

Accounting Standards and the Economics of Standards

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Questions:

- 1) What does the economics of standards have to say that may be relevant to accounting standards?
- 2) What models does the economics of standards have that could advise on the right *number* of accounting standards?

The Benefits of Standards

- Standards can support these mechanisms:
 - The division of labour
 - Reduced transaction costs and increased trade
 - Trust between trading partners
 - Innovation
 - Competition in open markets
 - Co-operation to exploit network effects

The Potential Downside of Standards

- Strategic Idiosyncrasy and Barriers to Entry
- Risk of Monopolisation / Regulatory Capture
- Raising Compliance Costs
- Constraints on Product Design: Limits on Variety

Which of the benefits are considered most relevant by accounting practitioners?

Especially:

- Division of labour
 - Transaction costs
 - Trust between trading partners
- Ownership – Control
 - Earnings ‘Management’ (!)
 - Asymmetric information

Also:

- Network effects
 - Competition in open markets
- Global market for securities
 - Risk of monopolisation (see later)

Less concern about:

- Innovation
- Financial innovation depends on reliable standards

Which of the downside factors are of most concern to accounting practitioners?

Main concern relates to:

- Regulatory capture
 - Compliance costs
 - Barrier to entry
- Raising rivals' costs
 - Especially USA
 - Especially to USA

Less concern about:

- Constraining design & limiting variety
- Of more concern to *academic* accountants

Different Perspectives

- Accounting Practitioners
- Academic Accountants
- Academic Economists

Daimler Benz, Net Income, 1993

	DM million
German GAAP*	615
US GAAP*	-1893

Source: Nobes (1997)

*GAAP = generally accepted accounting principles

Is this an argument *for or against* global standardization of accounting procedures?

Practitioners concentrate on:

- Transaction costs arising from diversity

Academics also recognise:

- Varieties of business systems and non-convergence in corporate governance imply the need for variety in accounting standards
- Index number problems

Answer to Question 1

- What does the economics of standards have to say that may be relevant to accounting standards?
 - Quite a lot
 - Accountants comfortable with concepts and categories

Question 2

- What models does the economics of standards have that could advise on the right number of accounting standards?

(a) Simple theory of standards “races”

- Under the following conditions:
 - a) little demand for product variety **AND**
 - b) network effects are unbounded above **AND**
 - c) no risk of monopoly

A **single** standard is the “right” solution

- Condition (b) is implausible and condition (a) is unlikely
- The outcome of some standards “races” is two or more standards and that is for the best

(b) Standards and product variety

- Simulation models of standards and product variety tend to find that:
 - 1 standard does not generate enough variety
 - Around 3 standards is better
 - Diminishing returns (and efficiency losses) from a greater number of standards (>5)

(c) Optimum number of varieties

- Bongers' (1982) famous study of concrete post (!) standards
 - optimum number of standard sizes is about 5

(d) Number and vintage of standards

- UK Government Study of Standards and Innovation (Temple et al, 2005)
 - If stock of standards is “too small” or “too large”, then standards are more likely to constrain innovation
 - If stock of standards is “too old” or “too young”, then standards are more likely to constrain innovation
 - Suggests there may be an “optimum” number and vintage of standards

What is the right number of standards?

- No simple answer to the question
 - Only in special circumstances is the answer “one”
 - Often, the “right” number is “small but greater than one”

Accountants' reactions to these models?

a) Standards 'race' and network effects

- Yes. But in the accounting case, are network effects unbounded above?
- Similarity to W W W standards?

Accountants' reactions to these models?

b) Simulation model of standards and variety

- Yes, but not that relevant as (if?) variety not a big issue

Accountants' reactions to these models?

c) Concrete posts

- “Prof. Swann does not seem to realise that an accountant is not the same as a concrete post.”

Accountants' reactions to these models?

d) Number and vintage of standards

- Yes, but not that relevant as vintage not such a big issue

How do accountants assess case for and against SGS (a single global standard)?

- Cost Benefit Analysis (CBA) to balance advantages and disadvantages

Answer to Question 2

- What models does the economics of standards have that could advise on the right *number* of accounting standards?
 - What we have to say here seems less useful, but not *useless*

THANK YOU FOR YOUR ATTENTION
ANY QUESTIONS?