

# FINANCIAL ACCOUNTING STANDARDS: CONTROVERSY, CONCEPTS, AND CONSENSUS

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The Financial Accounting Standards Board is a unique institution in the United States-- indeed, it may well be unique in the world. It is the private-sector organization that establishes standards of financial accounting and reporting that are recognized as authoritative by the government (the Securities and Exchange Commission) and by private enterprise, auditors, and issuers of financial statements. Today, I want to address the controversy surrounding the setting of standards, the need to establish concepts on which financial accounting standards can be based, and the place for consensus in setting standards. The proper roles of controversy, concepts, and consensus need to be understood by all of us who share a concern for the development of sound financial accounting and reporting standards. What does controversy contribute? Are concepts necessary? What is the proper place for consensus? In answering these questions, I hope to show you what is, and is not, realistic and desirable in the process of standard setting. Some background about the process by which the FASB develops standards is essential to understanding my response to these questions. What is the FASB and how does it operate?

## THE INSTITUTION AND ITS PROCESS

Occasionally, the FASB has been referred to as the Federal Accounting Standards Board, an error that reflects a distressing misunderstanding of the institution and its role. As you probably know, the FASB is a private institution, free from political pressures and the strings attached to governmental funding. It is sponsored by six private-sector, professional organizations: the American Accounting Association, which is primarily an association of academics; the American Institute of Certified Public Accountants; the Financial Analysts Federation; the Financial Executives Institute; the National Association of Accountants, which, like the Financial Executives Institute, draws its membership primarily from industry; and the Securities Industry Association.

### A Tripartite Structure

The FASB is one part of a tripartite structure consisting of the Financial Accounting Foundation, the Financial Accounting Standards Board, and the Financial Accounting Standards Advisory Council. The twelve members of the Board of Trustees of the Financial Accounting Foundation are drawn primarily from the six sponsoring organizations. They are responsible for appointing the seven full-time members of the Board and for funding the Board's operations. The bulk of that funding is derived from annual contributions of individual business enterprises and accounting firms. The Trustees of the Foundation are also responsible for appointing the 30 to 40 members of the Advisory Council and for arranging the modest funding that the Council requires. The membership of the Advisory Council represents even broader backgrounds and interests than the Trustees of the Foundation.

The Advisory Council meets with the Board quarterly to provide advice about the Board's activities generally and about its agenda of projects specifically--not how to resolve the issues in those projects, but rather the relative priorities that should be assigned to projects, the special considerations that should be observed, and the organization and selection of task force members

to assist with FASB projects.

### Due Process and Participation

An important feature of this tripartite organization is the Board's ability to enlist highly qualified individuals to serve on FASB task forces on a volunteer basis. A task force, typically composed of 14 to 16 individuals who have special experience and expertise related to the subject of a project, is formed for each major Board project.

The activities of a task force usually begin by working with an FASB project team in preparing a Discussion Memorandum. The Discussion Memorandum provides a comprehensive discussion of the nature of the financial reporting problem and the specific issues that the Board is expected to address. The primary role of the Task Force is to insure that all of the important issues have been identified, that alternative resolutions to those issues have been adequately described together with the advantages and disadvantages of each, and that adequate research exists or has been undertaken.

Upon publication of a Discussion Memorandum, the Board invites interested parties to submit position papers recommending their solutions to the issues presented in the Discussion Memorandum, together with the reasons for advocating the positions they take. A copy of each position paper is distributed to each Board member and, in addition, the FASB staff analyzes those position papers and organizes the results systematically to facilitate an overall evaluation by the Board.

Typically, the Board conducts a public hearing to provide interested parties with an opportunity to emphasize or elaborate on positions submitted in writing. Most important, the public hearing allows individual Board members to question positions advocated, seek clarification or additional information, and engage in a constructive exchange of ideas with a variety of individuals having different backgrounds and interests and, inevitably, differing recommendations. Public hearings are likely to last two or three days with perhaps 25 to 30 presentations.

