the costs of complying with pollution-related regulations, without bearing any of the costs imposed by pollution outside of their jurisdictions. The net result is too much pollution. There is a similar externality produced by standard-setting bodies. In evaluating General Motors, an investor looks not only at GM's financial statements, but also compares them to the financial statements of Ford. If Ford chooses to comply with a different set of reporting standards, then evaluation of GM becomes more difficult and less precise. Externalities of this sort pose problems only when there are multiple, competing jurisdictions. Why introduce this problem into the U.S. financial-reporting environment by inviting the IASB to compete with the FASB in the U.S.?

C5: It is interesting that you present the example of why there are national, and not municipal, standards for air pollution. Just as air travels from one municipal jurisdiction to another—making air quality difficult to control satisfactorily by local standards—capital also travels across national boundaries, making it difficult to control by national standards. This argument lies at the heart of the case for giving the IASB a fair trial in the U.S.

Achieving the right balance in air pollution controls is not a trivial problem. However, neither is choosing the right level of accounting standards. The most difficult problem in developing accounting standards, it seems to me, entails determining the right balance between "excessive" and "insufficient" standardization. The value of financial reporting is diminished at either extreme. Insufficient standards make it difficult for financial statement readers to identify the principles firms applied in constructing the statements. Excessive or inordinately narrow standards may prevent firms from selecting a reporting procedure that accurately conveys the substance of their economic situation.

Competition can help the economy "zero in" on the right level of accounting standards. It is difficult to conduct a social cost-benefit analysis of proposals for new standards, or for eliminating existing ones. Estimates of the economic consequences of such proposals are notoriously inaccurate. Asking firms or others to furnish their own estimates of the economic consequences of an accounting proposal runs into two problems. First, only those people or firms whose individual gains or losses are sufficiently large respond to such solicitations, resulting in a selection bias. Second, when they do respond, firms and other interested parties have obvious incentives to exaggerate their estimates in the hope of influencing the adopted policy.

Because accurate social cost-benefit analyses are difficult to conduct, accounting rules actually implemented may be inappropriate. Moreover, the difficulties attending the assessment of standards makes standard-setters susceptible to the so-called Law of the Instrument;[11] that is, standard setters may recommend the promulgation of increasingly more standards even when better alternatives exist. The resulting standards do not achieve the best social outcomes. This may account for the explosive growth of standards during the years since the creation of the FASB.

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[11] "I call it *the law of the instrument*, and it may be formulated as follows: Give a small boy a hammer, and he will find that everything he encounters needs pounding" (Kaplan 1964, 28) (emphasis in the original).

Competition among standard-setting organizations can eliminate some of these problems and increase the efficiency of standards. Reactions to competing standards furnish each standard-setting organization with real feedback from their constituents. Instead of posturing as they often do at present, firms will "vote with their feet" in adopting or rejecting standards.[12] Competing standard-setting organizations are likely to be more responsive to demands for better standards than is a monolithic standard setter. If one set of standards is deficient relative to another, then competition will eliminate the former. Both insufficient and excessive standard setting will be curtailed as a consequence.

SURVIVAL OF THE FITTEST AND VOTING BY FEET

M6: Your argument seems to be a variation on the Darwinian "survival of the fittest" line of reasoning. Following this logic, one can make a case for not having any standards at all. After all, standards are a form of social norm or custom, and customs tend to evolve to efficient forms over time. This is the basic premise of the law and economics movement championed by Posner (1992) and others: the common law will eventually lead to socially efficient rules of behavior over time. Since the law does not face competition from other laws in a society, but is presumed to become efficient eventually, why shouldn't we expect accounting standards to become efficient over time, also—with or without competition?

C6: I agree that, like all social norms, accounting standards may converge to efficient rules over time with or without competition. However, and also like social norms, the evolution of accounting standards toward efficiency is neither rapid nor certain. Under rapid and continual change, accounting standards can permanently lag behind current business conditions, causing resources to be misallocated. Thus, there is a demand for organizations that develop financial-reporting standards. If we must have some formal standard-setting body, it is sensible not to allow any single body to have monopoly control of this process. A single source of accounting standards doesn't allow firms to "vote with their feet," and hence increases the chance of errors being perpetuated over the long term.