Only after the public hearing does the Board convene to deliberate the issues. All Board meetings are open to public observation. The agenda is available the previous week and, depending on the subjects to be discussed, anywhere from a handful of observers to a full house of 35 to 40 observers may be present. Board members and staff are sufficiently inured to the presence of outsiders that expressions of individual views tend to be quite uninhibited. The Board's deliberations at this point are geared to issuing an Exposure Draft of a proposed Statement of Financial Accounting Standards --again, for public comment.

Depending on the complexities of the issues and the degree of agreement or disagreement among Board members, the deliberative process may take several months. In terms of time and public response, probably no project can be said to be "typical," but as a recent example, a Discussion Memorandum on accounting for interest costs was issued in December 1977. The Board received 145 position papers during the three-month comment period, and 18 presentations were made during a two-day public hearing in April 1978 in New York. The

issues in that project were relatively straightforward, but there was substantial disagreement among Board members and an Exposure Draft was not issued until December 1978, eight months after the public hearing and a year after issuing the Discussion Memorandum.

The next step is an analysis of the comment letters received in response to the Exposure Draft. Because those comment letters are in reaction to a tentative decision made by the Board, they tend to be more pointed than the position papers submitted in response to the neutral Discussion Memorandum. They range from “We have suffered through the drivel coming out of your office for far too long” to “This Exposure Draft is truly a breath of fresh air,” to quote two recent submissions on the foreign currency project. But in between the few diatribes and kudos are many constructive reactions and suggestions.

Getting from an Exposure Draft to a final Statement of Financial Accounting Standards can also take the Board several months to accomplish, depending on the information submitted in response to the Exposure Draft. For example, 249 comment letters were received in response to the Exposure Draft on capitalization of interest cost. The final Statement for that project, No. 34, was issued in October 1979, seven months after the close of the comment period on the Exposure Draft and nearly two years after the distribution of the Discussion Memorandum.

To many of you, that might seem like an inordinate amount of time. But a lot of important activity goes on behind the scenes during that time. The staff is continuously gathering new information requested by the Board and developing written materials that are discussed and modified and rediscussed. Also, of course, a number of projects are underway simultaneously. At any time, 12 to 15 significant projects may be at various stages of development.

Occasionally the Board has amended an Exposure Draft enough that a second Exposure Draft was considered necessary--for example, that was the case in Accounting for Leases and in Accounting and Reporting by Defined Benefit Pension Plans. In neither of those instances was the basic thrust of the first Exposure Draft changed. Instead, the responses led to significant improvements to the proposed standard that made it more effective, and reactions to those changes were considered desirable. The need for constructive reactions of those who are affected by proposed standards is exactly why the exposure process is so important to the development of standards that are both sound in concept and operational in implementation.

Agreement upon a final Statement requires a simple majority vote of the seven Board members. The rationale behind the Board's majority decision is included in each Statement, and the views of those Board members who dissent are also presented.

Presently, the FASB distributes 30,000 Discussion Memorandums, 40,000 Exposure Drafts, and 92,000 Statements. Those numbers are indicative, I believe, of the widespread interest in the establishment of financial accounting standards and their impact on the financial results and financial positions reported by individual enterprises to their shareholders and other interested parties.

## FASB Predecessors

Two private-sector standard-setting bodies preceded the FASB. Both were arms of the American Institute of Certified Public Accountants: the Committee on Accounting Procedure, which published 51 Accounting Research Bulletins during its 20-year life ending in 1959; and the Accounting Principles Board, which published 31 Opinions and 4 Statements during its 14-year life that ended in 1973.

Among the factors that led the AICPA to replace the Committee on Accounting Procedure with the Accounting Principles Board were the perceived needs to bolster the research program supporting the standard-setting activity and to establish a conceptual foundation for accounting standards--at that time described as the basic postulates underlying accounting principles generally and the broad principles of accounting. The Accounting Principles Board made three separate efforts to fulfill the latter charge, ultimately settling for its Statement No. 4 that was characterized correctly as describing the "way things are" not "the way things ought to be." Although a useful document in understanding where things stood, it provided little guidance for standard setting. The research program got off to a fast start and tapered off just as quickly, having little impact on the APB's standard-setting activities.

Meanwhile, the APB attacked the hot accounting issues of the day in much the same ad hoc fashion as its predecessor, the Committee on Accounting Procedure. Some of its solutions to those hot issues were unpopular. Reactions led to criticisms of the process by which standards evolved and even to the APB itself. Among the most serious criticisms were that the APB was dominated by members from accounting firms who could not act independently from their clients, and that those most directly affected by the APB's decisions--preparers of financial statements and users of financial information--had inadequate opportunity to participate in the process.

In establishing the Financial Accounting Standards Board to replace the AICPA's Accounting Principles Board, insuring the independence of individual Board members and providing an opportunity for active participation by all interested parties were primary considerations. The FASB is not an arm of the AICPA; as I have indicated, six sponsoring organizations are represented on the Board of Trustees of the independent Financial Accounting Foundation. Board members serve full time and must have severed all relationships with former employers. The process I have described provides for extensive participation by all who wish to be involved. The major accounting firms are among the most active participants, but a number of corporations and professional organizations are also consistently active and a wide variety of individuals and organizations are involved in each project.

## CONTROVERSY

Controversy is probably inevitable whenever someone tries to impose change on someone else. And a large part of the FASB standard-setting activity is concerned with imposing change - -most directly on those who prepare financial statements, somewhat less directly on those who audit financial statements, and indirectly on those who use the information contained in financial statements.

Resistance to change is an understandable phenomenon. Each of us can recall instances when we tried to prevent a change that affected us, or we can recall instances in which we complained or felt abused by change that we were helpless to prevent.

If you were the chief financial officer of an enterprise that had been using the full-costing method of accounting for its oil- and gas-producing activities--and your performance and annual bonus depended on the amount of earnings measured on that basis and reported to shareholders--you could reasonably be expected to resist, perhaps vociferously, the Board's attempt to require a change to the successful-efforts method.

Arguments that alternative methods of accounting for identical circumstances diminish the credibility of financial statements, destroy their comparability, and detract from their usefulness--arguments that seemed so persuasive when others who were capitalizing their research and development costs as assets were required to change to your enterprise's practice of expensing all research and development expenditures at the time they were incurred--may seem unconvincing when it is your preferred accounting practice that is threatened.

If you were a partner in an auditing firm and had encouraged a client to establish a reserve for self insurance only to have the FASB subsequently conclude that the use of such reserves is unacceptable, you could reasonably be expected to be less than enthusiastic about the Board's decision.

If you were a financial analyst whose reputation was partially based on your ability to forecast next year's earnings per share for the multinational enterprises you follow, you could be expected to complain bitterly about a new accounting standard that introduced significant unpredictable fluctuations in reported earnings when floating foreign exchange rates changed and your earnings forecasts were clobbered.

If you were an accounting student who after many tedious hours of perplexity and frustration had finally mastered an accounting standard--say, foreign currency translation--understandably, you might curse the FASB for changing to an entirely different method before you had a chance to take the CPA examination the following May. Indeed, your accounting professor might share your wrath because the problems that were assigned during the past five years will have new and unfamiliar solutions next term.

### The Nature of Controversy

Controversial issues make up most of the Financial Accounting Standards Board's agenda. The 38 Statements of Financial Accounting Standards issued by the FASB to date cover a wide variety of problems. Some of those Standards are quite narrow and specific, but at least nine of them address major, pervasive accounting issues. The primary thrust of six of those nine was to eliminate alternative accounting practices that were being used in essentially identical circumstances. I refer to Accounting for Research and Development Costs, Accounting for

## Contingencies, Foreign Currency Translation, Accounting for Leases, Accounting by Oil and Gas Producing Companies, and Capitalization of Interest Cost.