PEOPLE MAY NOT KNOW WHAT IS GOOD FOR THEM

M7: This "voting by their feet" argument assumes that people who make these decisions have sufficient understanding of the alternatives on hand to know the consequences of each option and to choose correctly what is in their best interest. I know that it sounds like an elitist argument, but years of experience with standard setting lead me to a different conclusion. The issues involved in setting accounting standards are technically quite complex, and it is not realistic to expect more than a handful of people to make the effort to gain more than superficial understanding of these issues. People do not always know what is in their own best interest when it comes to accounting. I already gave the example of the FASB's standard, *Other Post-Retirement Employee Benefits,* and there are many other examples. If the FASB could ever get its original proposal for a new standard on accounting for employee stock options approved, I believe firms will then ultimately understand that it was in their own best interest to recognize these expenses. The FASB has

[12] See Tiebout (1956) for the effects of competition between jurisdictions on the efficiency of the provision of local public goods. See, also, Tjiong (2000) for some counterarguments.

little chance of reaching that stage in such a politically charged issue. In any case, that is the reason why we need panels of experts like the FASB and IASB rather than referendums to set accounting standards.

C7: Your concern about the receptivity of business to new accounting standards such as those involving accounting for stock options or post-retirement benefits actually provides another reason for allowing competition between standard-setting bodies. Let's take the debate on accounting for derivatives. Alan Greenspan, Chairman of the Federal Reserve Board, agreed with the major banks' objections to mark-to-market accounting for derivatives. It was not until Congress introduced legislation to intervene in this matter, citing his position, that Mr. Greenspan reiterated his support for the independence of the FASB's process. With multiple sets of standards, the political pressures on the FASB, or any other standard-setting body adventurous enough to propose significant new reporting requirements, would be lower. That body could say, "Look, if you don't like these standards, opt out and select another set." The net result of introducing competition in standard setting might be just the opposite of what you call a "race to the bottom." Competition could reduce the lobbying pressure on any single standard-setting body compared to the present regime in which a single authoritative accounting body is subjected to considerable political pressure whenever it proposes an accounting innovation.

THE U.S. IS DIFFERENT (BETTER?) THAN THE REST OF THE WORLD

M8: Your argument implies that the IASB could serve as a foil for the FASB. Think about the specifics of how international accounting standards are set. Instead of developing in a vacuum, they respond to specific institutional settings. German accounting rules, for example, permit a plethora of "reserve" accounts. Lack of disclosure about these accounts makes it difficult for the reader to assess the value of a firm from its financial statements. Yet, this opacity of financial reports presents no problem for German banks—historically the principal source of capital for German firms. As lenders, these banks are privy to additional information not available to the general readers of German firms' financial statements. A representative of the bank often sits on the firm's board of directors. Under this financing and corporate governance structure, German GAAP does not hinder financing of German firms. However, financing and corporate governance structures in the U.S. are different. Individuals and other "nonbank" financial institutions hold much of the equity and debt issued by U.S. firms. Allowing U.S. firms the freedom to issue opaque statements loaded with reserve accounts will not work well because the providers of capital do not have access to the information hidden behind the reserve accounts.

Moreover, international accounting standards necessarily gloss over the variations in the functioning of national capital markets. They tend to be based on one of two strategies. One strategy is to base the international standards on standards already in force someplace. If sufficient support is not forthcoming for any existing standard, then a new standard is drafted. The new standard needs to gain substantial support from countries with diverse accounting practices and institutions. Often, the outcome of this process is a "minimum common denominator standard," which is just another way of phrasing "the race to the bottom" we discussed earlier. Unless the standards chosen are modeled after the practices of a country with a strong bias in favor of equal access to information, the outcome will be a step backward for investors. Since the U.S. is the leader in standard setting, forcing U.S. standard setters to compromise their principles for the sake of international harmonization will only have the effect of watering down U.S. GAAP. This is not the best outcome for participants in the U.S. securities markets.