As a result of those six standards, some enterprises were required to change from what they were doing to what others were doing in the same circumstances; those others, of course, were already accounting in the manner prescribed by the standard. For example, some enterprises which had been capitalizing costs incurred in research and development activities as assets were required to expense those costs when incurred, but other enterprises were already expensing research and development costs when incurred. Some fire and casualty insurance companies were required to abandon the use of so-called catastrophe reserves, but other fire and casualty insurance companies had never adopted the use of such reserves. Some enterprises were required to commence including interest cost as part of the historical cost of constructing a new plant and getting it ready for use, but other enterprises were already including interest cost as part of the cost of constructing such a plant.

Yes, causing an enterprise to change an accounting practice that it has used for some time and presumably considers to be preferable is bound to create controversy and dissension. The more important the change--important as gauged by the number of enterprises affected and by the immediate impact on their reported earnings and financial position--the more heated the controversy.

Three of the FASB's major projects imposed a different type of change. Instead of eliminating a particular practice, they dealt with perceived information voids in financial accounting and reporting. For the most part, the change imposed was from doing nothing to doing something. Those three projects involved financial reporting for segments of a business enterprise, providing supplementary information about the effects of changing prices on a business enterprise, and financial statements for defined benefit pension plans. In each project, a change was imposed on virtually every enterprise subject to the standard. The controversies that arose were the result of requiring new information to be presented, the desirability of which some considered questionable. The standards evolving from these projects did not discriminate between enterprises that were required to change and enterprises that were already complying with the standards; the controversies were essentially unrelated to accounting practices previously in use and simply involved those who were generally in favor of the proposed change and those who were not.

### Ramifications of Controversy and Resistance

Controversy and resistance to change are healthy. They play salutary roles in the unique process of setting standards in the private sector. Controversy and resistance to change are inevitably accompanied by challenges: challenges to the purported objective of the proposed change, challenges to the consistency of the change with other attempts to achieve the same or a similar objective, challenges to the practicability of implementing the proposed change, and challenges to the perceived relationship of the benefits of the proposed change and the costs of bringing it about. These challenges enhance the likelihood that proposed changes that survive and are ultimately imposed will constitute improvement. Those having responsibility for imposing changes also have the responsibility for satisfying themselves--and, to the extent

possible, others--that the challenges are understood and either accommodated or rejected on solid grounds.

In the private sector, those imposing change must be able to explain the logic underlying their decisions; they cannot render arbitrary judgments and then hide behind the shield of congressional authority. The direct involvement of those who are most affected and the direct responsibility of the standard-setting body to explain the basis for its actions are major strengths of standard setting in the private sector.

### CONCEPTS

That leads to the second component of this address. In the face of recurring controversy, with resistance and dissension constantly shifting among the constituency, how can a standard-setting body whose membership also changes, albeit infrequently, successfully explain and uphold its decisions?

In my opinion, the only hope is through the establishment of fundamental concepts. Your immediate reaction to that opinion may well be that with a 20-year academic background I could be expected to reach such a "foolish" conclusion. I can assure you, however, that opinion is shared by most, if not all, of the 12 other individuals who have served on the FASB since its inception, people with backgrounds in industry, public accounting, financial markets, or government. This opinion is also shared by many others who have been closely involved in standard-setting activities.

#### Development of the Conceptual Framework

As you may know, the development of a conceptual framework for financial accounting and reporting has high priority on the FASB agenda; it was one of the seven original projects formally placed on the agenda in April 1973. Some phases of that project undoubtedly will still be on the agenda in 1983 and perhaps 1993.

Unlike accounting standards, fundamental accounting concepts have no immediate impact on the reported earnings and financial position of enterprises. Their establishment may eventually call for a reconsideration of certain existing standards but that is only a potential impact, not an immediate one. Accordingly, establishment of concepts is somewhat removed from the arena of controversy that surrounds accounting standards. Concepts may still be controversial, but the reasons for controversy are different--they tend to be philosophical rather than technical.

Actually, the process of developing a conceptual framework commenced before the FASB was created. The AICPA appointed a Study Group on the Objectives of Financial Statements--the "Trueblood Committee"--at the same time that it appointed a group to study the establishment of accounting principles--the "Wheat Committee." It was the Wheat Committee report that led to the establishment of the FASB early in 1973. The study group published its report on objectives in October 1973, a few months after the FASB became operational.

Eight months later, in June 1974, the FASB published a Discussion Memorandum that presented a series of specific questions about the report on objectives. A public hearing based on that Discussion Memorandum was conducted in September 1974. The report, which concluded that “the basic objective of financial statements is to provide information useful for making economic decisions,” was widely criticized. One major target of criticism was the objectives themselves, particularly the relatively insignificant position given to financial statements as reports of management stewardship. Another major area of criticism was a perceived lack of impact; critics charged that the objectives provided no useful guidance.

The FASB continued to consider the objectives of financial statements as it developed a second Discussion Memorandum, Elements of Financial Statements and Their Measurement. In December 1976, coincident with the new Discussion Memorandum on elements and measurement, the FASB published its tentative conclusions about the objectives of financial statements. That was more than two years after the public hearing on objectives.

The reactions to the Board’s tentative conclusions on objectives expressed in letters of comment and oral presentations at the hearings on elements and measurement were less critical than the reactions to the study group report, but some controversy was renewed. A year later, in December 1977, the Board issued an Exposure Draft of its proposed Statement on objectives and, by then, the reactions were more favorable.

In November 1978, after analyzing and digesting all the input on objectives that was received during the previous five years, the Board issued its Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises. At the most general level, the Board concluded that “financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.” I believe it is fair to say that Concepts Statement 1 has been well received.

I have described the evolution of that first Statement of Concepts in some detail to illustrate what I believe to be an important observation: it is unreasonable to expect that abstract concepts will be widely understood and accepted without considerable exposure and a lengthy period of discussion.

The difference between Concepts Statement 1 which has been well received and the study group report which was severely criticized is primarily time--about five years. The substance is essentially the same. Presently, the content of Concepts Statement 1 is being cited with great frequency in position papers and letters of comment received by the Board in response to Discussion Memorandums and Exposure Drafts on technical projects. That is exactly the purpose that a Statement of Concepts is expected to serve.

The subject of the second Statement of Concepts, Qualitative Characteristics of Accounting Information, issued in May 1980, also grew out of the Trueblood Committee’s 1973 report on objectives. It evolved through the same process as the objectives, but with considerably less controversy and of financial reporting, the derived qualities of relevance and reliability and the more specific ingredients of those qualities followed logically. That logical derivation of

qualitative characteristics from objectives also illustrates an important point: the components of a conceptual framework for financial accounting and reporting are hierarchical.

### The Hierarchy

As in a framework for a building or a bridge, the most fundamental building blocks must be firmly established before the superstructure can be attached without fear of collapse. Some skeptics have called for the Board not to issue individual Concepts Statements until the entire framework has been completed and the entire picture is fully in view. In my opinion, to approach the project in that manner would doom it to failure; the likelihood that it could be accomplished in one fell swoop is virtually nil. Experience with what is potentially the third Concepts Statement may illustrate the basis for that opinion.

The Statement on objectives proceeds by steps from the general objective of decision usefulness to the more specific conclusion that “financial reporting should provide information about the economic resources of an enterprise, the claims to those resources...and the effects of transactions, events, and circumstances that change resources and claims to those resources.” Information about economic resources, claims to those economic resources, and changes in them is the stuff from which financial statements are made: the elements of financial statements. In the hierarchy of the conceptual framework, therefore, it was time to make those elements more concrete--to define assets, liabilities, owners’ equity, earnings, revenues, expenses, gains, and losses.

After the standard procedure of issuing a Discussion Memorandum for comment and conducting public hearings, the Board issued an Exposure Draft of proposed definitions in December 1977. That Exposure Draft had the unanimous support of all seven Board members. One of them had been a member of the Board for less than a year, but the other six had worked together for from three to five years and had experienced the need for established elements in resolving several major accounting issues.