C8: We both agree that business environments vary across countries. Let us also agree that in an ideal world it might be best to develop a unique set of ideal accounting standards for each environment. However, even within a legal jurisdiction, organizations of different sizes operate in different industries and in regions with different business environments. In fact, one could make a good argument that there is less difference between the business environments of Exxon and British Petroleum than between Exxon and Paradise Inc., a small Florida confectioner traded on the NASDAQ. So the problem you rightly point to is not unique to international accounting standard setting.

Fortunately, the resolution on the table leads to a reasonable solution to the problem. Under a competitive standard-setting system, the harmonization of reporting standards across the globe can proceed at a voluntary pace determined by local conditions. Firms with local clientele and little or no international exposure may find comfort in conforming to locally optimized standards written by their domestic standard-setting body, such as the FASB in the U.S. Other firms with international clienteles will choose to conform to international standards if they believe they are better off by doing so. This two-tiered system allows more freedom of choice to firms in all countries. Instead of suppressing it, such an approach will actually promote the legitimization of local standard-setting bodies. Within the U.S., for example, various stock exchanges compete by setting their own standards for listing firms. This competition creates a multitiered market that is healthy for the securities industry. It led to an equilibrium in which the New York Stock Exchange coexists with the NASDAQ, several regional exchanges, and even the Vancouver Stock Exchange with its reputation for trading highly speculative securities. Introducing competition between the IASB and local standard-setting bodies will encourage similar healthy competition in setting accounting standards.

Moreover, the possibility of segmentation of accounting standards is not new to the U.S. There has been much discussion about the "Little GAAP, Big GAAP" controversy over adjusting reporting standards for clientele effects. Competition between IASB and the FASB will respond to clienteles on a global scale. In short, I agree that, while there may be a problem resulting from IASB standards not being directly competitive with U.S. GAAP, there is a simple resolution of the problem—just introduce more competition!

BROADER AGREEMENT MEANS WEAKER STANDARDS

M9: You turned my own argument against me. But it is not that simple. Because the IASB must gain approval from a much larger constituency, the number of things they can agree on must be smaller than what the FASB agrees on. A possible result is lax standards compared to those of the FASB. Lax IASB standards allow firms more opportunity to manage their earnings, making financial reports less useful to investors. One of the costs associated with reaching the political consensus necessary to get international standards adopted is that the standards must be constructed relatively broadly and less specifically. Broad standards create more ambiguities and enhance chances that opportunistic, if not illegal, accounting treatments are blessed by generally accepted accounting principles. Earnings and balance-sheet management is one consequence of this vagueness. Earnings management misleads and harms investors who read and rely on the financial statements of culpable firms. A firm may be made to look more profitable and less risky. This practice injures not only the investors in the culpable firm, but also harms investors in other firms who may make invalid comparisons among the financial statements of firms that do/do not manipulate their earnings.

UNIFORMITY OF FORM OR UNIFORMITY OF SUBSTANCE

C9: Achieving uniformity and comparability of financial reports across firms and across time is a difficult problem in financial accounting. Contrary to popular belief, more detailed and more rigid or "uniform" standards that allow fewer options to managers do not make financial reports more comparable, or more informative. Statement of Financial Accounting Standards No. 2 is a good example. It requires all research and development outlays to be expensed, allowing managers no discretion when accounting for such costs. As a consequence, two firms that spend equal amounts on research report identical financial results, even when one's research is successful and the other's research yields no usable results. The idea that detailed rules lead to uniform and comparable results can be easily rejected on the basis of the exponential growth of the Internal Revenue Code, and the public dissatisfaction with the inequities of the tax burden and the administration of the Code.[13]