Unfortunately, shortly after issuing the Exposure Draft the terms of three Board members ended. The continuity that is essential for establishing something as fundamental as a conceptual framework was broken. It took two years, during which time the term of another Board member ended, to reestablish Board agreement and issue a new Exposure Draft of proposed definitions. Presently, four years after issuing the Discussion Memorandum, the Board is attempting to reach final agreement on a Concepts Statement that will establish the nature of the elements of financial statements.

That experience illustrates the importance of continuity of Board membership in reaching agreement even on a relatively restricted phase of the conceptual framework. If my observation is correct that understanding and establishing each phase of the conceptual framework requires a significant period of time for exposure and widespread discussion and reaction, then it is simply unrealistic to expect that continuity can be maintained over the time it would require to put all of the building blocks in place. The project would likely meet the same fate that it did under the auspices of the AICPA’s Committee on Accounting Procedure and the AICPA’s Accounting Principles Board, whose membership of part-time volunteers was constantly changing.

## CONSENSUS

Now, where does consensus come in? In my view, the proper place for consensus is in relation to the conceptual framework. If a consensus can be established about the objectives of financial statements, the qualitative characteristics of financial information, the elements of financial statements, criteria for determining the proper time for giving accounting recognition to those elements, and their measurement and presentation, then accounting standards can be evaluated on the basis of their consistency with that framework.

At an FASB Conference on Financial Reporting and Changing Prices on May 13, 1979, Harold M. Williams, chairman of the Securities and Exchange Commission, stated:

...we are at a critical period in assessing the ability of the private sector to move responsibly in addressing the financial reporting issues that confront us today. We need assurance that we have constructive and effective processes through which changes in accounting principles will occur promptly as the needs arise and as the product of both informed experimentation and the best thinking available. That task will require the FASB to continue its efforts to provide leadership --not merely consensus building --and will require that members of the accounting profession and the corporate community encourage the Board to provide that leadership, support the Board's decision--even when a particular decision has an adverse impact on the financial results of a particular company--and join more actively in the process of innovation and experimentation which provides the raw material for meaningful decision making. In my view, the future vitality of the private standard-setting process hangs in the balance.

Chairman Williams called for aggressive leadership on the part of the FASB in developing a conceptual framework and "enlightened followership" on the part of the accounting profession and the corporate community. He declared that "the accounting profession must have a conceptual framework adequate to guide future developments." But he predicted that "such a framework will never be the product of consensus."

As my views on the controversy that surrounds the standard-setting process indicate, I agree with Chairman Williams that expecting to achieve a consensus about the resolution of specific technical accounting issues is unrealistic. However, a consensus that must be achieved and maintained if standard setting is to remain in the private sector relates to the process by which those standards are developed and to the basis for evaluating the effectiveness of that process. In my view, consensus about the standard-setting process, including the use of an established conceptual framework in resolving financial accounting and reporting issues, is both essential and achievable.

## Evidence of a Consensus

Fortunately, there is encouraging evidence that a consensus about the process exists. The trustees of the Financial Accounting Foundation recently engaged Louis Harris and Associates, Inc. to study “the attitudes toward and an assessment of the Financial Accounting Standards Board.” That study was undertaken as part of the Trustees’ oversight responsibility with respect to the standard-setting process, in contrast to the standards them-\_\_\_\_\_ each with 415 leaders--88 chief financial officers from the Fortune 1250 list, 55 chief executive officers from the Fortune 500 list, 54 top officers of investment and brokerage firms, 30 leading scholars in accounting from the nation’s universities, 42 key governmental officials from appropriate government agencies, 27 representatives of the financial media, 50 top officials of the largest 20 accounting firms, 34 comparable officers of medium-sized and smaller accounting firms, and 35 chief executives of medium-sized and smaller business corporations.

Not all of those interviewees were familiar with the FASB procedures--78 percent were familiar with the procedure of issuing an Exposure Draft of a proposed standard for public comment; only 44 percent were aware that any individual or organization may request that the FASB review or reexamine any pronouncement. When the trained executive interviewers of the Harris organization described each of nine steps in the process, however, an overwhelming majority judged each step to be “sound and proper”--a high of 92 percent rendered that judgment about issuing Exposure Drafts (3 percent judged that step to be “not sound and proper” and 5 percent were not sure); the low was 79 percent who considered it “sound and proper” that each final Statement identifies the Board members who voted for and against adoption, along with dissenting opinions (11 percent judged that practice to be “not sound and proper” and 10 percent were not sure).

As for consensus and a conceptual framework, the 415 interviewees were asked: Do you feel it is desirable or undesirable to have a standard-setting process that attempts to establish standards that are consistent with each other and with an overriding conceptual framework? Ninety-one percent considered it desirable, 5 percent undesirable, 4 percent not sure. The most enthusiastic in that regard were 29 academics, all of whom considered the conceptual framework approach desirable, and the 50 interviewees from the top 20 accounting firms, all but one of whom considered it desirable.

Attitudes about attempts to establish standards by developing a consensus on specific issues with solutions in accord with that consensus were somewhat less favorable, except for the 35 chief executive officers of medium to small companies, 83 percent of whom considered the consensus approach desirable. Overall, 91 percent rated the conceptual framework approach desirable, 5 percent undesirable; and 78 percent rated the consensus approach desirable, 18 percent undesirable.

## The Conceptual Framework in Operation--An Analogy

My favorite analogy of a conceptual framework for financial accounting and reporting is the law of contracts. Businesses enter into transactions involving oral and written contracts. Lawyers are sometimes involved to insure that legal consequences are understood. And

accountants are sometimes involved to insure that the accounting consequences are understood.

Picture, if you will, a court composed of seven judges. They are attempting to determine, in the absence of an established concept of contract, whether or not the negotiations between two parties resulted in a contract. Each judge might have strong convictions about the merits of his own personal notion of what it takes for a contract to exist. He would, naturally, analyze the relationships between the two parties in terms of that personal opinion. If at least four judges could agree, the decision might then be made in keeping with democratic principles by a majority vote.

On the other hand, given an established legal concept of contract, the judges' roles would be to analyze the relationship between the two parties in terms of the elements of a contract--to determine whether the parties had capacity to contract, whether there was mutual assent, whether there was consideration, and whether the subject matter was valid.

That analysis still involves a great deal of professional judgment--even where the concept of contract is established and used as a common frame of reference by all judges. But surely all will agree that justice and equity would be far less likely to prevail in the absence of an established concept of contract. Perhaps most important, predictability would suffer. In the absence of an established concept of contract, clients would have little basis for confidence in the professional judgment of individual lawyers about the legal enforceability of the agreements they make.

When plaintiffs or defendants lose cases involving damages for violations of contracts, they may be critical of the court's decision but they are not likely to attack the legal concept of contract or the legal process that led to the decision. If the judges are not competent to interpret and apply the concept satisfactorily, it is they who should be replaced, not the system.

### CONCLUSION

A private-sector institution like the Financial Accounting Standards Board will continue to be successful if there is a consensus that its mission is important and desirable, if there is a consensus that the process used to carry out that mission is fair and effective, and if there is a consensus that the conceptual framework that serves as the basis for its decision is sound and operative.

To strive for a consensus about the resolution of a specific controversial accounting issue, however, is not only unrealistic but undesirable. Establishing standards for a specific accounting issue cannot and should not depend on the results of a popularity poll. Accounting standards must emerge from thoughtful and even-handed analysis of the issues in relation to an established framework for analysis.

There is good evidence that a favorable consensus about the FASB's mission and the procedures it uses has largely been achieved. With enough effort, patience, and time, hopefully a consensus among an intelligent, well-informed constituency can be achieved for a conceptual framework. Once that framework is established, standard setters should be expected to explain

and defend their decisions in terms of that framework. Like judges and the law of contract, if the standard setters are not competent to interpret and apply the framework satisfactorily, it is they who should be replaced, not the system.

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