When you permit firms to choose from a set of accounting alternatives, firms do not necessarily reduce the amount of information they reveal to the readers of their reports, as long as the method they choose is also disclosed in the reports. Their choice among methods reveals what they know to the discriminating reader, just as the choice of an auto insurance policy with a low deductible reveals a policyholder's private information to an insurance company (see Levine 1996). By choosing a low-deductible policy, the policyholder reveals his/her high driving risk and high aversion to financial risk. Financial analysts continually scrutinize the choice of accounting methods by firms to assess the quality of firms and the quality of their management. Nothing generates a faster sell decision by an experienced analyst than a financial report in which management enlists all possible accounting tricks to burnish the report. Managers cannot resort to such methods without also revealing to knowledgeable readers that their firm is in a desperate condition. By eliminating such options in favor of "tight" standards, we also close off yet another channel of communication from the firm to the investing public.

Besides, managers who wish to be in the good graces of shareholders and analysts, and have confidence in the prospects of their firm, always have the option of revealing more than the applicable standards require. Adding IASB to FASB standards will not change any of this.

[13] Also see Havighurst (1965); Sunder (1997, 143–145).

INTERNATIONAL STANDARDS BODY MAY BE CAPTURED BY NONBUSINESS INTERESTS

M10: I want to step back to an earlier point about how the nature and extent of lobbying might be affected by competition between standard setters. You think that introducing competition will take the heat off a single standard-setting body and so, in principle, induce that body to be more adventurous in choosing innovative, even aggressive, standards. Contrary to your conjecture, I think competition will exacerbate, not relieve, lobbying pressures. We know how children try to play one parent against the other to get what they want. Competition between standard setters to attract client firms will only make them more susceptible to such pressures. It is easier to take a hard line when you are the only game in town.

Moreover, I worry about the pressures that could be brought to bear on the IASB. In the U.S., some accountants complain about the excessive influence of the Financial Executives International and the Business Roundtable in the standard-setting process. However, lobbying pressure from nonbusiness interests could be even worse. Think of the IASB as the United Nations of accounting boards. It is a voluntary association created by accounting organizations across 114 countries. If environmental or governmental interests in enough countries dominate business interests, then the IASB might be induced to issue standards unacceptable or irrelevant to business firms. International labor unions, various governmental groups, environmental and consumer groups may all try to sway IASB standards. One possible result of all this pressure is for the business community to stay away from IASB standards entirely. The conflicts among business, accounting, and other groups I mentioned could produce a deadlocked, paralyzed IASB—a paper tiger.

C10: Early in this conversation, you argued against more than one standard-setting body because the resulting competition would pose a serious challenge to the FASB, and that is undesirable. Now, you're saying that it is undesirable to have more than one standard-setting body because it wouldn't create viable competition. You can't have it both ways.

The possibility of IASB standards being co-opted by nonbusiness interests is remote. Even if that happens, the business community will not sit and watch from the sidelines any more than they did when the FASB's standards became mandatory in the U.S. Business will have a significant voice in all standard-setting decisions. Moreover, when businesses can choose which set of standards to adopt, neither the IASB nor any other standard-setting body can afford to write standards that alienate the business community. Even if your worst fears came true, and the IASB were captured by interests hostile to business, under the proposal we are debating the business community could simply ignore those standards and carry on.

My overall argument is simple: either IASB would be a viable alternative or it wouldn't; let's experiment by giving it a chance! The costs of conducting the experiment aren't that high. How can you lose?[14]

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[14] The importance of "experimenting," or taking an action that may not be the best possible given current information, in hopes of making improved future decisions based on additional information collected today, has been the subject of intense study in the statistics literature. These problems have been classically referred to as "bandit" problems. See Berry and Fristed (1985) for an overview. This literature occasionally receives attention in economics as well. See, e.g., Grossman et al. (1977) for the earliest such treatment in economics. An interesting discussion about how successful firms may be averse to innovating, and consequently lose what made them successful, may be found in Christensen (1997).

THE COST OF STANDARDS AND EXPERIMENTATION

M11: The cost of failed experimentation with accounting standard-setting mechanisms is not low. Let's go through the list. Costs of standards include: (1) the costs incurred by the standard-setting body and the constituents in the formulation of standards; (2) the direct costs of implementing the standards by firms preparing the financial statements; and (3) the indirect costs of various agents adjusting their behavior to the new standard, and the economic consequences of the altered behavior. Most of our debate so far has centered on the third category. However, the costs in the first two categories are not small. Indeed, much of the opposition from business to new proposals for accounting standards is based on business' beliefs that their benefits do not exceed their costs.

The duplication of effort in evaluating competing standards is inevitable and wasteful. On top of this, firms may incur significant implementation costs if they decide to switch between competing standards. In addition, competing standard-setting groups lack the incentives to engage in due diligence when developing standards. Since the output of a standard-setting body is what economists call a "public good," a competing standard-setting body can use the concepts and ideas underlying a standard for free without incurring the cost of developing it. A developer of standards has no enforceable property right to its ideas and concepts. In contrast, a monopoly standard-setting body has the appropriate incentives to do due diligence without wasteful duplication.

C11: Keeping your three cost categories in mind, I agree that it is easier to estimate the costs in the first and second categories than in the third.[15] But the third category of costs is an order of magnitude higher than the other two. In a competitive environment, the standard-setters have reasons to minimize the sum of all three costs—essentially minimizing the third element. This inherent tendency of a competitive system is absent in a monopoly regime.

While your schema of costs is quite comprehensive, it is difficult in practice to provide reasonably precise estimates of any but the most trivial of these costs. Consider just one of the costs that is difficult to evaluate: the cost of obtaining "representative" standards board members. No standard-setting body can perfectly represent of all its constituencies. Limitations on the feasible size of such a body, and the large number of interests in society on which its actions may impinge, ensure that the constitution of such bodies must be less than perfectly representative. Competition among standard-setting bodies reduces the import of such imperfections. It ensures that such bodies must take into account the interests of various constituents even if they are not directly represented on the body itself. Disgruntled interests can shift their allegiances to the competition. This argument is invoked against federal chartering of corporations in the U.S. All 50 states of the union compete vigorously in the market for corporate charters, and Delaware seems to have won a lion's share of the market by designing laws, or

[15] Accounting and management generally are plagued with instances in which decisions are based on the easily assembled or computed information, rather than information most relevant to the decision at hand. A classic example is the emphasis on the "total costs of quality," consisting of appraisal, prevention, internal failure, and external failure costs (see, e.g., Kaplan and Ittner 1988). While the existence of these costs cannot be denied, they probably are an order of magnitude smaller than the effects of quality on customer demand.

"standards," attractive to various corporate constituents. In the 1980s, when some states tried to pass laws in support of corporate takeover defenses, economists argued that such laws only drive business away from the states that enact them. In brief, the composition of a standard-setting body becomes less critical when standard-setting bodies have to compete.

As I mentioned earlier, the costs of setting standards are difficult to quantify. To evaluate a monopoly standard-setter, one needs to know the magnitude of various costs. With competition among standard setters, there is less of a need to make such judgments. Competition helps ensure that the right amount of time, money, and effort is devoted to each of the activities the various standard setters engage in.

M12: There are other costs of competition. Economists study network externalities—the benefits of having multiple customers adhere to the same standard.[16] The telephone and facsimile machine provide classic examples of network externalities. One telephone, or one facsimile machine, is not of much use by itself. The usefulness of a telephone, or facsimile machine increases with the number of others who use compatible machines. Accounting standards also have network externalities. Using or interpreting financial reports to infer a firm's economic condition and performance is prone to error. If multiple firms adhere to the same set of standards, readers can compare across firms and interpret the reports better. This is a big advantage of having a single set of standards, and hence a single standard setter. I can only imagine the consequences if each firm reported by its own unique set of "standards."

As another example, think about the rationale for a single set of health and sanitation standards for restaurants in a city. Diners could go into a restaurant and ask themselves, "Is the set of health standards used here appropriate for what I would like to order for lunch today?" Instead, they prefer to have experts set uniform standards to ensure that all food served in all restaurants is safe. Analogously, investors don't want to have to wade into technical arguments about variations in GAAP when interpreting a firm's financial reports. You win investors' trust, and eliminate their confusion, by having all financial reports prepared in accordance with one GAAP.

C12: I agree that network externalities apply to accounting standards. Without such externalities, each firm could follow its own rules and there will be little need for standards (see Sunder 1997, chap. 11). The critical issue is how the magnitude of network externalities of accounting standards changes with the number of conforming firms. The economics literature typically assumes that the benefit of using a common standard increases with the number of consumers, according to some functional relationship. We do not know this function. It is possible that the rate of increase in benefit drops significantly as the numbers grow, in which case the advantage of adhering to a single set of standards in a large economy is minimal.

Let's consider the following thought experiment for the network externalities associated with telephones. Suppose everyone in the U.S. has a phone, but no one in Russia does. Under this hypothetical situation, it is not clear that most U.S. residents would get much added benefit if all Russians were given phones. We

[16] See Farrell and Saloner (1985) for an early reference.

should expect the incremental network externalities associated with more users to become small at some point. While network externalities may be important, we should not overstate their magnitude.

If the potential benefits from network externalities diminish rapidly with the number of firms adhering to the standards, then competing standard setters may do as well as a monopolist standard setter. This is true even without considering the other benefits of competition I mentioned earlier.

Your analogy with uniform sanitation code is inappropriate. First, investors do not have to know the details of GAAP, only their investment advisors do. People order and eat their meals without professional advisors at their side. Second, U.S. GAAP already permits many financial-reporting alternatives, forcing investors and analysts to cope with the different choices firms make.

M13: Perhaps the largest of the costs of accounting standards we haven't discussed yet is their effect on the risks borne by investors and the risk premium investors demand when pricing securities. Reporting standards cannot reduce the risk arising from the covariance between the market and firm returns. They can affect portrayal of the risk associated with the firm's cash flows. A monopoly standard setter, concerned with the risk borne by the shareholders of firms that adhere to its standards, could attempt to minimize this latter risk premium in the aggregate. Would competition among several standard setters do as well?

C13: I believe that competitive standard setters would do better. If the only objective of standard setters is to minimize the "informational" risk premium, then there will be no difference in the disclosures proposed by a monopoly standard setter and a set of competitive standard setters.[17] However, socially concerned standard setters must also consider whether increased disclosures result in firms' disclosing proprietary information to their competitors. When such proprietary costs are taken into account, it is very difficult to determine efficient or optimal standards. As I stated above, competitive standard-setting bodies are more likely to make the right choices in such tough decision-making circumstances.

SUMMARY

M14: I think we have put as many issues on the table as is possible in one debate, so let me summarize. I do not believe we need to fix something that is not broken. You believe in laissez faire competition, even in fields where the presence of externalities mitigates against the advantages of competition. As a practical matter, the SEC will never countenance the "choice" solution you propose. As a regulatory agency, the SEC has low tolerance for ambiguity and always champions the cause of uniformity over flexibility, even when, in your opinion, such uniformity is more a matter of form than substance. It is the least likely body to accept a regime under which companies subject to its jurisdiction can choose their own accounting standards. Of course, that does not mean that we shouldn't discuss and debate it. Do you have any final thoughts?

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[17] See Dye (1990).

C14: Informed by a wider debate of this kind, we could make a better decision about opening the U.S. to the IASB standards. I wish we could elicit the best arguments by inviting more people to participate in this debate, even offering a prize to the person who makes the most persuasive case. However, I guess to be consistent with the philosophical position you advanced throughout this debate, you prefer a debate with only one person present, whose assertions are final and binding.

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